Should You Buy These 3 Forgotten Financial Stocks?

Description

One of the weaknesses of the Canadian market is often said to be its lack of diversification. A full 70% of the **S&P/TSX Composite Index** (^OSPTX) is made up of just three sectors — finance, energy, and basic materials. Sure, Canada has world-class companies in other sectors, but often investors are left to choose from only a handful of leaders.

When it comes to finance, Canadian investors have all sorts of choices. Not only can investors invest in the "big five" banks, but they also have three life insurance companies, and a plethora of smaller, more specialized financial companies. Since most investors concentrate on the large ones, there are many smaller financial companies that never cross their radar screens.

This is too bad, since some of these companies are operating in niche sectors with little competition and high profit margins. They also have a higher potential for growth, since they're smaller and more nimble. Some even compete directly with the big banks, but do so in a different way. Canada's big financial companies may have size and prestige, but these smaller players have growth prospects and buyout potential.

First National Financial (TSX: FN) is probably the biggest lender you've never heard of.

The company is currently the seventh-largest lender in the country, controlling 3% of total market share. That may not seem like much on the surface, but it translates to more than $75 billion worth of mortgages under management. The most impressive part? The company doesn't own *one* retail lending branch. All its business is done exclusively through mortgage brokers.

This translates into a huge advantage for First National, which is able to hire far fewer employees than a traditional lender. Since the company almost exclusively deals with loans that are CMHC-insured against default, investors are essentially investing in a bank without all the overhead.

The company continues to deliver stellar results to investors. It has doubled revenue since 2010, and grown net earnings by more than 90%. It also pays investors a generous 6.4% dividend, which has gone up 30% since 2011 and is easily covered by earnings. Oh, and the company trades at a P/E ratio of less than 10 times. So why is it so cheap?

Three words: Canadian housing bubble.

The thesis on First National is simple. If you think the Canadian housing market is going to keep chugging along, you'll want to be buying at this point. However, if the bubble ends up bursting, even solid lenders like First National will feel the pain.

Carfinco (TSX: CFN) operates in an interesting niche market — it finances vehicles for people who can't qualify for traditional financing. These loans come with a huge price tag for borrowers, often between 2% and 3% *per month*.

You'd imagine there would be lots of write-offs in that business, but they really aren't that bad in comparison to the interest rates the company could get away with charging. This helps the company deliver some extraordinary results, including a return on equity close to 30%, loan growth that regularly exceeds 20%, and earnings growth to go with it. Even better, the company only trades at 10 times earnings and less than eight times forward earnings.

Carfinco's shares have been beaten up lately, falling 28% this year on slightly weaker results and smaller competitors continuing to enter the space. Long-term investors should like the fact that the sector is so successful that it's attracting competitors. This could be a good entry point, and investors are getting paid a 5.4% yield to wait.

IGM Financial (TSX: IGM) is the parent company of Investors Group and Mackenzie Financial Group, which collectively have more than $138 billion worth of assets under management, mainly in mutual funds.

Normally I'm bearish on mutual fund managers for one simple reason — ETFs are generally a better choice for investors who don't take an active role in the management of their portfolio.

However, IGM Financial has one big positive going for it. It has an army of nearly 5,000 consultants that give investment and financial planning advice to nearly a million Canadians. This ensures there's always a market for the company's products, and that someone is always actively selling.

IGM's days of high growth are behind it, but the company has managed to grow earnings by 4% a year for the last decade, and almost double its dividend. It's a stalwart in the sector, and should continue to be a solid performer.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:FN (First National Financial Corporation)
2. TSX:IGM (IGM Financial Inc.)

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