The Stress-Free Way to Buy Bank Stocks

Description

It’s pretty hard to argue against the Canadian banks being a great long-term investment. Their stunning returns over the decades have proven these to be excellent sources of capital returns as well as fantastic dividend payers. In the end it becomes a matter of which bank you would like to buy rather than whether or not you should own them at all.

With the advent of exchange-traded funds (ETFs), the choice has gained a new level of complexity. Instead of choosing a bank to own, an investor can simply choose one of the many ETFs that target the sector. No matter which strategy you choose, there are advantages and disadvantages to each style of investing.

Buy the banks through an ETF

While there are a number of ETFs that track the Canadian banks, probably two of the best are the **BMO Equal Weight Bank Index ETF** (TSX:ZEB) and the **iShares S&P TSX Capped Financial Index ET**F (TSX:XFN). These two have exposure to the Canadian banks and have decent dividends.

ZEB is the best way to gain exposure to the Canadian banks. It holds the six biggest banks in an equal weight format, giving you balanced exposure to each company. The ETF has a yield of 3.33%, a yield that has grown along with those of the banks themselves. If you wanted to push the yield somewhat higher, you could buy the **BMO Covered Call Canadian Bank Index ETF** (TSX:ZWB), which is essentially the same as the ZEB with a covered call strategy added in. The covered calls limit the capital gains somewhat but boost the yield to 5.14%.

XFN is slightly different from ZEB in a couple of important aspects. The most important difference for bank investors is that the ETF includes not only the big six banks, but also insurance companies, smaller banks, and other companies related to the financial industry. While the broader holding does diversify the risk to a degree, it does not become a pure proxy for the Canadian bank.

Furthermore, the ETF uses a capped strategy that gives larger companies a bigger share of the ETF. The capped strategy limits companies to a maximum of 25% of the ETF. This helps the ETF better replicate the market, where a larger company has a larger impact on the overall portfolio than a smaller one.

Another advantage of owning either of these ETFs is the fact that commissions are free for buying ETFs, especially in discount brokers.

The downside of ETFs

ETFs have the major advantage of giving investors broad exposure to a particular index. This greater diversification provides your portfolio with industry-specific risk. But there is a cost to adding this layer of protection to your portfolio. Each ETF charges a fee known as the Management Expense Ratio (MER) for managing your ETF fund. While the MER is not as large as those that mutual funds generally charge, they are significant enough to cut into investor's overall returns.

The ZEB, for instance, charges an MER of 0.62%. The XFN charges a nominally lower fee of 0.61%. The ZWB has the highest fee at 0.71%, largely due to the fact that the covered call strategy comes at a higher cost. These fees aren't huge, but they do take away from investor returns. Buying a Canadian bank stock will not have a continuous fee after you have paid the commission to buy the shares.

Buying ETFs could also limit upside individual stocks may attain. If you choose the right stock at the right time, you could potentially ride the stock for gains that exceed that of the other, lower-performing stocks. With an ETF you get the index return and that's all.

To ETF or not to ETF, that is the question

Generally, I prefer to buy stocks and not the ETFs. I personally like the challenge of picking banks I like and getting a slightly higher yield from an asset that does not charge a continuous fee. That said, an ETF is perfect for someone who just wants to own a basket of stocks in a particular index, like the Canadian banks, and not think about it. If that is you, then one of the ETFs listed above may be an excellent addition to your dividend portfolio.

CATEGORY

1. Bank Stocks
2. Dividend Stocks
3. Investing

TICKERS GLOBAL

1. TSX:XFN (iShares S&P/TSX Capped Financials Index ETF)
2. TSX:ZEB (BMO Equal Weight Banks Index ETF)

PARTNER-FEEDS

1. Msn
2. Newscred
3. Sharewise

4. Yahoo CA

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