Views from the Desk

Decoding Q3 Canadian Bank Earnings

Sohrab Movahedi, Chris Heakes and Daniel Stanley cover the most recent bank earnings announcements and what they mean for investors and the Canadian economy as well as looking at different ETF strategies that give you exposure to the Canadian Banks. Daniel Stanley is an ETF Specialist at BMO Global Asset Management. He is joined on the podcast by Chris Heakes, Portfolio Manager and ETF Specialist, BMO Global Asset Management and Sohrab Movahedi, Managing Director, Financials Research, BMO Capital Markets. To listen to the full podcase please visit bmoetfs.ca

Poverty of revenue growth, lower credit to drive earnings

If you look at the big 6 banks as an industry, they reported cash operating earnings of 15.1 billion (up 55% from last year) in the third quarter of 2021. Provision for credit losses were in a net recovery of 400 million.

The second quarter of 2020 there was a need to beef up reserves for potential future losses due to the pandemic and took the reserves up to a peak of approximately 25 billion dollars. So far, this fiscal year they have been steadily decreasing these reserves. The decline in performing loans accounted for 7.2 of the 7.5 billion improvement of their pre-tax earnings. Revenue growth was at a modest 4%.

Canadian Banks with better diversified revenue such as wealth and capital markets advisory reported better revenue growth. Lower credit was a common driver of earnings across the big 6 banks.

Most efficient way to own Canadian Banks and fee cuts to ZEB

ZEB - BMO Equal Weight Banks Index ETF management fee has gone down from 55bps to 25bps. ZEB is one of BMOs longest standing ETFs with 12 years history and a 12% average return. ZEB uses an equal weight methodology, so you don't have to guess which bank to get exposure to. The equal weight approach has outperformed the market cap approach in banks by almost 1% per year over the past 12 years. With the equal weight approach, you tend to buy the banks that have sold off and trim the banks that have outperformed. ZEB has assets under management of 2 billion and is one of the largest most liquid financial ETFs in Canada.

Revenue earnings growth going forward

The big 6 Canadian banks collectively had an annualized return on asset of 91bps in the third quarter of 2021. This was the highest return on asset since Q1 of 2012. The banks also had a 17.4% ROE this quarter. The highest ROE the banks had was in 2014 at 10%. During the third quarter of 2021, Canadian banks profitability was mainly from credit recovery.

It is worth noting that investors historically have been more comfortable rewarding the bank stocks with higher P/E valuation multiples when the top line growth is 5% or better. We are really close since we are around 4% top line growth across the industry right now. If the momentum continues, we could find ourselves in a situation where we have the benefit of both top line growth, positive operating leverage and better credit and we think that should be helpful for higher valuation multiples.

Owning bank stocks vs ZEB

It is comfortable to know that banks haven't cut their dividends during the financial crisis and the pandemic and in the investors eyes the dividend payments are very reliable. We think there is some pent-up energy for banks to increase their dividends and ZEB will raise their dividends accordingly when the banks do in fact increase them. ZEB will take the dividends from the banks and divide them by 12 and pay them out as monthly distributions vs the bank stocks that pay out dividends on a quarterly basis.

Historically banks have beaten the TSX

Canadian Banks tend to be attractive investments to income-oriented investors and those investors are looking for the dividends payed out by the banks. Bank dividends are also much higher than what bonds typically pay out. A quarter of the total return from the banks are coming from the dividend yield. The banks are looking to get back to their historical dividend payouts we are accustom to (since regulators stopped them from raising dividends during the pandemic). The banks have consistently outperformed the Toronto Stock Exchange 75% of the time in the last 50 years. We expect the relative outperformance to continue into 2022 as well.

To get exposure to the Canadian Banks please see:

- ZEB - BMO Equal Weight Banks Index ETF
- ZCN - BMO S&P/TSX Capped Composite Index ETF
- ZWB - BMO Covered Call Canadian Banks ETF
- ZDV - BMO Canadian Dividend ETF

To get exposure to the U.S Banks please see:

- ZBK - BMO Equal Weight US Banks Index ETF
- ZUB - BMO Equal Weight US Banks Hedged to CAD Index ETF
- ZWK - BMO Covered Call US Banks ETF

All of the above tickers trade on the Toronto Stock Exchange.

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Source: Bloomberg, All returns and data points June, 2021.
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