



Should Canadian Bank Investors Turn Their Attention South of the Border?

Description

Canada's banks have been fantastic investments over time. Nobody is disputing that.

Take **Royal Bank of Canada** ([TSX:RY](#))([NYSE:RY](#)) as an example. Over the last 20 years shares of Canada's largest bank have returned 16.66% annually if an investor had reinvested dividends. That's enough to turn an initial investment of \$10,000 into something worth nearly \$220,000 today.

That's the kind of return that'll really make the difference in a portfolio.

There are plenty of other reasons for investing in Royal Bank. It, along with its four peers, make up approximately 85% of Canada's banking system. Royal Bank is the leader of that oligarchy, having dominant positions in everything from lending to credit cards to capital markets. It has a market share of either first or second in every major retail banking category in Canada.

Royal Bank didn't just stop in Canada. The company has successfully moved into the United States, recently announcing it would expand its operations south of the border by acquiring California-based City National Bank. Its U.S. operations generate about 20% of total profits, which will go up once City National is folded into the core.

Finally, Royal Bank has both a reasonable earnings valuation and a stellar dividend. Shares trade hands at just over 12 times trailing earnings with the P/E ratio slated to go down over the next year as earnings creep up. Shares yield 4%, which is a nice payout in today's low interest rate world. And remember, Royal Bank has paid dividends for the last 150 odd years without missing a beat.

After saying all of this, how can I possibly say that Royal Bank (or its Canadian peers) might not be the stock to own today? The logic goes something like this.

Risks

There are two massive risks facing Canada's banks today.

The first is a weak economy. Natural resources, which have been a big driver of Canadian growth over

the years, are still struggling, even after recovering from earlier lows. Our retail sector is burdened by oversupply. And consumer debt is higher than ever as citizens stuff themselves on a feast of cheap debt.

These are not good things for a bank.

And then there's the second risk, and that's the housing market. Toronto and Vancouver get all of the attention, but there are compelling cases to be made about many of Canada's other major markets being overvalued as well. Sure, the banks are insulated from much of this risk from mortgage default insurance, but a sustained downturn in housing will still hit major lenders hard.

Mortgage lending will always dominate a bank's loan book. If the housing market dives, loans will go down with it. As goes loan growth, so follows earnings growth. It's pretty simple.

Look stateside instead

Some investors are beginning to look at major U.S. banks for their exposure to the sector.

There are a few reasons why this makes sense. U.S. borrowers aren't nearly as leveraged as Canadians. Houses in many markets are very affordable with an ownership rate that's the lowest in a generation. And banks in the U.S. are well capitalized after being forced to clean up their balance sheets.

Bank of America Corp. ([NYSE:BAC](#)) is a prime example. The company has a good balance sheet, trades at under book value, and could earn as much as US\$40 billion in "normalized" earnings before taxes, at least according to CEO Brian Moynihan. That puts shares at just over six times potential earnings assuming a fairly normal tax rate.

Investors are likely to get superior dividend-growth rates from Bank of America since it has only recently been given the go-ahead to really goose dividends from regulators. Even after raising its quarterly dividend 60% to \$0.08 per share, Bank of America still has a payout ratio of approximately half of Royal Bank's.

Which to buy?

There are plenty of reasons to buy Royal Bank. Prior returns have been excellent, the company enjoys a dominant position in Canada, and there's plenty to like about its U.S. expansion as well.

But at the same time, investors who buy U.S. banks are betting on an economy that's healthier than Canada's while getting good value. There's certainly a case for going in that direction.

CATEGORY

1. Bank Stocks
2. Dividend Stocks
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1. Editor's Choice

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1. NYSE:BAC (Bank of America)
2. NYSE:RY (Royal Bank of Canada)
3. TSX:RY (Royal Bank of Canada)

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