Hedge funds take aim at Canadian banks

By NICOLAS JOHNSON
Published on Friday October 14, 2011
Globe and Mail

Some hedge funds are shorting the lenders on wager that any economic calamity will bring share price down

Canadian banks are often described as boring, safe and stable, but some speculators are beginning to apply another adjective: expensive.

The country's five biggest banks trade at some of the highest price-earnings multiples in the global banking industry. That's partly because their shares have held up relatively well this year, while their peers worldwide got clobbered on concerns related to Europe's debt crisis and a possible recession in the U.S.

The valuation gap is prompting some observers to bet that Canadian bank stocks will fall, even as their defenders argue that the financial institutions' rock-solid retail base and prudent management will help them withstand any slowdown.

"The hedge fund community has shown an increased interest in shorting Canadian bank shares of late," RBC Dominion Securities Inc., the brokerage unit of Royal Bank of Canada, said in a research note this week. "While we recognize downside risks in a recessionary scenario, we ultimately believe Canadian banks will hold up relatively better than other sectors in the event of a downturn."

Canada's banks have largely sidestepped the woes, ranging from subprime mortgages to Europe's sovereign debt issues, that have dogged many of their international rivals.

But while the strength of Canada's economy helped propel the banks through the last financial crisis, some foreign investors are now eyeing the elevated level of household debt in this country and wondering how the financial sector would weather a cooling off of the red-hot housing market.

"The key investment concern from U.S.-based investors is the Canadian consumer's health, and the level of indebtedness in the mortgage market," said Cheryl Pate, a New York-based analyst with Morgan Stanley, which has a "neutral" rating on Canada's banking industry. "We are looking broadly for a slowdown, but I would say it's a slowdown to a normalized level."

While the banks may look expensive against their global counterparts, other measures show their valuations haven't deviated from historical trends. Canadian banks now trade at an average of 11.5 times earnings, versus an average of 11 for the past decade.

Veritas Investment Research, an independent firm in Toronto, evaluated the bank stocks by looking at their current prices against their average inflation-adjusted earnings over the past 10 years. This price-earnings gauge, developed by the economist Robert Shiller, strips out the effects of the business cycle on profits.

"History suggests that investors with a five-year or longer time horizon have generally made very good returns buying the Canadian banks at the kind of Shiller P/E ratios available today," ***Ohad Lederer*** and ***Yuting Liu*** said in a report last month.

The ***Veritas*** researchers noted that some investors worry that the banks will feel the ripple effect of Europe's financial crisis. However, the European liabilities disclosed so far by the banks "appear manageable," the analysts wrote.

No one is betting, though, that the banks would be immune in the unlikely event that Europe's problems bring on another global credit crunch.

Canadian bank stocks dropped more than the S&P/TSX in two past financial crises: between July and October 1998, when Russia defaulted on its debt and the hedge fund Long-Term Capital Management LP almost collapsed; and in the final months of 2008, following the bankruptcy of Lehman Brothers Holdings Inc.

"The Canadian banks are great companies with very durable business models, but we would be careful with the idea that the Canadian banks are immune to global events," said Rob Wessel, managing partner at Hamilton Capital, a Toronto-based fund manager specializing in financial services stocks.

Valuation gap

Canadian banks have some of the highest price-earnings ratios among the biggest banks worldwide.

Name	P/E Ratio	% Change YTD
Toronto-Dominion Bank TD-T	11.9	0.5
U.S. Bancorp	11.9	-9.8
Royal Bank of Canada RY-T	11.7	-8.5
Commonwealth Bank of Australia	11.6	-6.3
Bank Of Nova Scotia BNS-T	11.5	-8.6
CIBC CM-T	11.4	-4.0
Bank of Montreal BMO-T	11.3	2.0
Deutsche Bank AG	11.0	-28.8
Credit Suisse Group	10.1	-31.5
HSBC Holdings	9.2	-19.7
Wells Fargo & Co.	9.2	-15.5
Westpac Banking	8.7	-2.1
Mitsubishi UFG Financial Group	8.4	-22.6
Citigroup	8.5	-41.6
Banco Santander	7.0	-20.6
Industrial & Comm. Bank of China	6.7	-23.3
UBS AG	6.7	-28.9
JPMorgan Chase & Co.	6.1	-25.5
Bank of America	5.1	-53.4
BNP Paribas	5.0	-30.0
Mizuho Financial Group	4.9	-28.1
Societe-Generale	4.6	-46.3

Source: Bloomberg