Why the Short Sellers Are Wrong About Toronto-Dominion Bank (TSX:TD)

Description

Despite reporting solid full year and fourth quarter 2018 results, Canada's second largest lender **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) remains a favourite target of short sellers. The bank is the second most shorted stock on the TSX and has been attracting considerable attention from short sellers for some time.

A large proportion of that interest comes from U.S. hedge funds, which believe that a hot housing market, substandard mortgages, and high levels of household debt will cause the volume of non-performing loans to rise sharply. This would along with a range of other economic factors would cause the value of Toronto-Dominion's loan portfolio and hence stock to fall sharply. While there are certainly risks, the negative outlook taken by short sellers is overbaked.

Now what?

A key driver of the considerable negative attention from investors south of the border is the belief that the financial system is flooded by substandard and poorly underwritten mortgages. This has seen many for years trying to replicate the success of 'The Big Short' where some traders shorted U.S. mortgage backed securities and banks in the lead up to the subprime mortgage meltdown in 2007. While subprime mortgages exist in Canada, they haven't reached the volumes witnessed in the U.S. in the run-up to the housing collapse, which precipitated the worst financial crisis since the Great Depression.

The fear is that as interest rates rise, those households with subprime mortgages will become increasingly vulnerable to external economic shocks that could prevent them from being able to meet increased repayments.

While high levels of household debt coupled with inflated home prices and rising interest rates could certainly spark a surge in non-performing loans as well as higher loan losses the impact would not be as severe as the short sellers believe. This is because the Office of the Superintendent of Financial Institutions (OSFI) has been steadily tightening prudential standards including those that govern mortgage underwriting, causing the volume of new subprime mortgages to fall.

Housing prices have also cooled to see the national average home price according to the Canadian Real Estate Association for October 2018 fall by 1.5% compared to a year earlier. While the average price in the one-time super hot market of Vancouver only gained 1% year over year, although the average price in Toronto shot up by 2.6%.

Furthermore, any mortgage where the borrower has a deposit of less than 20% must be insured, thus reducing the financial impact on the institution, which has underwritten the loan should the borrower default. In Toronto-Dominion's case, 35% of its mortgages are insured, and those that aren't have alow loan to value ratio (LVR) of 52%, which means that there is considerable room for both the bankand borrowers to resolve repayment problems.

Overall credit quality remains high. Net impaired loans make up a mere 0.37% of total loans outstanding which is significantly lower than any major U.S. bank in the leadup to the subprime crisis. Toronto-Dominion has also been working to reduce its exposure to the riskier Toronto condo market and ensure that credit quality within that segment of its mortgage portfolio is consistent with the broader portfolio.

The bank's considerable exposure to the U.S., where it is a top-10 rated bank, helps to boost its growth prospects, particularly when it is considered that margins have risen because of higher interest rates. Toronto-Dominion's loan portfolio south of the border is also expanding because of strong U.S. growth as illustrated by third quarter 2018 GDP expanding by a notable 3.5% according to the U.S. Bureau of Economic Analysis.

Thus, there is a direct correlation between economic growth and rising demand for loans and other financial products, which will help offset the lack of growth opportunities in Canada's saturated financial services market and bolster Toronto-Dominion's earnings.

So what?

The overall rational for shorting Toronto-Dominion appears flawed and it has proven to be costly exercise for short sellers. The quality of the bank's loan portfolio remains high and it has employed a range of strategies to mitigate the risks posed by external economic shocks.

Overall, Toronto-Dominion's prospects are extremely positive, and it will continue to benefit from a stronger U.S. economy that will see it report further solid results. For these reasons, it remains an attractive core holding for just about any portfolio, especially once its steadily growing and sustainable dividend yielding 3.5% is considered.

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