With Higher Rates, Which Bank Is Best for Your Portfolio?

Description

The central bank of Canada announced a 0.25% rate hike on Wednesday amid what Bank of Canada governor Stephen Poloz told reporters was a robust Canadian economy fuelled by household spending.

Higher rates will have a direct impact on Canadians, meaning higher borrowing costs as it relates to mortgages and other household debt, including the cost to finance a car and the interest charged on a personal line of credit.

This is certainly not a good piece news for Canadian households, but it is long awaited and welcomed by the Canadian lenders.

While higher rates will dampen borrowing activity somewhat by making access to credit more restrictive, the rates charged on the banks' existing book of loans will see a benefit that will flow directly to these corporations' bottom line.

So, it might be a good time to add to your existing bank holdings, or it may even be a good opportunity to add a new holding to your portfolio altogether.

The question is, which bank should you be adding?

Getting the best "value"

As far as the "Big Five" Canadian banks are concerned, investors are getting roughly equivalent value across the board.

All of the banks trade at forward price-to-earnings multiple of between 11 and 12 times — except for **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM), which trades significantly lower at 9.8 times next years earnings.

This means that if CIBC were to experience a market re-adjustment to see it shares trade equal to its peers, investors could expect to see the value of their investment go up by 10-20%.

Getting paid to wait

When considering the banks' dividend payouts, all five are all pretty efficiently priced as well, meaning there isn't really much difference between them.

Four of the five banks trade at dividend yields of between 3.4% and 3.7%; yet again, the exception here is CIBC, which trades at a yield upwards of 4.6% — the best of the bunch.

What's more, CIBC also has the highest return-on-equity at 30% and the lowest payout ratio at 41% which means that on top of offering the highest yield today, CIBC also has the greatest potential to grow its dividend moving forward with a sustainable growth rate of 12.6%.

This compares rather favourably to the rest of the group, which, on average, offer sustainable growth rates closer to 8%.

Best positioned for higher rates

Financial leverage is one way to evaluate the "riskiness" of an investment.

The more debt or fixed costs a firm has, the higher the leverage it employs.

While debt and fixed costs can be dangerous for shareholders in times of crisis, when things are moving in the company's favour, leverage helps to "amplify" success by essentially multiplying a company's profit-making power.

CIBC, once again, is the most leveraged of the Canadian banks.

This means that when higher interest rates are flowing directly to the profits of the banks, CIBC will see a multiplier effect from its added leverage, which should result in higher growth in earnings per share versus the rest of the competition.

Add to this the fact that CIBC shares trade at the "cheapest" multiple of the major banks, and investors effectively get a winning combination of growth and value.

One last thing….

The allure of an investment in CIBC doesn't come without its risks, namely the risk of higher leverage, outlined above.

If the much-discussed fears of a looming Canadian debt crisis turn out to be true, the market will reward the safer Canadian banks and "punish" those stocks which are riskier on a relative basis, like CIBC, for example.

Yet that story has been in the headlines for several years now without any tangible evidence of a crisis looming to date.

The question really is, how Foolish are you going to be?

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jphillips