TD Asset Management

Investor Knowledge 10 Minutes

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Banking on the Banks

Should all Canadian bank ETFs be painted with the same brush?

Banking in Canada can be traced back to the founding of Montreal Bank over 200 years ago.At that time banks were traditional, deposit taking institutions providing the safe keeping of money and loans and mortgages to customers and businesses. Canadian banks have evolved considerably in the last 50 years. They consolidated many parts of the Canadian financial system through acquiring trust companies and brokerage firms and have diversified the into new areas such as investment banking, wealth management and personal insurance.

At a glance

- Canadian banks benefit from high levels of profitability and have a growth runway thanks to efficiency improvements, immigration, and acquisitions opportunities.
- Over the past 10 years, the total returns of the big 6 Canadian banks have diverged. The ones that increased their dividends the most were also the best performers.
- TD Canadian Bank Dividend Index ETF (TBNK) provides attractive exposure to Canadian banks and takes a differentiated approach by weighting each bank holding based on dividend growth.

What makes Canadian banks so profitable?

Banks in Canada have been more profitable than other sectors for many years (with a notable exception during the Global Financial Crisis). The chart below depicts the return on equity (ROE) of Canadian banks and the broader equity market in Canada. The banks have delivered a 14% ROE compared to 10% for the rest of market. Higher profitability has yielded superior returns over the long-term.

Moreover, Canadian bank stocks have delivered a ten-year total return of approximately 10% per year, better than the 7% to 8% annual return for the broader Canadian stock market[1]. This impressive profitability and shareholder returns are thanks to the consolidated nature of the industry, a supportive regulatory environment, and excellent management teams.

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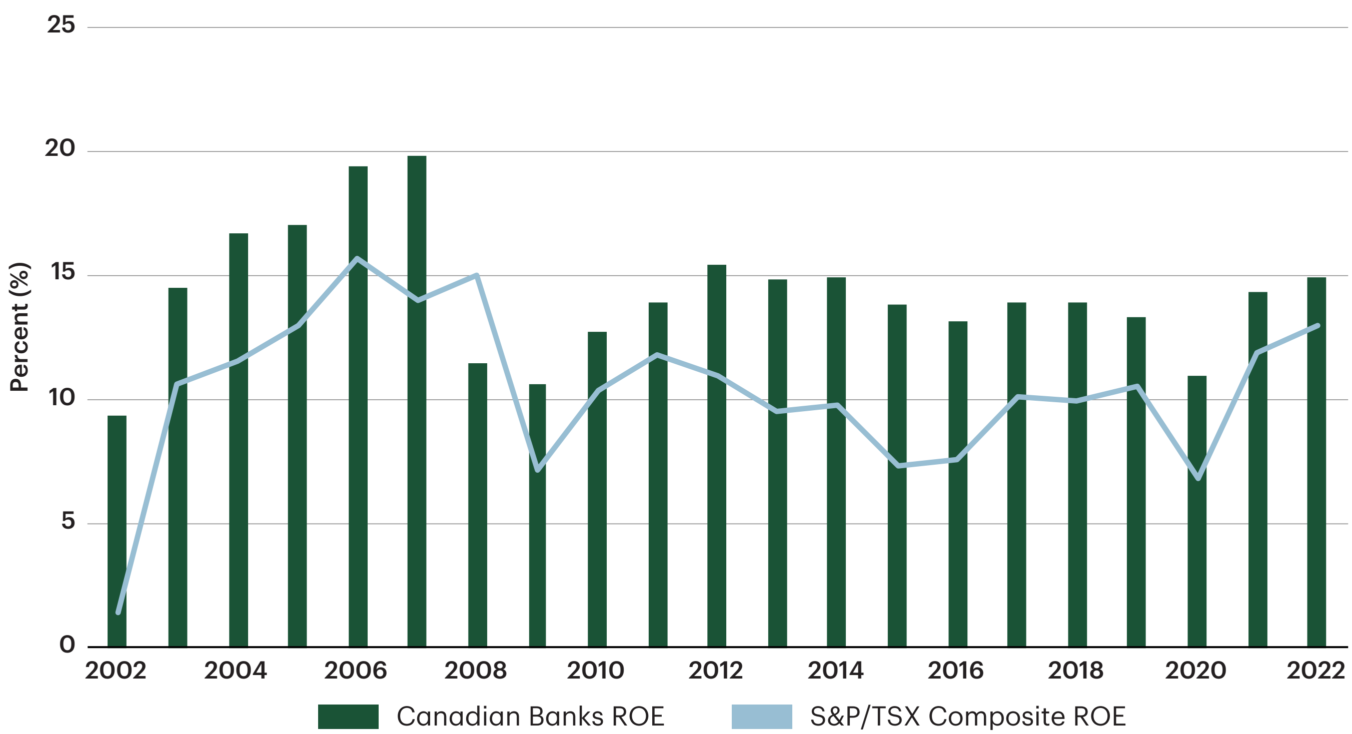
Canadian Bank Return on Equity vs. the Rest of the Canadian Equity Market



