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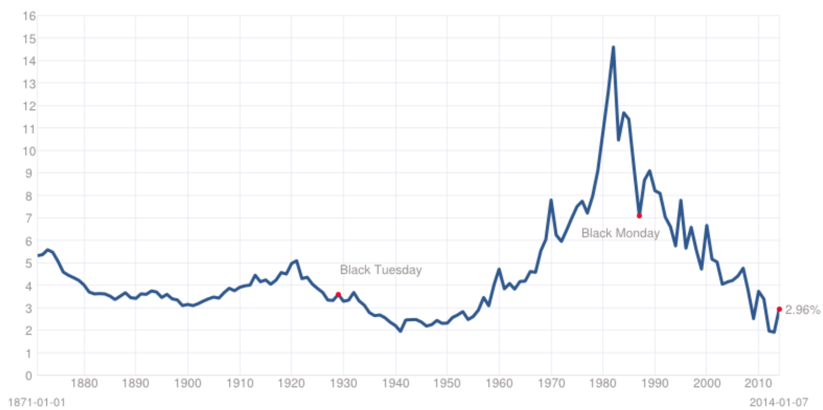
Focus on Fundamentals, not Fuzzy Forecasts

The question of what happens when interest rates rise is one that has no clear answer. Many investors are trying to understand the impact of a rising rate environment on the equity markets so they can invest accordingly. Interest rates remain near historically low levels, but some investors are assuming that we may have already started, or may soon be starting, a prolonged move higher. It has been a long period of time since there was a sustained increased in interest rates (see following graph), so the collective knowledge is somewhat uncertain regarding the implications for equity markets. Sionna continues to believe that the most successful investment approach, regardless of the interest rate environment, is to find quality businesses at attractive valuations and invest for the long term.

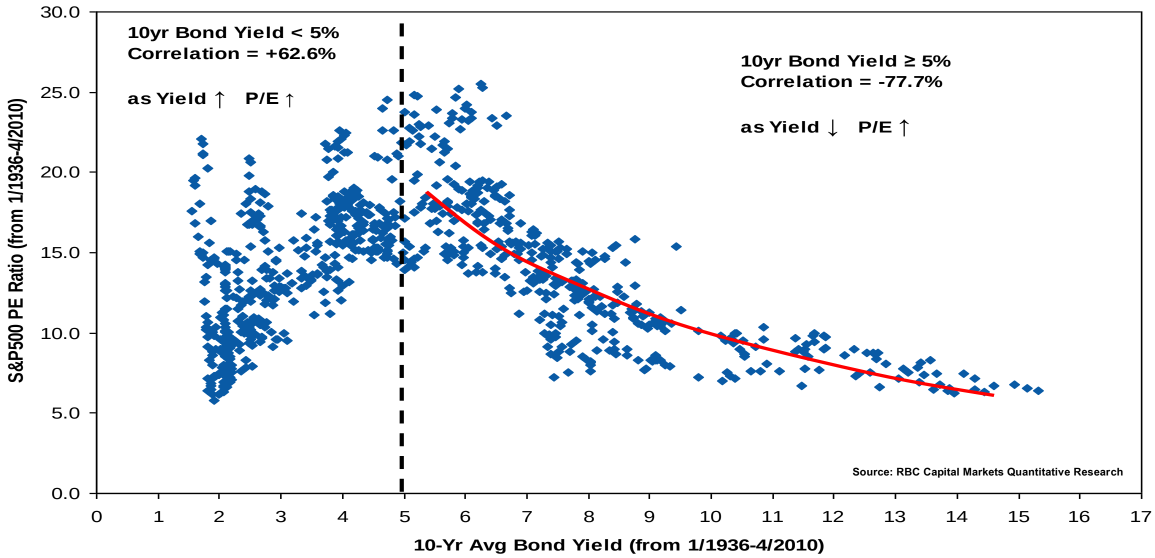
10 Year U.S. Treasury Rate (Percentage)



Source: U.S. Treasury and Robert Shiller, as at January 7, 2014

Generally speaking, the conventional thinking is that higher interest rates are bad for stocks. The logic behind this assumption is that if a stock price reflects the present value of future cash flows, then an increase in interest rates will increase the discount rate in the present value calculation, which will depress prices. This line of thinking explains why the recent changes in interest rates are of such great concern to equity investors. However, research indicates that, in both Canada and the U.S., the actual impact of rising rates on historical equity market returns has been largely unpredictable and inconclusive. The level or trajectory of interest rates does not necessarily correspond with particular equity market performance.

Besides looking directly at market returns, we can also examine the impact of interest rates on stock price multiples. Research suggests that interest rates and price-to-earnings multiples of common equities tend to be negatively correlated, which would suggest that an environment of rising interest rates would depress multiples. However, research also indicates that this relationship breaks down when interest rates are low. The graph below illustrates how the negative correlation of interest rates and price-to-earnings multiples is quite strong when rates are above 5%, but the correlation actually reverses when rates are below 5%. Given the current low level of interest rates, it may be that rates can move up, for a time, without putting downward pressure on equity multiples.



Source: RBC Capital Markets Quantitative Research

In addition to examining the equity markets broadly, we can also look at the impact of interest rates on particular industries. What is most apparent from such an analysis is that there is no clear answer as to how industries will perform – the impact will vary greatly depending on the individual business and its unique position.

If we make the assumption that interest rates rise due to an improving economy, then rising rates may be positive for many businesses, particularly cyclical ones. Energy companies may benefit from growing demand for their commodities. Technology and industrial companies may benefit from rising product demand. Insurers may benefit from lower provisions for future liabilities, while banks may benefit from improved margins on their deposits and higher spreads on their loans. For consumer companies, higher interest rates may reduce disposable income and depress spending, but if accompanied with solid economic growth, may result in employment growth, which is positive for consumer spending.

On the other hand, for businesses that rely heavily on debt, rising interest rates will mean an escalating cost of debt, higher interest expense, and lower project returns. Ultimately, this can negatively impact the earnings and cash flows of the business. Energy infrastructure companies, in particular, have benefited from the falling interest rate environment because their cost of debt has been declining – a tailwind that will abate if rates rise. That said, many utility and power companies have interest rate protection mechanisms built into their contracted and regulated assets, which may mitigate the risks of rising rates.

Real estate investment trusts also tend to be heavily indebted, and therefore could be negatively impacted by higher borrowing costs. Yet even this relationship is arguable because real estate operators often have pricing power to pass along higher costs by raising rents during a rising rate environment, albeit with a time lag. Telecommunications companies may also be negatively impacted by higher borrowing costs, but this may be partly offset by lower pension obligations (which are especially material for telecommunications companies).

While we all may want a clear answer as to what happens when interest rates rise, the impacts are by no means certain – some businesses may benefit, some may be challenged, and many will experience both benefits and challenges. Further, while it may appear that interest rates will rise, it is also possible that rates remain at these low levels for longer.

Irrespective of interest rates, Sionna invests in individual companies and management teams – we do not invest based on the potential future direction of interest rates. We remain focused on finding healthy businesses that have sustainable earnings and cash flows. We prefer businesses that have solid competitive positions and conservative levels of debt. Ideally, these businesses are led by strong management teams that are skillful at capital allocation. We believe that such businesses, if purchased at attractive valuation levels, will provide stability in the near term, and will prosper in the long term, regardless of the interest rate environment. By staying focused on these fundamentals, we believe our strategy can provide an appropriate balance of downside protection and above-average returns over the long term.

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