Special Report

Portfolio Advice & Investment Research

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Report prepared by:

Shawn Levine, CFA
Senior Analyst,
Canadian Equities

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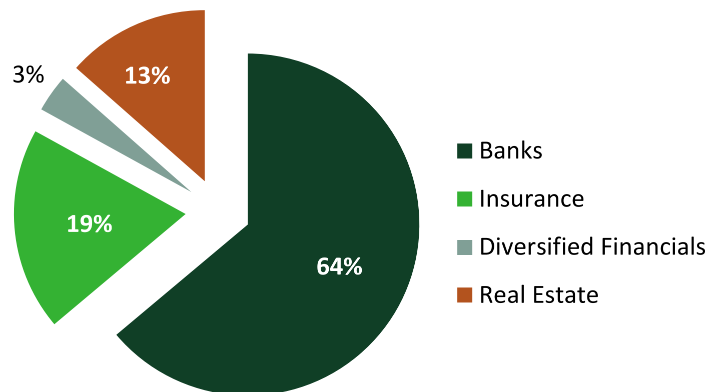
Please refer to Appendix A in this report for important information.

Sector Impact of Higher Rates – Canadian Financials

The magnitude and speed of the recent increase in longer-term interest rates has dominated the financial headlines and has been the topic of many publications. Some of the most heavily impacted sectors have unsurprisingly been the interest-sensitive ones such as telecommunications, utilities and financials. In this report, we discuss the impact of rising interest rates on the Canadian financial sector, focusing on the sub-industries and the companies that are likely to be most impacted.

The Canadian financial sector makes up 34% of the S&P/TSX Composite Index (S&P/TSX). As shown in Chart 1, banks are the largest industry group within the financial sector at 64%, followed by insurers at 19% and real estate at 13%. While the financial sector is classified as interest sensitive, the industries within this sector have varying degrees of interest rate sensitivity and can move in considerably different directions.

Chart 1 – Industry Breakdown of the Canadian Financial Sector



Source: TD Securities S&P/TSX Index Breakdowns, as at July 5, 2013.

Banks

Banks generally benefit from a higher interest rate environment as long as the increase in rates is felt across the yield curve and reflects an improving economy. It is difficult to isolate which banks would benefit most from higher interest rates due to limited disclosures. TD Bank (TD-T) estimates that a 25 basis points (bps) parallel increase in the yield curve would boost annual pre-tax income by approximately $300 million over time (we are research restricted on TD and cannot provide the percentage impact on TD Securities' 2014 net income estimate). Bank of Montreal (BMO-T) estimates the same rate move increasing pre-tax income by approximately $190 million, representing 3.3% of TD Securities' 2014 after-tax net income estimate for BMO.

Perhaps the most direct impact on banks would be on net interest margins, which reflects the spread earned by the bank on its lending and securities books (interest income) over its borrowings and deposit base (interest expense). As long as prudent lending and investing practices are adhered to, the higher the net interest margin, the better. Higher short-term rates would likely lead to improved margins on short-term deposits fairly quickly, while higher medium-term interest rates would gradually improve margins on zero-cost funds as loans re-price/come due. Without getting too granular, not all banks would be equally impacted by higher rates, as it is a function of the relative size and composition of their deposit book (a rising rate environment benefits banks with more low cost funds like chequing accounts) and the competitive environment (deposit-rich banks may be less aggressive on deposit rates). Based on Q2/13 financial statements, TD has the highest percentage of demand and notice deposits to loans among the big six banks.

In addition to the positive impact on margins, wealth management and capital markets businesses could improve, assuming equity markets rally on the improved economic fundamentals; higher assets under management generate higher asset-based fees while trading and underwriting activity would likely improve on increased confidence and reduced capital market volatility. Finally, economic growth may result in increased loan demand, boosting loan growth at a time of higher interest rates. Given the current level of domestic household indebtedness, the appetite for increased credit may be more limited than in previous periods of economic growth.

On the credit side, an improving economic picture should bode well for employment and incomes, which increases the credit quality of the banks' borrowers. That said, impaired loans as a percentage of the loan book is presently at very low levels, perhaps limiting the benefit of higher quality borrowers. Nonetheless, we expect an improved economy to be a tailwind for the banks.

While dividend-paying equities generally lose some appeal as interest rates increase, we believe that the ability of banks to grow earnings and dividends could mitigate some of the outflow of funds from the space. From a portfolio standpoint, we would maintain exposure to the Canadian banks over the medium-term, particularly for income-focused investors. There may be periods of volatility as interest rates move higher or as Canadian housing market concerns heat up, but we believe banks remain a core part of a well-diversified portfolio.

