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The Krygier Report

An exclusive newsletter from Mark J. Krygier, Vice President & Portfolio Manager | September 2019 www.krygierwealthmanagement.ca

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Bullish on Canadian stocks? Don’t bank on it!

One of the most interesting phenomenon this year in the North American stock markets, and even more so in the Canadian TSX stock market, has been the price action of the bank stocks. Anyone who has followed the history of the markets knows very well that a very significant portion of the economy, as reflected in the stock market, is based on the financial sector. In Canada, the financial sector, which is dominated by the banks, currently comprises 32.1% of the overall Canadian TSX market index. In contrast, while an important part of the American economy, the financial sector only comprises 12.69% of the US S&P 500 index. As a result, the direction of the bank stocks will have a major influence on the overall performance of investments in the Canadian market – especially those buying “the index” through a low-cost ETF, or a quasi-index of a broad-based large cap Canadian mutual fund which benchmarks off the index.

For the average retail investor, buying the bank stocks has provided an easy entry to investing. Traditionally, Canadian bank stocks provided attractive, tax-efficient dividend yields versus GIC or bond yields, and their performance in the past 30 years has been excellent, with annualized total returns since January 1, 2000 of 12.3%. Portfolio Manager Martin Pelletier says that the reason the banks have provided such wonderful returns is because, “they operate within a tightly-held oligopoly, they are heavily protected by self-regulation, and as a result are able to cut costs and increase margins while fiercely working together to protect their market share.” I would suggest that a confluence of two unique factors since the early 1990s combined to make Canadian bank shares so successful. Those factors were the collapse of interest rates from double-digits to low single digits and the change in Federal legislation which broke down the “four pillars” of the financial sector (allowing the banks to purchase the Trust companies and the brokerage houses and to create their own insurance businesses). One could argue such stimulating factors will likely never again occur, and, if so, the likelihood of them continuing to provide such good returns is also increasingly unlikely. As of the last week of August, while the overall TSX is up over +14% year-to-date, the 5 big banks are up on average only +5.3%, with the best being TD Bank at +9.02%, and the worst being CIBC at only +1.33%.

Canadian banks have been struggling to grow their earnings in the face of a slowing mortgage market with extreme real estate prices, an already over-indebted consumer, and added taxes for foreign buyers in B.C. and Ontario. Wealth management has been an area of growth, but it faces a head-wind of declining average fee revenue. While the banks will not disappear as businesses, as investments one has to consider if there are better opportunities in other sectors.

Furthermore, as a reflection of the overall Canadian stock market, potential mediocrity in returns from the banks means an investor focused on “total returns”, and not just dividend yield, also has to consider diversifying even more of one’s portfolio outside of Canada. Our very own Canadian Pension Plan (CPP) investment board is leading by example in this regard, as it invests in 52 countries and has only a 15.5% weighting in Canada – an amazing fact of which I am sure most Canadians are unaware.

In light of the challenges facing banks and investors in bank shares, it is very interesting to note that famed investor Warren Buffett has been reported by the Wall Street Journal as having purchased, over the course of the past several months, very large sums of U.S. bank shares. Apparently, his company Berkshire Hathaway holds $96.5 billion worth of bank shares in a total portfolio of $200 billion or about 48% of the total, with one stock alone – The Bank of America – now becoming Berkshire’s largest single holding at $26 billion. That is a very big bet on the U.S. economy improving significantly in the coming years, and on long-term interest rates rising dramatically from recent low levels. While Mr. Buffet’s long-term record is outstanding and speaks for itself, it is not without mistakes, including his purchase of Heinz in 2013 which was joined with Kraft Foods (as a joint venture with 3G Capital private investment fund) in 2015, as the share price in that investment is down a whopping -39% so far in 2019.

Bottom line

The Canadian bank stocks have provided a safe haven for investors for several decades. However, that may be about to change. In order to try and obtain reasonable returns in the coming years, one may have to consider investing outside of one’s “comfort” zone. Currently, at ***Krygier Wealth Management***, our growth-oriented managed portfolios hold the least amount of exposure to bank shares that we have ever held in our past 22+ years of investing in the financial markets. Hindsight investing is wonderful, but in planning ahead don’t bank on it!

Global benchmarks
As at August 31, 2019 (Canadian $ Returns)

Asset class	YTD	1 year	3 years
S&P/TSX Composite T/R (Canada)	17.1%	4.3%	7.2%
S&P 500 TR - US$	18.3%	2.9%	12.7%
NASDAQ Composite - US$	20.0%	-1.8%	15.2%
MSCI Europe Index Price Return	5.2%	-4.0%	3.5%
MSCI Emerging Markets	-0.5%	-4.8%	3.8%
China S.E Shanghai A Price Return	8.6%	3.3%	-3.9%
MSCI World Index Price Return	10.8%	0.4%	8.1%

Asset class	YTD	1 year	3 years
30-year U.S. T-Bond - US$	26.6%	27.9%	4.7%
10-year U.S. T-Bond - US$	12.9%	15.8%	2.7%
Long GOC Bond (2048)	18.8%	21.5%	3.5%
10-year GOC Bond	8.6%	11.9%	1.7%
5-year GOC Bond	4.4%	6.4%	1.1%
3-month CDN T-bill	1.1%	1.6%	1.0%
US$/CDN$ (1.3310)	-2.4%	2.1%	0.5%

Source: RBC Capital Markets Quantitative Research

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