Bank Investors: This Tested Investment Strategy Outperformed During Rising Interest Rate Periods

Description

The Bank of Canada is likely to announce a further interest rate hike by October 2017, and investors in the financial services sector are anticipating the possibly wonderful news as banks become generally more profitable with rising rates. However, a random pick on bank stocks, or merely increasing your investment portfolio's exposure to financials may not be the best investment strategy to reap outperforming returns.

A recent research paper from S&P Global Market Intelligence, Quantamental Research released in June 2017 by Richard Tortoriello argues that general fundamental research has historically been less effective in identifying bank stocks that outperform when rates increase.

Instead, the report, titled: *Research Brief: Four Important Things to Know About Banks in a Rising Rate Environment*, proposes an interesting back-tested strategy that could add an edge to a bank oriented investment portfolio by helping investors pick potential outperform candidates.

The strategy

Based on data on Russell 3000 banks from 1990 through May 2017 in the United States, Tortoriello identifies four important factors that bank investors must consider when adding bank stocks to their portfolios in a rising interest rate environment. The strategy works well in a flat rate environment too.

The strategy is a valuation based four factor model that uses the core earnings per share (Core EPS) to price ratio, the pre-provision net revenue to price ratio, tangible book value to price ratio as well as bank deposits structure as key differentiators between average return and outperforming bank stocks.

Pre-provision net revenue to price

This ratio was the strongest and best performing valuation strategy in the test period. It out-performed the general market by an annualized 9.2% during periods of rising rates.

The ratio is a banking equivalent of the general price to sales ratio.

Pre-provision net revenue adds net interest income before provision for credit losses, to non-interest income, all on a per share basis.

Core EPS to price

Core EPS is net income after taxes and before extraordinary items, less the following items: net income attributable to non-controlling interest, gains on the sale of held to maturity and available for sale securities, amortization of
intangibles, goodwill and nonrecurring items, all taken on a per share basis.

Tangible book value to price

This ratio adjusts the book value of a bank's equity by removing intangible assets like goodwill from the valuation. Intangibles are sometimes, and most often, arbitrary and subjective figures usually emanating from overpriced past acquisitions.

A higher value of this metric would indicate a relatively cheaper stock.

Deposit structure

The proportion of non-interest bearing deposits to total deposits on a bank's balance sheet is a very important performance differentiating factor in a rising interest rate environment. A bank with a higher proportion of interest free deposits will enjoy cheaper financing when interest rates rise.

While the **Royal Bank of Canada** (TSX:RY)(NYSE:RY) holds the largest deposits in the country, two of the most significant valuation factors in this model, the core EPS to price, and the pre-provision net revenue to price seem to indicate that the **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) is a cheaper investment option.

Using trailing twelve months (TTM) data from the two financial conglomerates and stock prices on August 21, the pre-provision net revenue to price for Royal Bank of Canada (RBC) stands at 0.2868 (28.68%) while it is 0.2961 (29.61%) for Toronto-Dominion Bank (TD). Thus, 28.7% of RBC's stock price is comprised of tangible net revenues, while Toronto-Dominion Bank's share price incorporates more than 29.6% of net revenues.

Furthermore, 8.22% of RBC's share price is comprised of more reliable core EPS, while TD 's share price is marginally cheaper with 8.25% of its share price made up of TTM core EPS.

To add more, TD is trading at a lower price to tangible book value multiple of 2.14 times versus RBC's relatively higher multiple of 2.40 times. TD is priced cheaper than RBC as three of the model's factors predict, yet TD is forecast to grow its EPS at a higher rate of 8.3% in the long term compared to RBC's 7% long term growth rate.

Investor takeaway

The model above generated annualized excess returns of 11.1% during periods of rising short term rates, but we cannot be guaranteed of repeated out-performance going forward as more investors capitalize on it.

CATEGORY

1. Bank Stocks
2. Dividend Stocks
3. Investing

TICKERS GLOBAL

1. NYSE:RY (Royal Bank of Canada)
2. NYSE:TD (The Toronto-Dominion Bank)
3. TSX:RY (Royal Bank of Canada)
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