Wells Fargo to Cut Dividend: Buy Royal Bank (TSX:RY) Stock Instead

Description

Warren Buffett has invested in **Wells Fargo** for 30 years. Who would have thought that the big bank will be reducing its dividend this month? It's doing so to comply with the Federal Reserve's stress tests, which included a COVID-19 component this year.

So far, the big Canadian bank stocks have kept their dividends intact. The banks have set aside millions of dollars to cover an increase in bad loans due to the closure of big parts of the economy to combat COVID-19. This is going to eat into the banks' profits this year.

An ugly year for the banks

The big Canadian banks are some of the soundest banks in the world. As the market leader with a diversified business, **Royal Bank of Canada** (TSX:RY)(NYSE:RY) stock should be among the first banks globally to recover once COVID-19 comes to pass.

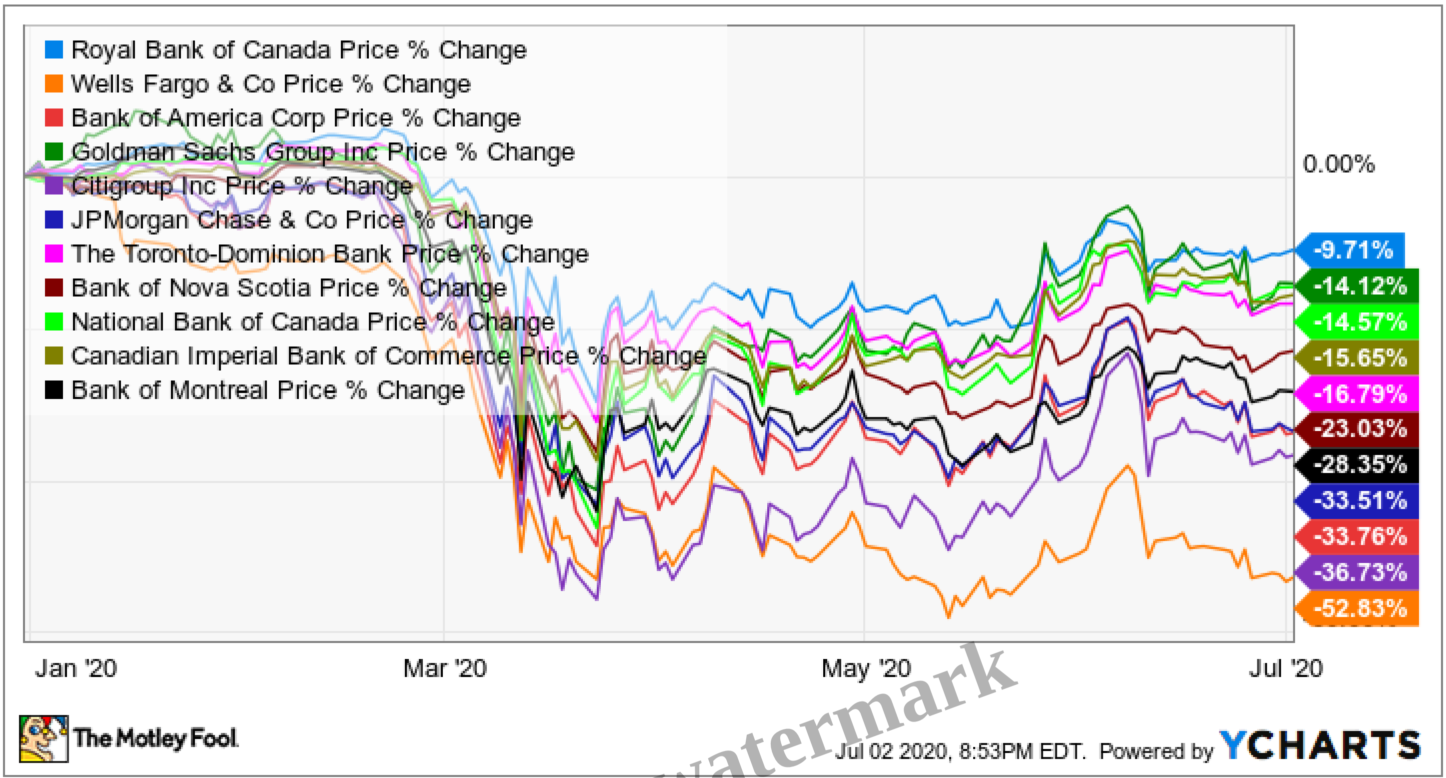
There's pain in the near term, though. In the first half of fiscal 2020, Royal Bank's diluted earnings per share (EPS) declined by 22% year over year. And its return on equity was 12.5%, down from 17.1% in the prior year's period.

These results were already helped by fiscal Q1 numbers, which had no COVID-19 impacts. (For the first quarter, Royal Bank's diluted EPS rose 10% year over year.) So, expect things to get worse likely for the remainder of the year.

The big Canadian banks are on sale

Because of the near-term negativity in the economy, the banks have sold off. For investors who have an investment horizon of at least three to five years, this year should be a window of opportunity to buy secure Canadian banks on sale.

Royal Bank stock fell 10% year to date, which greatly outperformed Wells Fargo. In fact, it has been more resilient than many big North American banks.



RY data by YCharts. The year-to-date chart comparing Royal Bank stock with other big North American banks.

Royal Bank should continue to be an easier hold than other large-cap North American banks through volatile 2020.

Over the next three to five years, Royal Bank aims for earnings-per-share growth of at least 7% per year, a return on equity of more than 16%, and a dividend-payout ratio of 40-50%. Investors can consider these to be normalized metrics for the quality bank.

RY stock is undervalued

At $92.77 per share, Royal Bank stock trades at about 10.4 times its normalized earnings, which is a discount of about 15% for long-term investment.

Right now, the economy is still navigating through COVID-19. Consequently, depending on the developments of the pandemic, the bank stock can appreciate to the $100 level or fall to the $80s range.

What’s more certain is [Royal Bank’s dividend](), which yields 4.66% at the recent quotation.

The Foolish takeaway

Investors should be ready for a rocky ride in Royal Bank this year. That said, the bank stock is a low-risk investment among the big North American banks, as suggested by the chart above.

Because of its low volatility, the conservative investment won't deliver the greatest returns among the group. RY stock is the kind of stock that will outperform in a down market and perform in line or slightly outperform in an up market.

Whenever RY stock yields 5% or greater, consider it to be a bargain. That'd imply a maximum buy price target of $86.40 per share based on the current quarterly dividend of $1.08 per share.

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