Source: Factset. Data as of January 31, 2023.

[1] Source: Bloomberg Finance L.P. Data as of March 31, 2023.

What are the growth prospects for the banks?

Economic expansion is fundamental to the growth prospects of the banks. People often think of the Canadian economy as driven just by real estate. While real estate does certainly play a key role as the largest sector at 20% of GDP, one-tenth of economic activity is attributable to each of trade, natural resources, and manufacturing (the list goes on from there). The banks participate in the growth of the country by lending and facilitating transactions across all of these industries. Earnings growth for the banks will ultimately be an outcome of factors such as **efficiency improvements**, **immigration**, and **acquisitions**.

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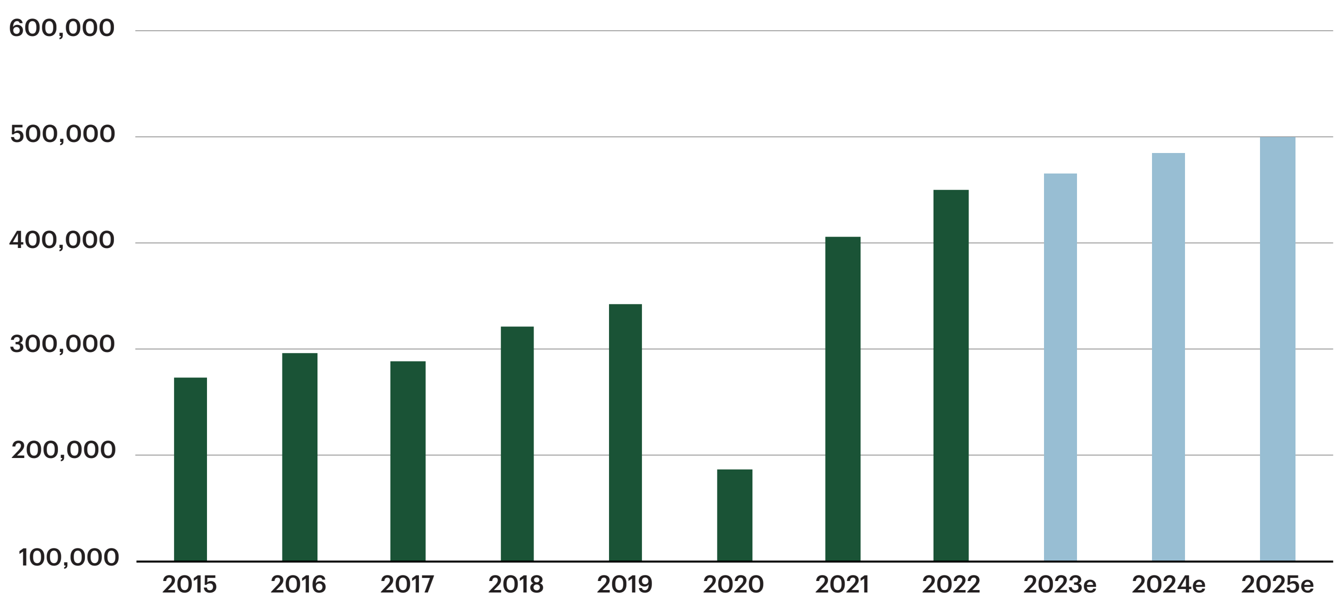
Operating efficiencies — The banks can improve profit margins through digitization and expense control. An increase in cashless transactions and the use of online banking products, for instance, will continue to shift the banks' cost base away from expensive branch networks. Increasing capabilities to analyze big data should also bring the banks deeper insights into customer goals and preferences. The Canadian banks' efficiency ratio (expenses/revenues) was 54% in 2022[2]. This could improve to 50% by 2030 and would be a strong contributor to earnings growth.