Insurance

Having learned hard lessons from the global financial crisis, life insurance companies have greatly reduced their exposures to changes in macro factors (equity markets, interest rates and credit spreads). This move helped reduce earnings volatility but has also reduced—but not eliminated—the benefits of an improvement in these macro factors. The S&P/TSX Life and Health Insurance Index gained 17% from the end of April 2013 to July 10, 2013, handily outperforming the financial sector and the broader S&P/TSX. Clearly, investors don't seem to mind the reduced sensitivity to rates and equity markets.

Lifecos are more exposed to long-term interest rates than banks. A steepening of the yield curve would be of particular benefit to the lifecos and the impact on profitability could be seen more quickly for the companies that update their investment return assumptions on a quarterly basis (Manulife Corp. (MFC-T) and Sun Life Financial Inc. (SLF-T)). The assumption here is that equity markets do not decline in material fashion to act as an offset. An increase in interest rates precipitated by an improving economic outlook would have positive implications for reserve releases, likely reduce strain from new sales and reduce hedging costs, and would result in higher fee income and higher margins on products with minimum crediting rates. Industrial Alliance Insurance & Financial Services (IAG-T) and MFC are the two lifecos most levered to rates. Income-seeking investors may have to be selective as the dividend yields for the lifecos vary, with MFC and IAG currently yielding below 3% while SLF and Great-West Lifeco Inc. (GWO-T) currently yield more than 4%. We believe dividend increases from the lifecos are unlikely in the near-term but believe that capital appreciation in an increasing interest rate environment may contribute nicely to total returns.

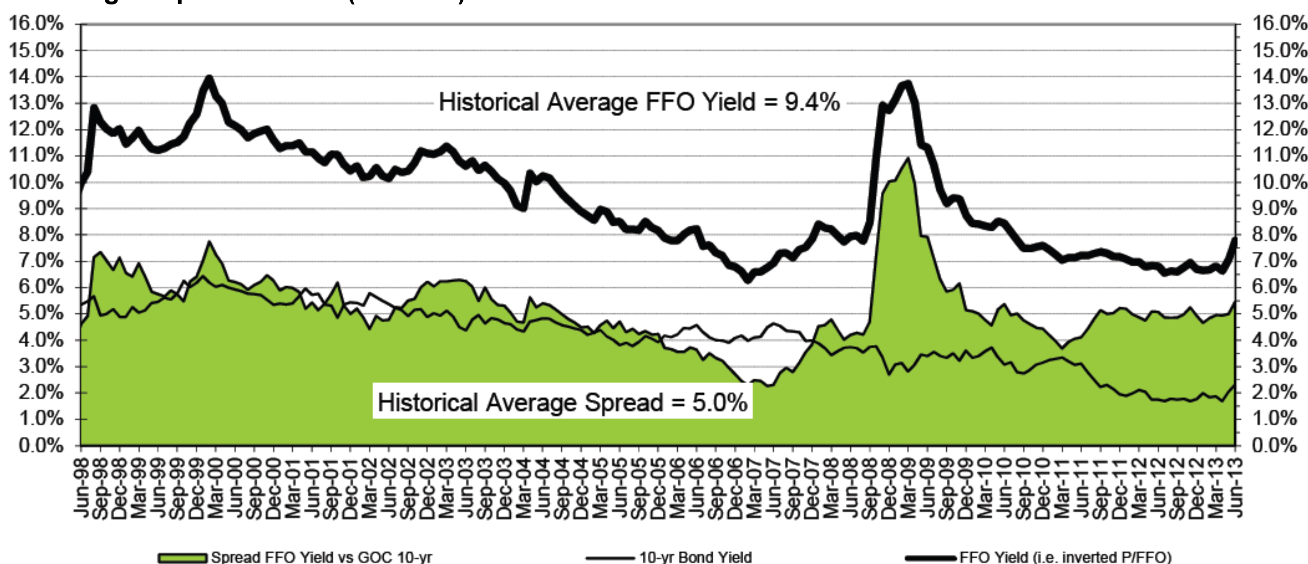
Real Estate

REITs/REOCs (real estate operating companies) have been one of the hardest-hit industries during this recent period of rising interest rates. The S&P/TSX REIT Index has declined 13% on a total return basis from April 30, 2013 to July 10, 2013, compared to a loss of 0.5% for the S&P/TSX. While some REITs may be less impacted than others, when interest rates rise, market values of REITs are likely to fall. The industry has been a beneficiary of the long-term downtrend in

interest rates, not only from higher property prices and interest cost savings on mortgage refinancing, but also from the flow of funds into higher-yielding securities.

