

LEITH WHEELER INVESTMENT OUTLOOK



Fourth Quarter 2008

Will Canadian Financials Weather The Storm?

American financial institutions are facing the most severe operating environment since the Depression. Financial giants including AIG, Bear Stearns, Merrill Lynch, Lehman Brothers, Fannie Mae, Freddie Mac, Washington Mutual and Wachovia have all either gone bankrupt, been rescued by the U.S. Government or been forced into a sale to a healthier competitor. It is worth reviewing these failures in an effort to make a judgment as to the likelihood of similar failures occurring in Canada.

In an ideal world, a healthy financial company would possess the following attributes:

- a sound business model characterized by above average levels of profitability and a secure and growing dividend
- an earnings stream that is diversified both by product and by geography
- a strong balance sheet and access to a variety of funding sources
- a competent and shareholder-oriented management team

While the list above seems reasonable and obvious, it is amazing how many financial institutions cannot satisfy these criteria. The major U.S. investment banks including Bear Stearns and Lehman Brothers shared a business model that utilized extremely high levels of leverage and relied on narrow sources of funding. These investment banks had virtually no retail deposits and were at the whim of the confidence of other banks and large institutional investors to provide them with liquidity. When this confidence was lost, their basic business model fell apart resulting in Lehman Brothers going bankrupt and Bear Stearns being sold to JP Morgan, a major retail deposit-taking institution. Merrill Lynch, which fortunately had a number of solid, profitable businesses to offset its faltering investment banking division, agreed to be sold to another major retail bank, Bank of America. It is interesting to note that the other surviving U.S. investment banks, Goldman Sachs and Morgan Stanley, were granted deposit-taking licenses by the U.S. government immediately after Lehman Brothers' demise. Clearly, having a variety of funding sources is vital to a financial institution.

In Canada, a period of consolidation occurred over a decade ago that resulted in our large independent investment banks joining forces with our large chartered banks; Dominion Securities was purchased by RBC, Wood Gundy was bought by CIBC, McLeod Young Weir was taken-over by Scotiabank and Nesbitt Burns was acquired by BMO. These Canadian investment banks would likely have been under severe strain in recent months if they had remained independent.

Washington Mutual and Wachovia were both large retail deposit-taking institutions that collapsed under the weight of concentrated bets in mortgage lending. It is not as easy to distance the Canadian chartered banks from these two U.S. institutions, however there are some important differences between mortgage lending practices in Canada and those in the U.S. Importantly, Canadian chartered banks are prohibited from issuing residential mortgages with greater than 80% loan-to-value ratios (the limit was 75% before the last revamp of the Bank Act in 2007). This means that the price of a home must fall by more than 20% before the banks face the prospect of a loss. Mortgages issued by a Canadian chartered bank with higher loan-to-value ratios must be insured by

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a third-party mortgage insurance company (usually government-owned CMHC) that protects the bank for the amount of the mortgage above 80% of the value of the home. A second difference in mortgage lending between the two countries is that mortgage interest is tax-deductible in the U.S. while it is generally not in Canada. The result is that an American homeowner has a much higher incentive than does a Canadian homeowner to leverage himself. Finally, mortgage innovation in Canada has been much more conservative than that in the U.S. It is rare to find “Ninja” mortgages (so named for mortgages granted to applicants that have “no income, no job”) in Canada while these were commonplace in the U.S. over the past several years.

In the cases of Fannie Mae and Freddie Mac, these were publicly-traded, quasi-government organizations in the U.S. involved in the mortgage industry that had the conflicting mandates of maximizing shareholder returns and enhancing the U.S. residential mortgage market. In hindsight, these competing mandates were unworkable and led to massive growth in mortgage origination, sky-high executive compensation, and ultimately, huge loan losses. The companies were effectively nationalized by the U.S. government this summer. In Canada, we have avoided this ambiguity as our national housing institution, CMHC, is 100% government-owned.

The near bankruptcy of AIG does give one pause to reflect. This was the world’s largest and most diversified insurance company with a best-in-class global platform operating in over 130 countries. The problems at the company stemmed from a relatively small division that wrote large volumes of insurance against corporate defaults. When Lehman Brothers went bankrupt, the value of AIG’s exposure to these corporate default insurance contracts soared and terms of the contracts called for it to come up with billions of dollars of cash as collateral. Given the extreme tightening of the credit markets, it was unable to access enough cash and it was forced to accept an \$85 billion loan from the U.S. government which will result in a liquidation of much of the company in order to generate funds to repay the loan. In hindsight, AIG’s risk management practices were not robust enough to allow it to function when credit markets seized up.

When one examines the list of a healthy financial company’s necessary attributes, the major Canadian chartered banks and insurance companies stack up extremely well relative to their global peers. The Canadian chartered banks have diversified streams of earnings that include powerful retail and commercial banking, wealth management, investment banking, corporate lending, and trading businesses. The large Canadian insurance companies have been building out their international insurance and wealth management franchises for over 100 years. The balance sheets, levels of profitability, dividend streams, access to liquidity, risk management practices and management teams of the major Canadian financial institutions are world class.

Our clients’ portfolios continue to have an overweight position in Canadian financial companies. The attributes of these companies will continue to be tested in the coming quarters as the world economy slows, perhaps into recession. Loan loss provisions and bond defaults will rise. However, this is also an environment that presents strong companies extraordinary opportunities. Manulife has an excellent balance sheet and over \$3 billion of excess capital that could be used to make a shareholder-enhancing acquisition, perhaps of some of AIG’s profitable life insurance assets. RBC continues to attract talent as it expands its investment banking and retail brokerage franchises in the United States. There is currently an abundance of such talent. TD Bank continues to look for opportunities to add branches to its U.S. retail banking platform. Prices are down and the number of competing bidders continues to fall.

While the environment for financial companies will remain challenging over the next year, we are confident that the Canadian financial companies in our portfolios will have higher levels of earnings and dividends three years from now and that total returns from current price levels will prove to be attractive.

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