Are High Dividends From Canadian Banks Really a Good Thing?

Description

Over the past several weeks, investors holding shares in Canadian banks have seen the momentum run out as share prices began to pull back. Shares of **Royal Bank of Canada** (TSX:RY)(NYSE:RY) have declined from over $98 per share to a current price closer to $94 over the past month alone. Over the past two weeks, shares of **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) have declined from approximately $67 to just over $64 per share.

Shares of **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS), which derives a significant amount of revenues from South America, experienced a decline from almost $79 to a low near $75 only to recover on Friday to a little shy of $77.

Looking at the net profits and dividends paid out of the net profits, investors need to ask a key question before choosing which bank to hold as an investment: "Do I want to invest in a company with a high dividend-payout ratio or a low dividend-payout ratio?"

In the case of Toronto-Dominion Bank, which has traditionally held one of the industry's lowest payout rates, the five-year price return has been close to 57% in addition to a dividend with a current yield of 3.75%. The total five-year return is close to 88%, assuming dividends were reinvested. For fiscal 2016, the company paid dividends of $2.16 out of profits of $4.67. This translates to a dividend-payout ratio of 46%.

Next is Royal Bank of Canada; in 2016 it made profit of $6.78 and paid dividends of $3.20, meaning the payout ratio was closer to 47%. Over the same five-year period, the total return (assuming dividends were reinvested) was close to 100%.

For 2016, Bank of Nova Scotia boasted a payout ratio of 50% based on earnings of $5.77 per share. The company has traditionally held a higher payout ratio than the other Canadian banks. Over the past five years, shares have offered a total return (assuming all dividends are reinvested) of 75%. The current yield is almost 4% per share.

By separating the dividends from the capital appreciation, investors can rank order. The highest price appreciation over the past five years came from Royal Bank of Canada with price appreciation in excess of 70%. In second place was Toronto-Dominion Bank with a price return close to 58%, while Bank of Nova Scotia lagged behind the competition, only returning 45%.

While investors need to consider total return, it is also important to recognize what the difference is between the component coming from dividends vs. what is coming from capital appreciation. The latter can be measured by looking at return on equity (ROE).

In the case of Royal Bank of Canada, the ROE for fiscal 2016 was approximately 15.6%, while the number was no better than 13.1% for the Bank of Nova Scotia. When comparing these two names, it is clear that investors should be demanding a higher payout from Bank of Nova Scotia as it is doing less with the money retained. Royal Bank is clearly doing a much better job in growing the retained earnings.

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