A gradual grind higher in rates is more likely to be absorbed by REITs than the sharp upward move we have witnessed in the last two months. As shown in Chart 2, Funds from Operations (FFO) yields (inverse of the P/FFO multiple) have generally tracked the move in government bonds and have compressed over the years as unit prices have climbed. While it gets lost in the long time horizon of the chart, we note that the FFO yield has recently widened by 99 bps, compared to the 79 bps increase in the 10-year Government of Canada bond yield from the same time period in the paragraph above. This indicates that REITs may have overshot somewhat to the downside, a point that many REIT analysts concur with. Initially, the sell-off in REITs was much more severe, perhaps providing higher-risk investors with an attractive entry point.

Chart 2 – Large Cap FFO Yields (ex-hotel) vs. Government Bond Yields



Source: TD Securities.

At present we see no reason for interest rates to continue to increase at the pace they have and therefore expect any further correction in REITs to be limited. We do not know what rates will do in the near term as they are highly dependent on U.S. economic data and U.S. monetary policy, but we do expect them to be volatile. For investors who wish to continue to hold REITs for the attractive yields they provide, there are certain qualities we would look for: superior asset quality, strong AFFO (adjusted funds from operations) growth profiles and relative undervaluation. Expanding on these criteria and recognizing that no REIT will be immune, we believe that REITs with shorter average lease terms that can benefit from the positive spread between in-place rents and current market rates, have some room for occupancy gains (it is harder to grow AFFO when the portfolio has no vacancy) and have higher-cost mortgages maturing in the near future (although mortgage rates have increased, there are still opportunities to refinance at lower rates than mortgages coming due) may be more resilient. TD Securities prefers Dundee REIT (D.UN-T), Chartwell Retirement Residences (CSH.UN-T), Canadian Apartment Properties REIT (CAR.UN-T), Canadian REIT (REF.UN-T) and Brookfield Canada Office Properties REIT (BOX.UN-T). CAR.UN is interesting to us because it meets many of the criteria we noted above. In particular, their leasing portfolio tends to re-price at least annually, a good portion of its debt matures in 2013 and 2014 and apartment REITs like CAR.UN typically have access to low-cost CMHC-insured mortgages, and if interest rates continue to make mortgages more expensive for prospective home buyers, this could arguably help the apartment sector with more people choosing to rent than own. Longer term, we do not expect government bond yields to provide the same level of tailwind that they have for the past 20 years and believe that investors should consider reducing exposure to the sector or become increasingly selective in their investments.

Diversified Financials

While this is a small component of the broader financial sector, several of the stocks in this industry group may be widely held. Since 2000, all six periods of longer-term bond yields rising more than 100 bps saw diversified financials not only outperform the financial sector on a total return basis, but also outperform the S&P/TSX. If the increase in interest rates is due to an improved economic outlook, equity markets could benefit. Positive equity markets should help boost assets

under management and the sales mix would likely be more geared towards higher-fee equity funds, both of which would improve profitability for the independent asset managers such as CI Financial Corp. (CIX-T), IGM Financial Inc. (IGM-T), Gluskin Sheff & Associates Inc. (GS-T), and AGF Management Ltd. (AGF.B-T), which generally have higher exposure to equities than the asset management divisions of the banks and lifecos. From a portfolio context, we would be selective in owning diversified financials but believe that they offer meaningful leverage to improving equity markets.

Conclusion

The industry groups that compose the financial sector all have exposure to rising interest rates but the impact can be considerably different. Depending on portfolio objectives, we would generally recommend paring back on REITs (or at least being more cautious in security selection) and increasing exposure to life insurance companies, who we believe would benefit over the medium-term. While banks have their own set of potential headwinds, they have held up quite well and we believe investors will continue to be rewarded by relative capital stability and growing dividends.

Appendix A – Important Information

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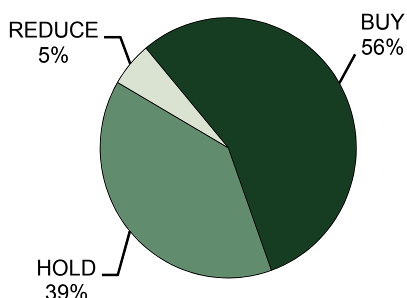

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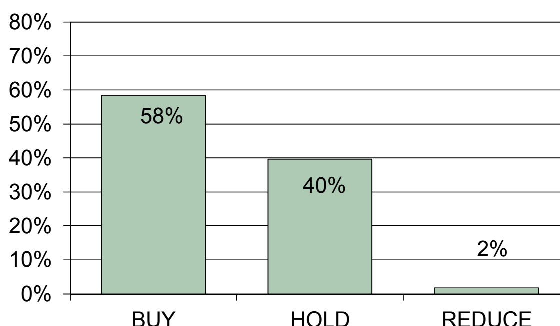

Current as of July 5, 2013

^ Percentage of subject companies under each rating category—BUY (covering Action List BUY, BUY and Spec. BUY ratings), HOLD and REDUCE (covering TENDER and REDUCE ratings).

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