Immigration — Another ingredient to growth will be more customers. Canada is very well positioned in this regard. We enjoy the benefit of the rule of law and due process, abundant natural resources, and an educated and growing population. The chart below depicts the amount of immigration to Canada: 400,000+ in recent years, with a target of 500,000 newcomers in 2025. This results in an elevated population growth rate of 1.3%. It may not sound like a lot, but this is 2x to 3x faster than the U.S., U.K. and Germany.

An appealing feature of Canada's immigration system is its focus on economic migrants. Over 50% of immigration fell into the economic category in 2022, a figure that has been rising over time. This is much higher compared to other countries. Economically prosperous newcomers are an important source of depositors and new users of the financial services of the banks.

Immigration to Canada



Source: Statistics Canada as of December 31, 2022.

[2] Source: TD Asset Management Inc.

Acquisitions — Canadian banks also have an opportunity to grow by acquiring other businesses. This is made possible by their conservative dividend payout ratios (below 50%) and ample organic capital generation. Royal Bank, TD Bank, Bank of Montreal and Scotiabank have all made notable acquisitions in recent years. Some were in Canada while others were in the U.S. But they spanned multiple business lines such as banking, wealth management and capital markets. Acquisitions can drive further growth.

Not all bank ETFs are created equal

There are quite a few ETF options available for Canadians that offer exposure to the big 6 Canadian banks. These ETFs can have very similar approaches to their weighting of the various banks. Two of the main strategies are:

