3 Dirty Secrets Bay Street Doesn't Want You to Know

Description

Canada's largest banks care about one thing and one thing only–maximizing profits for shareholders.

This isn't necessarily bad, of course. Canada's banks have made countless investors wealthy while providing a much-needed service for the economy. Ask the average mortgage holder if they hate their bank and the answer will probably be no. Sure, they'd like to be debt free, but a mortgage is a business deal that benefits both sides.

At the same time, folks have to be wary that their bank isn't taking advantage of them. Small fees like overdraft interest and monthly banking packages might not seem like much, but they can add up to hundreds of dollars over the course of a year. These kinds of fees matter.

That's not the only thing regular folks have to worry about. Here are three other ways their bank (or investment advisor) can take them for a ride.

You don't need funds … or even ETFs

While there are a few mutual funds that have done quite well over the long term, for the most part investing in mutual funds is a sucker's game. They just can't do well enough to justify their outrageous fees.

ETFs are a lot better. They offer the same kind of diversification as mutual funds for a fraction of the cost. Most funds have fees of less than 0.5%, and it isn't particularly hard to find one with a fee of less than 0.1%.

That works out to $1 in annual fees for every $1,000 invested. A mutual fund charging 2% would charge $20 for every $1,000 invested. That's a huge difference.

But ETF fees can add up too. Say you have $100,000 invested in a portfolio of ETFs that have an average management fee of 0.3%. That's $300 in annual fees.

Investors can save those annual fees by building a portfolio of great stocks that they intend to hold over the long term. One such stock is **Inter Pipeline Ltd.** (TSX:IPL).

Inter Pipeline is a medium-sized operator with almost all of its operations in Alberta, which is pretty friendly to pipelines. Its three main oil sands pipelines–which account for about 60% of revenue–are only running at about half capacity, which bodes well for whenever expansion starts up again in the region.

And, perhaps most importantly, Inter Pipeline pays an attractive 5.6% dividend, which comes with a payout ratio of approximately 70% of funds from operations.

Look deeper

Bay Street analysts spend much of their time covering companies that have market caps of over $1 billion, leaving the smaller companies for boutique investment houses to cover. Many investors ignore these smaller companies as a result.

These investors are making a mistake.

A study done in the United States looked at the performance of small-cap value stocks between 1926 and 2004. It found that smaller companies trounced the return of their larger counterparts, returning 15.6% annually compared to 9.3%.

There's one big reason why Bay Street ignores these smaller companies. They're just not profitable for bankers. Small-caps don't really need to access the capital markets. And if they do, they're raising less than $100 million. Large-caps often need billions at a time. Thus, they'll get all the love.

Speaking of biases…

How come you hardly ever see an analyst slap a sell rating on a stock?

The answer might surprise you. It's because of banking relationships–not because analysts are inherently bullish.

Look at it this way.

If you ran a company that needed to go to the capital markets for millions or even billions worth of financing, would you go to the bank that just downgraded your stock? I sure wouldn't.

This is one of the reasons why no Bay Street analyst saw the **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX) debacle coming. Even if an analyst did see accounting shenanigans, there's no way they would say so publicly. Doing so would likely be dangerous to their job and the investment banking relationship.

Smart investing will always win

There's a simple way to beat Bay Street at its own game. All you need to do is buy quality stocks when they're valued well and hold them for a very long time. That's how Warren Buffett did it–the original master at sticking it to bankers.

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