

The Educated Investor



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Barasch Wealth Management

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The Canadian Banks Well owned, but generally misunderstood

Our largest positions

For most Canadian-based investors, the Canadian banks make up the largest portion of their equity portfolios. In fact, if one added together the holdings that a typical investor has in Canadian bank stocks and the debt instruments of the Canadian banks (bonds, GICs, money markets), in some cases (perhaps even many cases), Canadian banks can make up close to 40-50% of one's investments.

The Canadian banks have been wonderful investments over the past three-decades. In fact, we once wrote a research piece that looked at the performance of the CAD banks vs. virtually anything else one could have invested in over the 25-year period beginning in 1991. The piece found that the Canadian banks outperformed virtually everything over the period, including the stock of Warren Buffett's Berkshire Hathaway.

But, if we asked most people how the banks make money, they might respond – fees or mortgages or I don't really know.

Banks are spread businesses

At their cores, the Canadian banks earn the bulk of their money from what are broadly referred to as "spread businesses." The largest of these spread businesses (and the one we will focus on)

is Canadian retail banking. Every time you deposit money in a savings account or buy a GIC, the bank pays you interest on that deposit. The interest the bank is paying you is, in effect, the cost to the bank of having the use of your money. Once that deposit has been made, the bank is then free to lend out that money, usually in the form of a mortgage or a personal loan. Of course, the bank will charge interest for the mortgage or the loan and the interest it charges is typically significantly higher than the interest it pays on the deposit you made. This "spread" provides a big source of bank earnings.

Now, it's important to note that you cannot stop the bank from lending out your money (aside from parking it beneath your mattress), but with deposit and GIC guarantees in place, you do not really need to or want to. In other words, even if the bank makes bad loans with your deposits (which they rarely do), you are protected as long as you remain below the maximum protection levels.

Now, the lending spread business is closely tied to three things – 1) the amount of loans that the banks make; 2) the spread that they are able to earn on these loans; and 3) the amount of loans that go bad.

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A Good Outlook But some challenges

The 3 Pillars of Lending

1. It is probably not surprising that the more loans banks make, the more money they make. Canada is coming through nearly a two decade period of significant loan growth led by a strong housing market. This has proven to be a boon to bank earnings.
2. There are times when spreads are wider – that is – the difference between what banks can charge on mortgages and what they pay for deposits widens. You may have heard of a “steeper yield curve” and this essentially refers to the widening of the difference between shorter-term rates (which is what banks typically pay on deposits) and longer term rates (what banks charge for mortgages). The steeper, the better for Canadian banks.
3. Canadians have a great long-term track record of paying their bills (unlike their Southern neighbours). However, there are times when credit losses rise (typically tied to rising unemployment) and this can be a real drag on bank earnings.

Outlook

We should start by saying that for the most part, the Canadian banks have proven to be very well-managed companies. Canada and the world have faced some major crises over the past three decades and the Canadian banks have maneuvered through them much better than have their US and global peers.

Canadian unemployment is low and this makes it likely that loan losses will remain low. However, Canadians have amassed a fair bit of debt over the past two decades, which will likely lead to lower growth in loans for at least the next several years.

To offset this, several of the Canadian banks have looked to diversify their earnings outside of core Canadian banking. BMO, TD and RY have sizeable US businesses, while BNS has a significant international presence. Further, other businesses such as Wealth Management, Capital Markets and Insurance have begun to play increasingly prominent roles in the overall earnings pie (although still dwarfed by traditional lending).

Thus, while there are headwinds for

the Canadian banks, we still expect them to be good investments with their dividends providing a nice return base. During periods of weakness, which inevitably happen, we might look to add some exposure, while when they get expensive, we might look to trim back a bit (although always likely to maintain a core position).

Family Corner

On March 26th, **Matt** will be walking the runway in support of Wellspring, which does wonderful things for families dealing with cancer. For those interested in his story, it can be found here:

http://wcsf.convio.net/site/TR/Events/General/429520704?px=1003382&pg=personal&fr_id=1040

Ann-Marie

We have a new addition to our family- not a dog, cat or baby. Rather, a 6 year old green cheeked conure named Ollie. My teenage son Trent promised us that he will be primarily responsible for the bird. This, of course, has not been the case so far mainly because the bird has taken a real liking to me. Ollie screams for my attention when he hears my voice and squawks when anyone comes too close to me. I have to admit, he’s pretty cute; however, when Trent decides to move out the bird is going with him!



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