Canadian Financial Stocks – Best Long Term Investments

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Many investors prefer buying a diversified equity mutual fund or exchange traded fund (ETF) that includes holdings in Canadian financial stocks.

Some like to purchase a sector equity fund or ETF such as iShares XFN.

Lastly some investors are stock pickers who choose one company over another.

The basic premise for selecting a sector fund or ETF is that it is just too difficult for the average investor to pick and choose the best investments.

In my opinion, that is the lazy man's approach to investing that has been encouraged by financial advisors. The dumb it down approach emphasizing minimization of risk and investment simplicity is used extensively by financial advisors.

However my belief is that the average investor is quite capable of determining the long term thrust of each Canadian bank and insurance company. Having this information readily available can make stock selection in this group a relatively easy task. While there are short term factors that affect share prices, it is ultimately the long term direction of each company that determines its profitability and share price performance.

Performance – Total Return

	1 year	**5 year**	**10 year**
iShares XFN sector ETF	11.58	11.39	8.82
TDBank	21.43	16.04	13.87
RBC	15.02	13.94	12.11
BMO	22.74	14.35	13.65
CIBC	22.03	13.26	11.93
National Bank	18.17	14.68	14.97
Scotiabank	1.29	9.71	8.85
Sun Life	12.09	13.95	7.10
Manulife	0.76	10.22	-1.13

As you can clearly see from the above table, there is a material difference in performance between one firm and another.

During the last 1, 5 and 10 year periods ending August 31, the TD, RBC, Bank of Montreal, CIBC and National Bank all outperformed the sector ETF by a significant margin.

However Scotiabank sharply underperformed on both a 1 and 5 year period, with only a market sector performance over the 10 year period that was much worse than its peers.

Manulife underperformed over all three periods, while Sun Life outperformed over the last 1 and 5 year periods, but underperformed over the last 10 year period.

The performance of these financial companies is extremely significant and clearly indicates that stock picking does indeed work.

Reasons for Performance

TD's performance can be largely attributed to its exposure to the US retail banking market. Currently TD has more US branches than Canadian and is benefitting from the strong US economy. TD's success was not a stroke of luck but a result of its strong management and their ability to forecast this US strength.

RBC's foray into the US retail banking market was not without controversy. Commencing in 2001 the bank made two major investments in the US under the direction of the former CEO, John Cleghorn. Unfortunately the 2007-2008 recession hit the US banking sector much harder than Canada's and RBC lost billions of dollars from this investment. The company announced the sale of all its US retail branches to PNC Financial on June 20, 2011.

Despite this major setback, RBC's management was not going to sit down and die. This bank has always been able to recover and this time was no exception. The bank has made several major acquisitions of US wealth management companies that have already proven very lucrative to RBC's bottom line. Senior management obviously learned from their past mistakes and have been quite savvy with their recent investments.

Bank of Montreal has benefitted from is long term US investment in Harris Bank in Chicago and its results reflect this. It has also continued to benefit from its strong wealth management platform that provides solid investment advice to investors.

While CIBC has only recently invested in the US by acquiring a wealth management company, the payback from this investment was immediate. The last quarter showed a material contribution from this US investment.

While National Bank's US exposure is not large, the bank's outperformance can be attributed to its strong regional presence in the Quebec market where 25% of Canada's population still live. This bank has always had strong management that is able to compete very effectively versus its much larger peers.

In my opinion it is no coincidence that Scotiabank has sharply underperformed its Canadian bank rivals over the last 1, 5 and 10 year periods. There are two major reasons for this underperformance. First of all the bank has very little US retail or wealth management presence in the US. Secondly the bank has invested a considerable amount of capital into the Caribbean, Latin America and Emerging Markets. We all know how poorly the economies of the Caribbean and Latin America have been for a very long time. In addition the growth in the Emerging Market economies has been much more volatile than North America or the EU and is currently being very negatively affected by Trump's trade protectionist policies and the strength of the US dollar where most of the Emerging Market debts are denominated.

By not investing materially in the US and overinvesting in highly unpredictable economies of the Caribbean, Latin American and in Emerging Markets, makes me question the quality of Scotiabank's management.

Finally in regards to the two major Canadian insurance companies, the difference in performance can be attributed to Manulife's management. During the last recession Manulife came close to bankruptcy by being far too aggressive on its segregated fund capital guarantees relative to its peers. The company was forced to issue equity at very inopportune prices in the middle of the recession to bolster up its capital. Having more conservative management, Sun Life did not get into trouble like Manulife did.

Since the last recession Manulife has bolstered its capital on its balance sheet and has been more disciplined in its business approach. However it does have a US subsidiary that continues to experience financial difficulties relative to its US peers. Manulife's foray into the US has not been a good one. In addition it is relying a lot on its future growth in Emerging Markets that remain very volatile and much less consistent than markets in North America and the EU.

Once again it is pretty obvious why Sun Life has outperformed Manulife over the last 1, 5 and 10 year periods.

Conclusion

Individual stock picking in this sector clearly is a good strategy.

You do not have to be an investment guru to differentiate the long term focus of each financial institution.

Corporate management is critical in your stock selection.

Both Scotiabank and Manulife's senior management need to prove it to investors that they have learned from their mistakes and are on the right track for future growth. It remains to be seen if they will be successful.

My advice is to focus your investments on the other Canadian financial stocks at this time.