Does Royal Bank of Canada Belong in Your Portfolio?

Description

Royal Bank of Canada (TSX: RY)(NYSE: RY) is not only Canada's largest bank, it is Canada's largest company. And for that reason, it is a staple holding in many portfolios.

But that alone is not a reason to buy the shares. Fortunately there are other arguments for buying the stock, but there are also reasons for avoiding the shares altogether. So below we take a look at two arguments for, and two arguments against, investing in RBC.

Reasons to buy

1. A strong domestic presence

There are few industries as profitable and comfy as Canadian banking, where competition is low and profitability is high. And RBC has built itself a solid lead domestically, with the largest branch and ATM network in the country. As a result, the bank has a top-two market position in every Canadian banking product.

Having a lead in banking is a tremendous advantage. Why? Well, there are massive fixed costs associated with operating a bank (technology and regulatory costs are the big ones), so RBC's larger presence makes it easier to absorb these costs. That allows the bank to remain more profitable than its competitors.

2. Well-positioned internationally

Outgoing CEO Gordon Nixon is generally admired, partly because he had the right priorities internationally. More specifically, he got out of U.S. banking, a low-return business, and has instead focused on wealth management and capital markets.

RBC is very well-positioned in these latter two lines of business, mainly because this is where other banks are pulling back. This gives RBC the opportunity to gain market share (capital markets) and pick up cheap acquisitions (wealth management). So looking forward, RBC has plenty of opportunities to grow earnings and invest its capital effectively.

Reasons to avoid

1. Unforeseen risks

Presently, RBC is firing on all cylinders. This can be very dangerous, especially if the bank starts to get overconfident. We all know how volatile banking can be, and with a bank like RBC, the risks are that much greater, for a couple of reasons.

First of all, many observers believe that Canada's housing market is in bubble territory. If they are right, and that bubble pops, it could have a serious effect on the Canadian economy in general. And RBC would be affected in numerous ways — loan growth would slow, losses could pile up, and profits would be greatly affected. Interestingly, during Canada's last major real estate downturn in the early 1990s, RBC was most affected.

Secondly, RBC's emphasis on Capital Markets comes with plenty of risks. Worst of all, it is practically impossible to know how big those risks really are. We'll just have to wait for a bear market to find out.

2. Price

As would be expected for a bank firing on all cylinders, RBC shares are not particularly cheap, after gaining 24% in the last 12 months. More specifically, they trade at 13.3 times earnings and 2.5 times book value, both above historical averages.

So as it stands, RBC is doing tremendously well, and that's what investors should normally be looking for. But if the environment turns against RBC, or if the bank falters, then the share price could get hurt badly. So be careful.

CATEGORY

1. Investing

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1. NYSE:RY (Royal Bank of Canada)
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Date
2025/07/25
Date Created
2014/08/11
Author

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