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BANKING ON PROFITS

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I wanted to talk this month about the outbreak of hysteria in the financial markets in the last couple of weeks, as Canadian banks, asset managers and life insurers get thrown over the side in an indiscriminate sell-off. If it seems ridiculous to readers that three of the six big Canadian banks (Royal, TD, Scotiabank, Bank of Montreal, CIBC and National) now are yielding over 5%, more than 1.5% above the yield on the 10 year Govt. of Canada bond (3.65% at time of writing) and that all of them are down at least 15% from this time a year ago, that other financials recommendations such as Power Financial and Sun Life are hitting 52 week lows and that the best performing Canadian asset management company (Jovian), according to a table compiled by the Globe & Mail is down 25% from its high while the worst (Mavrix) is off 69%, then they are not alone in being awed at the market's ability to misprice businesses.

The reason for the major sell-off is easily understood; the housing crisis in the US has led to the implosion of numerous structured financial products based on mortgages secured against overpriced houses granted to uncreditworthy borrowers who should never have been granted a loan in the first place. Everyone is now well aware of the sub-prime mortgages that have led to the severity of the downturn, as borrowers were not required to show proof of income, or put any money down. The best acronym amongst all of the alphabet soup of ABCP (asset backed commercial paper), SIV (Special Investment Vehicles) and VIE (Variable Interest Entities) has to be NINJAs. Banks and other lenders were giving loans to people with No Income, No Job or Assets and who were not required to prove the information they put down on their applications.

The major factor to be aware of as far as Canadian financial stocks are concerned is that the overwhelming majority of their assets are Canadian, so the undoubtedly severe sell off occurring in the US property market has far less effect on Canadian balance sheets. The majority of the Canadian banks' mortgages are Canadian mortgages, and the conservative nature of the banks and the regulators in Canada prevented the types of excesses seen in the US> Until 2 years ago the Canada Mortgage and Housing Commission (CMHC) the equivalent of Fannie Mae or Freddie Mac, would not insure mortgages that had maturities longer than 30 years or downpayments of less than 10%. When the authorities changed the rules to permit 35 and 40 year mortgages and 5% downpayments, the then Governor of the bank of Canada, David Dodge, wrote to them publicly, warning that they were encouraging borrowers to over stretch themselves to buy houses they could not afford. The contrast with the US housing market, where no money down, or even 110% to 120% mortgages were common, and the Fed Chairman encouraged borrowers to take out Adjustable Rate Mortgages (ARMs) with short term interest rates at 45 year lows is a neat summary of the difference between the two countries and their financial systems.

As a result, Canadian banks not only have limited exposure to toxic sub prime mortgages in the US, as even their US subsidiaries, such as TD BankNorth and RBC Centura, did not offer the more aggressive types of mortgages, they have a very strong asset base in Canada, where the average house price rose 15% in the year ending January 31st, 2008 against a decline of 9% for the average US house. The comfortable oligopoly enjoyed by the six large Canadian banks ensures that their return on equity is consistently in the mid to high teens when it is not over 20%, a position US banks would love to be in, and the principal problem the banks have faced in Canada has been what to do with the excess cash they generate. Dividend payout ratios have risen from 30-40% 5 years ago to 40-50% now, stock has been repurchased, but, with the exception of TD, which has built a consumer franchise in the US Northeast, soon to be crowned by the takeover of Commerce Bancorp of NJ and my recommendation from mid 2007, Scotia, with one third of its income coming from the Caribbean and Latin America, Canadian banks generally have more cash than they can usefully employ, as the government has twice (1998 and 2002) blocked potential mergers between banks.

As noted in last month recommendation of Sun Life, life insurers have a higher exposure to the US, but much less credit exposure, given the nature of their business, with Sun Life's exposure to asset backed securities amounting to less than 0.5% of its NAV at the end of 2007, equivalent to writing off 1% of its earnings if it had a complete loss on the portfolio. The weakening U$ does result in a drag on earnings for those financials with large US operations, but this is purely a reporting issue, as the assets in the US have a natural hedge in the borrowings which are also denominated in the same currency.

The three Canadian banks which reported specific write-offs for the year ending in October 2007, CIBC, National and the Bank of Montreal (of which GGOF is a wholly owned subsidiary) saw their prices decline 28.2%, 20.6% and 18.4%, while the better performing RBC, Scotia and TD were off 8.6%, 3.5% and 0.3%. Manulife, the largest life insurer, was up 3.1%, my 2005 recommendation, Power Financial 8.2% and Sun Life 13%, leaving the S&P/TSX Financial Index down 4.6% in price. After a 3% dividend was taken into account, the negative total return was 1.6% vs. 9.8% for the S&P/TSX Composite Index, an 11.4% underperformance, which analysis by Scotia found was the third worst year in terms of lagging the index in the last 40 years. This was after 2006, when financials had out performed the Composite by 19.2% vs. 17.2%, a reflection of the fact that interest rates in both Canada and the US, although they began rising in 2004, take some time to work through the system. Similarly, although interest rates have now fallen 2.25% in the US and 1% in Canada to 3% and 3.5% respectively, financials, which are negatively affected as rising rates squeeze banks' lending margins and the sale of market linked life policies, and vice versa, have tumbled this year despite large than expected falls in interest rates.

Year to date to March 7th, Bank of Montreal has fallen 24.3%, Power Financial 20%, Sun Life 18.9%, CIBC 12%, Scotiabank 11.7%, TD 10.6% and RBC and Manulife 9.7% while the TSX Composite is off only 4%. The financials index fell 6.2% in the first week of March, the biggest fall since the week of 9/11, to its lowest level since November 2005. As noted, the dividend yield on three of the six banks is over 5%, ignoring the dividend tax credit and the fact the dividends have been raised on at least an annual basis for the last decade and that no Canadian bank has cut its dividend in 25 years. The yield on Power Financial is 3.8%, on Sun Life 3.2% and Manulife's is approaching 2.8%. Any reasonable observers would conclude, looking at this massive underperformance and the valuations of the companies, that investors were tarring all North American financials with the same brush and ignoring the much stronger fundamentals of the Canadian economy. The total losses of the Canadian banks (excepting CIBC's $4.2bn on its exposure to CDOs) on ABCP, SIVs, CDOs, trading and ordinary credit losses amount to $2.6bn to date. Even if one was very pessimistic and doubled that number, the total would still amount to less than 20% of Merrill Lynch's losses to date alone. Canadian banks have simply been far more conservatively managed than their US counterparts over the last few years and the evidence is readily apparent in their results.

Investors with a time horizon longer than 6-9 months should be buying Canadian financials now. Even if the stocks do not appreciate over the next two years, then the after tax income is higher than any other "lower risk" alternatives such as government bonds, GICs or savings accounts.