Big Bank Showdown: Toronto-Dominion Bank (TSX:TD) vs. Royal Bank of Canada (TSX:RY)

Description

Fears of a sharp decline in credit quality, slower than anticipated GDP growth and heavily indebted households have led to Canada's big banks becoming targets for short-sellers. The largest domestic mortgage lender **Royal Bank of Canada** (TSX:RY)(NYSE:RY) is the most shorted stock on the TSX while the second-largest **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) is the seventh most popular stock to short-sell.

While there are headwinds facing Canada's banks, the fallout won't be as severe as the hedge funds, traders and other short-sellers believe. That means there is still a place in every portfolio for what can only be described as one of the best performing economic sectors domestically.

This has led to some investors asking which bank is the better buy. Among the Big Five, it's Royal Bank and Toronto-Dominion, which have long been favourites among investors. Given that they both pay regularly growing dividends yielding almost 4% and have experienced solid growth over the last decade, it's easy to see why.

Toronto-Dominion has greater growth potential

Since the start of 2019, Royal Bank has gained 14%, whereas Toronto-Dominion has lagged, returning only 11% so that Canada's second-largest lender offers better value currently. Lower-than-expected economic growth highlighted by the International Monetary Fund (IMF) dialling back its 2019 GDP growth forecast for Canada to 1.5%, combined with a cooler housing market will limit growth for the more domestically focused institutions such as Royal Bank.

Whereas, Toronto-Dominion has invested heavily in building a major retail banking business in the U.S., which now sees it ranked as a top-10 bank south of the border. That division for the first quarter was responsible for generating 43% of its adjusted net income.

Royal Bank has also focused on expanding its U.S. operations, but that has been more skewed to wealth management and doesn't have the same level of exposure as Toronto-Dominion. For the first quarter, Royal Bank's U.S. business generated around 17% of its net income.

That means Toronto-Dominion is better positioned to benefit from the considerable growth opportunities that exist in the U.S., the world's largest retail banking market. This stronger economic growth will give lending and deposit taking a significant boost, particularly because there is a direct correlation between economic growth and demand for credit. That potential is highlighted by the IMF's estimate that 2019 U.S. GDP will expand by 2.3% compared to the 1.5% projected for Canada.

Solid balance sheets

Both banks have high-quality loan portfolios, although Toronto-Dominion's proportion of gross impaired loans as a ratio of total gross loans under management of 0.78% is significantly higher than Royal Bank's 0.46%. This can be attributed to Toronto-Dominion's U.S. loan portfolio in which the gross impaired loan ratio surged by an unhealthy 0.19% to 0.55%, caused by a sharp increase in impaired loans in the U.S. power and utilities sector. The 0.01% year-over-year increase in gross impaired loans reported by Royal Bank to see its ratio reach 0.46% can be attributed to the same U.S. event that impacted Toronto-Dominion.

An important backstop for Canada's banks is compulsory mortgage insurance for any loan with a loan-to-valuation ratio of less than 20%, which will significantly reduce the impact of any marked increase in loan defaults. At the end of the first quarter, Royal Bank reported that 38% of its Canadian residential mortgages were insured, while for Toronto-Dominion that figure came to 34%.

Similar to each of the Big Five banks, Royal Bank and Toronto-Dominion are well capitalized, reporting a common equity tier one capital ratio at the end of the first quarter of 11.4% and 12%, respectively.

Pulling it together for investors

Both banks operate solid businesses, possess strong balance sheets which are more than adequately capitalized with high-quality loan portfolios. Either is a worthy addition to any portfolio, but because of its higher U.S. exposure, Toronto-Dominion is my preferred choice because of the substantial growth prospects that exposure provides the institution.

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Author
mattdsmith