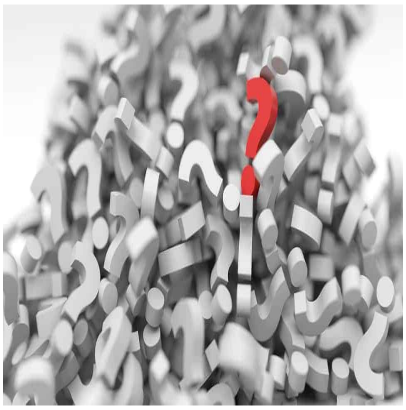

Why Can Past Outperformance Be Misleading?

Description

The big Canadian banks have had a great run. Since their lows in February 2016, the Big Three banks — **Royal Bank of Canada** (TSX:RY)(NYSE:RY), **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), and **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) — have delivered total returns of about 43%, 28%, and 45%, respectively, and annualized returns of about 34%, 23%, and 37%, respectively.

Many assumptions can come out of these results. For example, some investors may think that if a stock or fund has outperformed in the recent past, it can outperform again in the near future. That's not necessarily true.

Other investors may think that Royal Bank and Bank of Nova Scotia are better companies than Toronto-Dominion Bank because the former two outperformed the latter by 15-17% in the recent past. That's also not necessarily true.

Why recent outperformance doesn't imply future outperformance

The average market returns are 10%. For mature businesses such as the big banks to outperform the market greatly by delivering annualized returns of 20-40%, the valuation paid makes a huge difference.

In February 2016, the Big Three banks were trading cheap multiples. They were trading at price-to-earnings ratios (P/E) below their normal P/Es. Royal Bank, Toronto-Dominion Bank, and Bank of Nova Scotia's long-term normal P/Es are 12.1, 12, and 12.2, respectively. However, back in February 2016, they were trading at P/Es of 10.2, 11.2, and 9.4, respectively.

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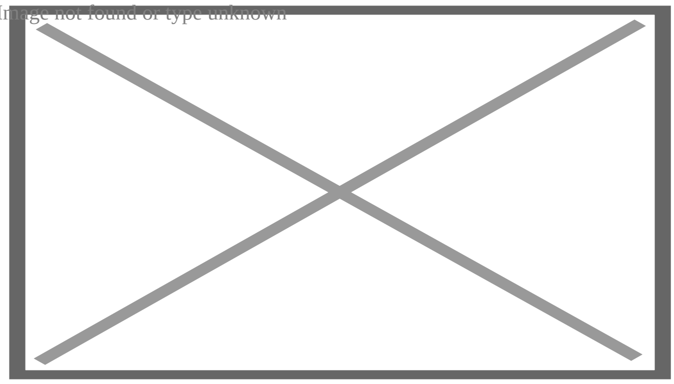

At the time, resource markets were having a hard time, which particularly dragged on Bank of Nova Scotia's share price.

If investors bought shares of all three banks in February 2016, naturally, they would have experienced a stronger rebound with Bank of Nova Scotia compared to the other two after shares reverted to the mean, because Bank of Nova Scotia was trading at the cheapest multiple.

At the recent share prices of roughly $93, $64, and $75, respectively, Royal Bank, Toronto-Dominion, Bank, and Bank of Nova Scotia now trade at P/Es of about 13.1, 12.7, and 12.2, which is at or above their long-term normal P/Es. So, in the near future, don't expect them to outperform the market.

Delivering higher returns doesn't mean a better company

Since February 2016, Royal Bank and Bank of Nova Scotia shares greatly outperformed Toronto-Dominion Bank shares. However, this doesn't mean the former two are better companies. They were better investments because they were trading at a lower P/E than Toronto-Dominion Bank at the time.

Investor takeaway

When any security or fund has outperformed in the recent past, investors need to reset their expectations.

I used Canada's Big Three banks as an example. The quality companies have outperformed since February 2016. After their shares have run up and their P/Es have expanded, investors need to reset their expectations from the banks going forward.

The banks can still grow their earnings per share at decent rates of about 5-9% for the next few years. Adding in their yields of 3.7-4%, they can deliver annualized returns of at least 7-9% (after accounting for potential multiple contractions for whatever reason).

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