



Warren Buffett Is Betting Big on Bank Stocks: Should You?

Description

Over the past five years, bank stocks have been some of the best gainers on the TSX index. In a period that saw the TSX as a whole return just 12%, financial stocks have risen 29%. Top-performing banks like **Toronto-Dominion Bank** ([TSX:TD](#))([NYSE:TD](#)) have handily outperformed the financial sector itself, with TD shares having risen 54% over five years.

Now, the question is whether this performance can continue into the future. Canadian banks are presently facing risks from [diminishing credit quality](#) and slowing mortgage growth, factors that have led to high short positions in banks like TD.

In the midst of all this, Warren Buffett is saying that banks are great buys. In a recent CNBC interview, he said, “banks will be worth more in 10 years than they’re worth now,” and has put his money where his mouth is by investing a huge chunk of **Berkshire’s** money in banks. Granted, Buffett is talking about U.S. banks here. But with Canada’s economy tied to that of the U.S., and with many Canadian banks having huge U.S. operations, it seems likely that Buffett’s comments carry over to Canadian financials.

So, why is Buffett betting big on bank stocks? First, we need to look at their valuations.

Why banks are cheap as hell right now

It’s no secret that banks are presently cheap. TD Bank is presently trading at 12.4 times trailing earnings, while **Royal Bank of Canada’s** ([TSX:RY](#))([NYSE:RY](#)) P/E ratio is 12.22. Of course, these P/E ratios factor in future earnings growth: big banks aren’t huge growers, so low P/Es are expected. That said, TD and Royal Bank are growing, albeit at a somewhat tepid pace. The ultra-low P/E ratios we’re seeing mean that earnings will equal price after just 12 years with no earnings growth; factor earnings growth around 8% a year into the equation and you’ve got a possible undervalued situation on your hands.

Growth prospects

As previously mentioned, Canadian banks are not growth stocks. Recently, TD's growth slowed to 2.4% year over year, while Royal Bank's revenue crept at 5.5%. However, these figures are down from historical averages, which have banks growing at 8-10% per year. Assuming that the recent slowdown is temporary, we could see the banks return to growth around 10% as soon as the housing market recovers and credit quality improves.

Risk factors

Of course, Canadian banks do have a number of risk factors at the moment. Slowing mortgage growth is a biggie: it recently hit 3% year-over-year, [a 17-year low](#). The aforementioned credit quality is also a concern, as several banks increased their provisions for loan losses in the most recent quarter. However, both of these factors seem to be symptoms of a slowing economy, and historically speaking, the economy tends to recover from slowdowns.

Foolish takeaway

When a 900-pound-gorilla speaks, everybody listens. Although Warren Buffett is far from infallible, he's done better than the average money manager over the year. The fact that Buffett likes bank stocks is at least reason enough to give them a look. As to whether Canadian banks will match the returns of the U.S. banks that Buffett is buying, that will depend on how swiftly the current headwinds simmer down.

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1. Bank Stocks
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