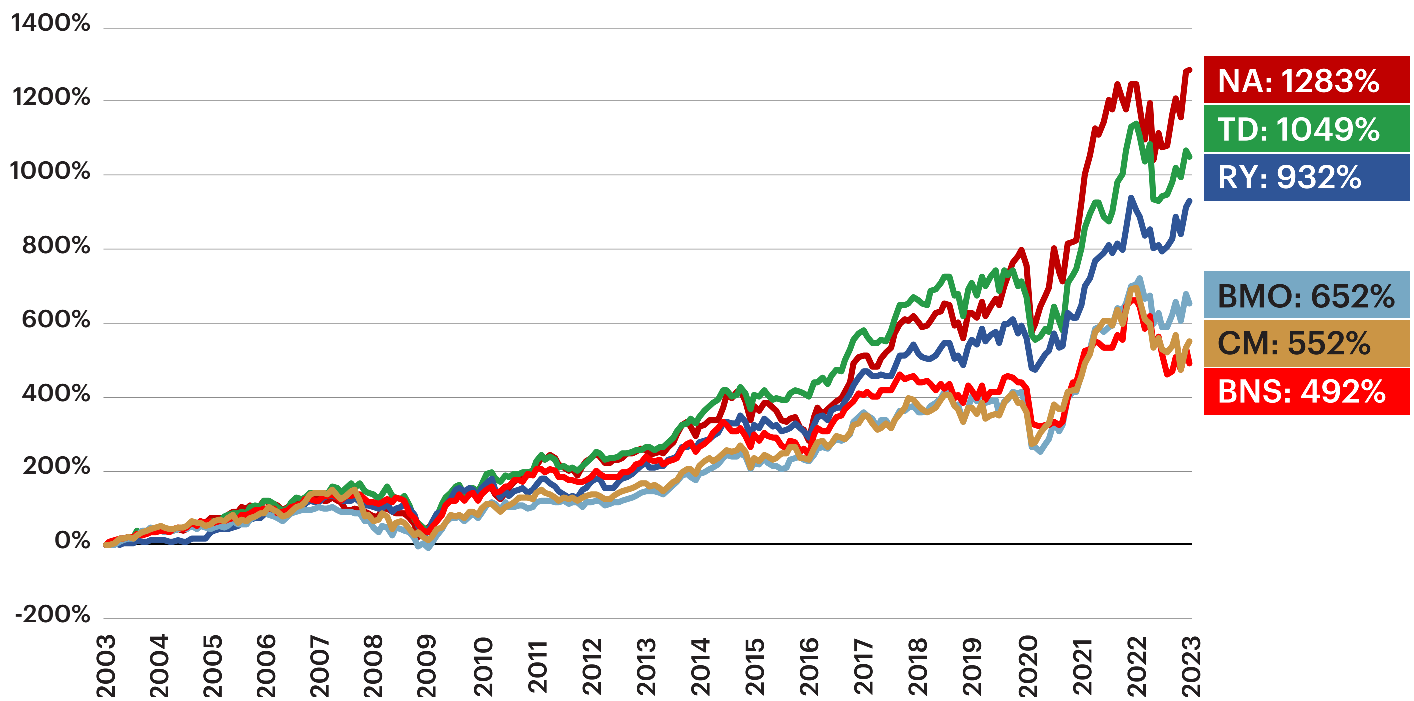
Strategies that provide equal-weight exposure, which invest the same weight in each of the 6 banks.

Strategies that rely on mean reversion, which will put more weight in companies that recently underperformed and less weight in companies that recently outperformed with the idea that they'll both converge to the mean.

The one key element that many strategies have in common is that they rely on the banks performing similarly over the long run. So, have the banks all performed roughly the same in the long run? Not quite.

The chart below shows the last 20 years of total returns of the big 6 Canadian banks. As you can see, after 20 years, although they've all moved towards an upward trend, three banks have outperformed the rest.

Have the Banks Performed Similar Over the Long Term? Not Quite.



NA: National Bank. TD: TD Bank. RY: RBC Royal Bank. BMO: Bank of Montreal. CM: CIBC. BNS: Scotiabank.
Source: Bloomberg Finance L.P., as of February 28th, 2023.

