Are Short-Sellers Making Toronto Dominion Bank (TSX:TD) Stock Cheap?

Description

TD Bank (TSX:TD)(NYSE:TD) is among the most shorted stocks in Canada. With approximately 48 million shares short on the TSX and 5.6 million on the NYSE, the bank is attracting major bearish sentiment from U.S. hedge funds.

When institutional investors short a stock, it results in large numbers of shares being sold. As a result, a huge short campaign can become a self-fulfilling prophecy, sending the value of a stock lower in the short term.

Although the short interest in TD is not huge as a percentage of shares outstanding, at 2.6%, it's big enough to drive the stock down a little. It's therefore possible that these short positions are part of why TD stock is cheap. But before we can say that for certain, we need to know why hedge funds are shorting TD.

Why they're shorting

The main reason bears have given for shorting TD is the phenomenon of deteriorating credit quality in Canada. For months, researchers have been sounding the alarm about increasing delinquencies and falling credit ratings in Canada, and TD has followed up by increasing its provisions for loan losses. So, it appears true that TD is expecting more bad debt going forward. However, whether it's large enough as a percentage of revenue to hit the company's bottom line in a big way remains to be seen. In its most recent quarter, TD reported sluggish earnings growth of 2.4%; however, that was mainly because of losses in wholesale banking, not delinquent loans.

Short interest vs. long interest

Although TD is one of the most shorted TSX stocks, the short interest is not huge as a percentage of shares outstanding. TD has over 1.8 billion shares floating around, which makes 48 million short positions a little less frightening than it appears at first glance. The bigger concern is the possibility that hedge funds are correct in what they're saying about the company. TD's recent earnings statements have shown that management is concerned about credit risks; the company is also facing heat in the form of a slowing mortgage market. Getting hit with a double whammy of defaults and mortgage stagnation would definitely hurt TD.

The question is whether these concerns are significant enough to have a bottom-line effect. Although TD is increasing its provisions for loan losses, it is not so far dealing with a torrent of defaults and delinquencies; the measures taken were preemptive moves to deal with a potential crisis — not a response to an existing one. As for mortgages, while growth is presently slow, it's not clear how long the current housing slump will last. Assuming growth picks up again this year, then TD may find itself in a fortuitous position instead of a dangerous one.

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