How Does Royal Bank of Canada Fit into Your Portfolio?

Description

Bank stocks remain one of the most sought after investments, primarily because they are money-printing machines. They provide the necessary resources for small businesses to flourish and for first-time home buyers to make that purchase. However, just because a bank plays an integral part of a person's life doesn't immediately mean it's a buy. So is **Royal Bank of Canada** (TSX:RY)(NYSE:RY), the largest bank in Canada, a good buy? How does it fit into the portfolio?

To answer that, it helps to analyze how the company did over the past year to help make a long-term decision.

On November 30, 2016, the company announced its fourth-quarter and full-year earnings. There was a mixture of good and bad.

On the good side, the company experience growth in its net income from $10.026 billion to $10.458 billion — a 4% improvement. Let that soak in for a second … It generated nearly $10.5 billion income last year. This is thanks to widespread growth across its many different divisions. Its personal and commercial banking increased net income by 4%; its wealth management pushed 41% growth in earnings (in part to its acquisition of City National); it had 37% earnings growth in insurance and 10% earnings growth in investor & treasury services. The only bad news was a 2% drop in capital markets.

But a full year can hide things.

In Q4, its earnings were down by 2% year over year and were down 12% from Q3. This was blamed primarily on a higher effective tax rate in 2016 versus 2015, but also because its capital markets and personal and commercial banking divisions saw lower earnings. But remember that just because every single quarter isn't better than the last doesn't mean that the stock is inherently bad.

Now, the really bad news was that its return on common equity (ROE) dropped from 18.6% to 16.3%. According to Investopedia, ROE is “the amount of net income returned as a percentage of shareholders’ equity.” The higher the percentage, the better. With it dropping by over 2%, it shows that, despite the company continuing to experience growth, it is having to work harder to generate that growth.

That inherently carries risks for long-term growth, which can cut into dividend growth (I’ll get to that in a second). But here’s the thing … Compared to most of the other banks in Canada, Royal Bank is higher. The entire sector is being pulled down, making Royal Bank less of an outlier.

Fortunately, growth doesn’t appear to be an issue thanks to a smart acquisition it made in 2015. It acquired City National for US$5 billion, a California-based bank that targeted high-net-worth clients. It had already been expanding into the United States, but this should generate lucrative income for the bank in the coming years. In Q4 alone, this acquisition generated $89 million in net income.

Let’s move on to the topic of dividends. Royal Bank is in a great position. It currently yields 3.53%, which is a lucrative $0.83 per share paid out to investors. But what’s appealing is that the company increased the quarterly dividend twice in 2016 — a 5% increase annually. With moves like the City National acquisition, I expect to see the dividend to keep going higher.

So here’s where I stand with Royal Bank.

Compared to other banks, it is cheaper, and its ROE is higher. Its dividend is lucrative, and it is committed to increasing it even more. For those that are looking to buy and hold, I think Royal Bank fits quite nicely into your portfolio.

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