TSX Pairs Trading: One Banking Stock to Go Long — and One to Go Short

Description

For those not familiar with the concept of "pairs trading" it's a strategy that typically involves buying or "going long" one stock the investor or trader believes will be going up, or appreciating in value, while at the same time selling, or "going short" another stock within the same industry that they expect will underperform the first, on a relative basis.

To be fair, it can be a complicated strategy at times — and one that is probably best suited for more experienced investors given that it not only involves an evaluation of the unique risks and returns between two different assets, but also an understanding of how the two securities returns have historically been correlated — not to mention the additional risks associated with "short selling" a company's stock.

But that doesn't mean it can't be a profitable strategy either.

Whether you're looking to establish a pairs trading strategy as part of your investment account or simply looking for the best investment opportunities while also seeking to avoid the "dogs of the TSX," here is one banking stock that I expect to outperform — and one that I would be very surprised if it did over the next 12 to 18 months.

Bank of Nova Scotia (TSX:BNS)(NYSE:BNS) has a lot going for it right now.

Not only is it continuing to invest in what it feels are faster growing markets in Latin American and Caribbean countries, but it's also been investing in various technological initiatives that, while they may drag on the company's earnings in the short-term, will hopefully deliver meaningful long-term results well into the future for long-term shareholders.

2018 was a busy year for BNS, including significant acquisitions in Chile and Peru in addition to its acquisition of wealth management company Jarislowsky Fraser for $950 million.

Naturally, those types of extra-curricular activities not only have the tendency to incur additional legal, administrative and consultancy costs, but they also tend to distract management from the task at hand.

As a result, Scotiabank lagged its peer group in 2018, but when you begin to look at how 2018's investments should play out longer term, the stock starts to look a lot like a long-term buy-and-hold no-brainer.

Canadian Western Bank (TSX:CWB) meanwhile, is a Canadian banking stock that I'd be considering very carefully before making a big investment.

CWB has traditionally focused its efforts on Canada's western region, which was all well and good until the region started to experience headwinds thanks to a drag on energy prices that began all the way back in 2014.

The bank's response has naturally been to diversify its operations so that it isn't so overly concentrated in one region, and particularly one region whose economic fortunes are so inextricably linked to one sector — in this case, commodity prices.

As a result, CWB's made a string of acquisitions in an effort to gain more exposure to Canada's eastern regions but the only problem with this is that because of the power that Canada's Big Five banks hold over the banking sector, there just aren't a lot of M&A options to choose from.

The consequence of this is that Canadian Western Bank has added significantly to its debt load while investing rather heavily in higher yield alternative lending businesses, which is all well and good, unless or course the economy were to head into a recession, in which case the stock would more than likely be expected to underperform.

Foolish bottom line

Don't get me wrong: I still like CWB as a long-term investment. However, at these prices, I'd be inclined to hold off on a purchase in its shares for now until the company's valuation becomes what I would consider to be a little more conservative — something closer to $20 per share.

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