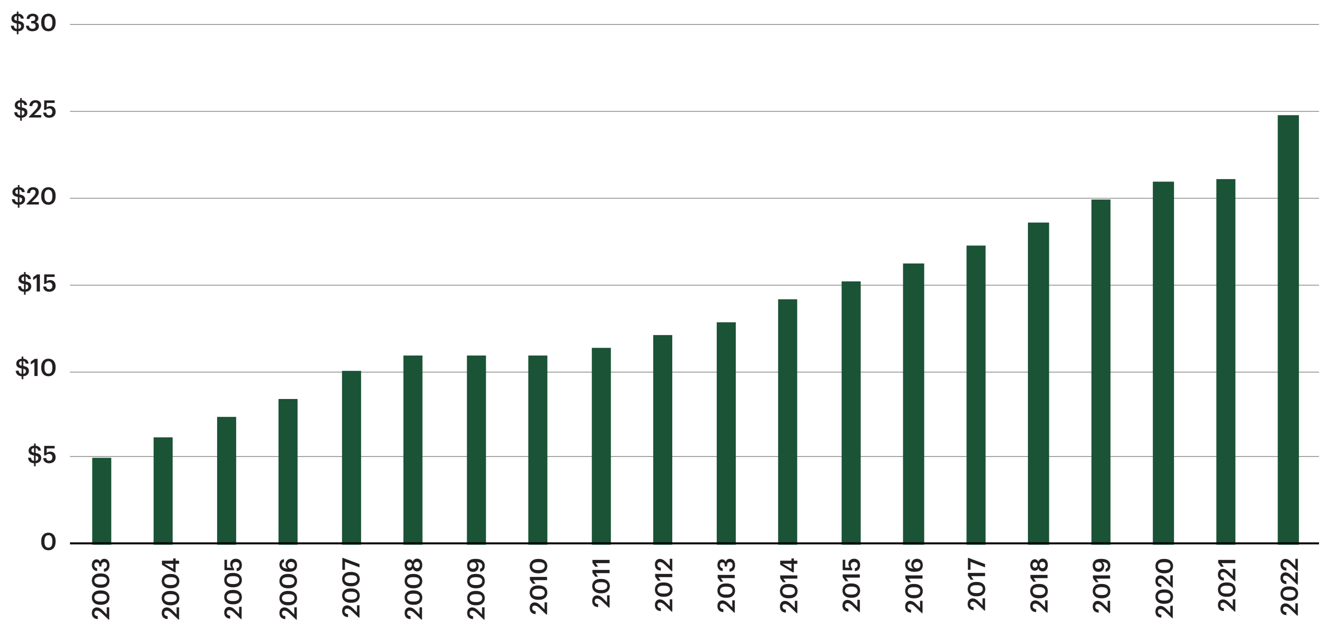
Is earnings growth correlated to dividend growth for Canadian banks?

There is one measurement that is essential to any business, and that is earnings growth. The next question for a company is what they do with those earnings. Three common uses include:

- **Reinvest in the company**
- **Buy back shares**
- **Pay dividends**

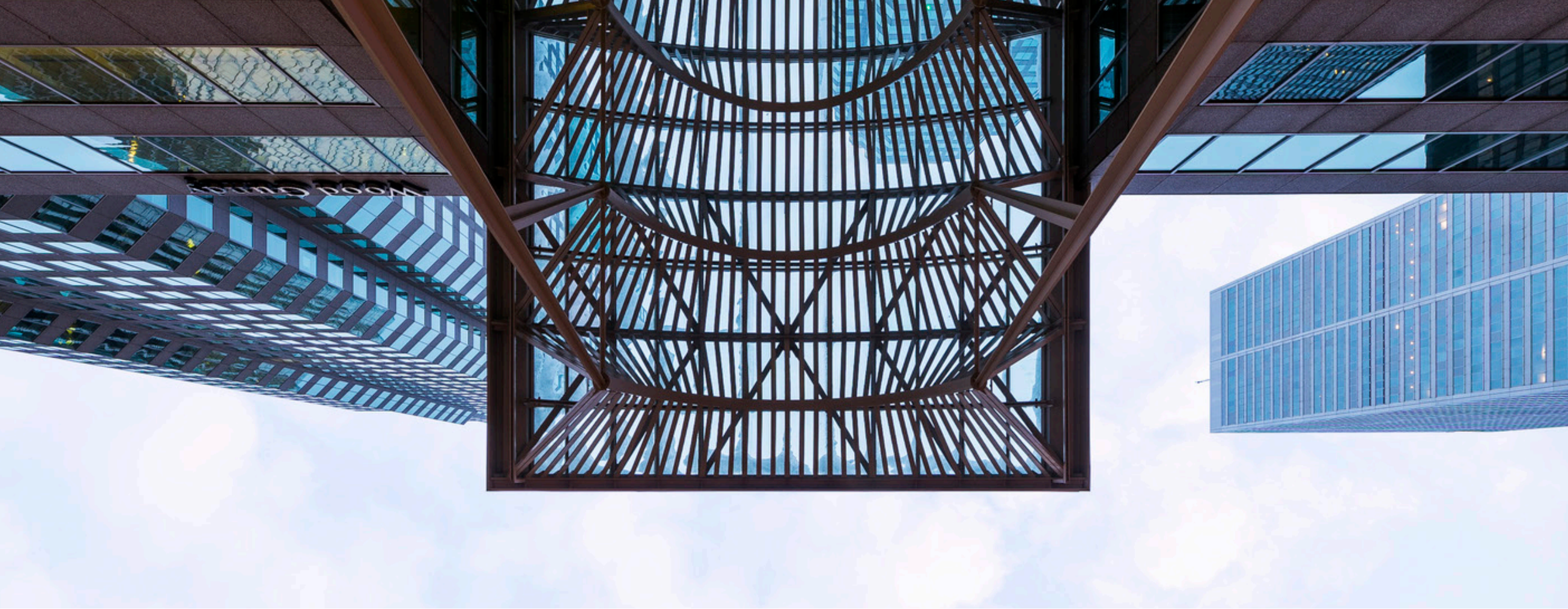
To simplify things, if a company is growing their dividend payments, this is typically a result of strong earnings growth, and if earnings are growing, a company's stock price will rise as well. So have the banks been growing their dividends against the backdrop of strong earnings growth?

