Is Toronto-Dominion Bank Canada's Most Boring Bank Stock?

Description

There is a perpetual debate over which Canadian bank stock to invest in, and the conventional wisdom is that the banks largely generate returns in tandem with each other, and that they are therefore more or less interchangeable.

Is this true? Partially—but with one major caveat. While Canada's banks all generated annualized total shareholder returns (capital appreciation plus reinvested dividends) in the double digits, there is a nearly 5% range between the best and worst performing banks. In addition to this, while the banks are considered safe, they differ considerably in terms of overall risk, and therefore share price volatility.

That is to say, some banks, due to a higher risk profile (which is caused by various factors), have more volatile shares, which means that shares experience much more movement compared with the overall market. In this regard, **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) is Canada's most boring bank stock. Does this mean that TD also has the lowest return? On the contrary—TD Bank has outperformed all its peers over the past several years.

Let's take a look at why TD Bank is so low risk and how shareholders are benefiting.

Good capital adequacy

The first place to check a bank's overall risk is to look at how well capitalized it is. Banks employ leverage—that is to say, they borrow deposits from consumers, and lend them out as mortgages, auto loans, and lines of credit, which in turn, form the bank's assets.

As a result, banks are required to have capital set aside in case loans need to be written off or written down to prevent the bank from becoming insolvent. The most recognized way of measuring bank capital is known as the Common Equity Tier 1 Capital Ratio, which measures a bank's equity (or capital) as percentage of assets that could be at risk.

In this regard, TD Bank is sitting at 9.9%, which is well above the minimum of 7% set by regulators, and is in line with its closest peer, **Royal Bank**, at 10%.

Best-in-class credit quality

Banks make loans, and the quality of these loans and how well the bank is prepared to deal with non-performing loans is central to a bank's ability to both prevent and manage loan losses. With Canada's real estate market appearing to be overvalued and interest rates poised to rise, banks need to be adequately prepared for potential write-downs.

In this regard TD Bank performs well. One measure to check this is by looking at the gross impaired loans as a percentage of total loans. Impaired loans refer to loans that are 90 days past due, and for which there is a significant chance the loan will not be able to be recovered in full. Currently, TD Bank has 0.3% of total loans impaired. This compares with 0.46% for RBC, and 0.65% for **Bank of Montreal**

, demonstrating TD Bank’s low amount of impairments.

Strong diversification and focus on low-risk retail banking.

While TD Bank does have strong credit quality and excellent capital adequacy, the real reason the company is low risk is because it is largely devoted to low-risk businesses and is well diversified across geography.

In Q2 2015 95% of TD Bank’s earnings came from retail banking. Retail banking refers to the low-risk business of collecting deposits from customers, lending them out, and meeting customers’ day-to-day banking needs. This is in contrast to capital markets operations, which tend to be much more volatile and higher risk.

In addition to this, TD Bank is one of the most well-diversified banks geographically, which helps insulate it from Canada’s economic risks, including low oil prices, an overvalued real estate market, and slow economic growth.

The bank currently obtains 59% of revenue from Canada, 31% from the U.S., and 10% internationally. This is compared with RBC, which obtains 93% of revenue from Canada, and BMO, which obtains 61% from Canada.

The end result is higher returns with lower risk

Being boring pays off. TD Bank has the lowest amount of volatility of its peers (according to a measure called beta, which measures volatility compared to the overall market), and the highest returns. The bank has a total five-year shareholder return of 16.5% compared with 15.5% for BMO, 12% for RBC, and 13% for **Bank of Nova Scotia.**

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