20 Years of Aggregated Dividend Per Share of the Six Canadian Banks



Source: Bloomberg Finance L.P., as of December 31, 2022. The above shows the sum of the dividend per share of the 6 big Canadian bank equity securities. Tickers: TD, RY, CM, BNS, BMO, NA.

The short answer is yes. As the chart illustrates, the banks have collectively grown their dividends by almost 400% over the last 20 years. As a collective, the banks have regularly increased dividends over time, but how about individually?



The table below shows how much each bank increased their dividend over the same period.

	National	TD	RY	BMO	CIBC	Scotia
20 Year Performance	**14.05%**	**12.87%**	**12.28%**	**10.35%**	**9.84%**	**9.26%**
Performance Rank	1	2	3	4	5	6
20 Year Dividend Growth	**646%**	**586%**	**560%**	**333%**	**315%**	**415%**
Dividend Growth Rank	1	2	3	5	6	4
10 Year Performance	**14.51%**	**12.16%**	**12.33%**	**11.77%**	**9.31%**	**5.72%**
Performance Rank	1	2	3	4	5	6
10 Year Dividend Growth	**137%**	**146%**	**120%**	**99%**	**81%**	**81%**
Dividend Growth Rank	2	1	3	4	5	5

Source: Bloomberg Finance L.P., as of February 28, 2023.

As you can see above, both in the last 10 years and 20 years, banks that have increased their dividends the most were also the best performers most of the time. In both timeframes, the top 3 performers were also the top three dividend growers. Now, if only there was an ETF in Canada that could use this information to formulate a strategy to Canadian bank investing.

A Unique Canadian bank dividend investing strategy

Leveraging extensive research on the correlation between earnings growth and dividend growth for Canadian banks, TD Asset Management Inc. (TDAM "we", "our") has built an innovative Canadian bank ETF, TD Canadian Bank Dividend Index ETF (TBNK), providing more options and opportunities for investors.

Here is where TBNK is different. We worked with Solactive, an indexing company, to build a custom index that follows a unique rules-based methodology that puts a higher weighting in the banks that grow their dividend the most. Specifically, once a year the index will rank all constituents from 1 to 6, based on their 12-month trailing dividend growth. The best ranked bank will get the highest weighting, the second best ranked will get the second highest weighting and so on. The portfolio then will rebalance to these weights on a quarterly basis.

We believe this to be a more rewarding strategy because banks with the highest levels of profitability, and superior execution through a business cycle, will ultimately increase their dividends more quickly than their peers. As an added benefit of gaining exposure to the Canadian banks, investors can also enjoy a dividend yield of over 4%. This is higher than the broader stock market and has been sustained through past economic recessions. TBNK is an ideal holding for investors looking for income and growth and is suitable for registered and non-registered accounts.

Dividends

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