Interest Rates:

A Friend and Foe to Growth Stocks

> "Interest rates are to asset prices what gravity is to the apple. When there are low interest rates, there is a very low gravitational pull on assets"
>
> – Warren Buffet

As another quarter is behind us, it feels we're one step closer to returning to normal times. The stock market concurs, as the S&P 500 was up 6.2% for the first quarter of 2021. However, there's always more to the story than what the headline number reveals. We saw a modest shift in performance leadership among stocks, as the companies that thrived during the pandemic began to underperform (particularly high-growth, technology companies) while companies more negatively impacted in 2020 began to gain steam (such as small-cap, mid-cap, and "value" stocks). Simultaneously, the 10-year US Treasury Bond yield rose from 0.9% to 1.7%. A sizable move in a short period of time.

Mr. Market's decreasing appetite for large, fast-growing tech stocks and the rise in interest rates are more related than you may think. The good news is that rates are generally increasing because the US economy is recovering and returning to growth. The potential for modestly higher inflation also matters, which seems likely in the near-term (long-term is still up for debate). **But the bottom line here is, at least for the time being, many of the fastest growing stocks have shown sensitivity to rising interest rates.**

How can this be? It would seem on the surface that these fast-growing companies should be the least concerned about interest rates. They tend to use limited, or no debt, and they rarely pay dividends. However, it has very little to do with how interest rates impact the company directly and everything to do with how these companies compare to other investment options – with interest rates as the guidepost for expected returns. **Warning:** The following may sound like technical mumbo-jumbo, so feel free to skip ahead to the next page for our key takeaways – rest assured, we think about this stuff a lot, so you don't have to.

Warren Buffet has stated on multiple occasions that the valuation of every asset is dependent on what the general level of interest rates are (namely, the 10-year US Treasury Bond). **Like the law of gravity, when interest rates are expected to stay low, the future stream of profits from an investment are more valuable to an owner versus when interest rates are high.** Think of it this way: the "bogey" (or hurdle rate) is the expected yield you get on a government bond, as this is viewed as the closest thing to a risk-free investment out there. **The rate of return someone should get for any asset is at least equal to that risk-free return; and furthermore, commensurately *higher* to reflect the level of additional risk (or uncertainty) accepted by that investor (higher risk = higher expected return).**

Therefore, as the expected cash flows for high-growth stocks are **back-end weighted** in future years (perhaps significantly so if current profits are minimal), then the "market" will value those future cash flows higher when the alternative rate of return (risk-free interest rate) is lower. For example, if you put $100 in a bank account and expect to get only $1 per year (1%) for the next ten years (in addition to your original $100 back at the end), you'd certainly be willing to pay more than $100 now if you had the option to get a $120 lump-sum in ten years. But if that annual income stream goes up to $2 per year (2%), the lump-sum option becomes equally, or even less, attractive (as you might prefer getting your money sooner so you can spend or reinvest it). **This is akin to comparing a slow-growing, dividend paying stock like AT&T to a fast-growing (and newly profitable company) like Peloton.**

This is a *very* technical concept, we know, but what we want you to take away from this is:

1) Big interest rate moves act like a large lever that can pull asset prices up and down.
2) Over the past year, the sizable decrease in interest rates created a tailwind for certain assets (not just stocks, but take a look at things like real estate, and non-traditional assets).
3) Not all investments are treated equally by the move in interest rates – when rates drop, large future cash flows become more valuable relative to a shorter-stream of near-term cash flows, all else equal.
4) **Again, like gravity, what goes up must come down if the current market value is not fundamentally supported.** However, as we don't live in a vacuum, we must take other considerations into account (see right).

Lest we run the risk of oversimplifying this concept, we should point out that, as with many things in the complex world of finance, reality is much more nuanced. First, what really matters is what actual interest rates are, not just what they are expected to be. That is unknowable. But what we can do is make estimates based on probability. **Finally, we have to remember that the market often behaves differently than theory – for example, if interest rates are increasing due to hope for better growth (which is true right now), then the sentiment of the market can stay high in spite of the theoretical framework we just discussed.**

This is where sound judgment and a solid plan come into play. From an investment strategy standpoint, we take a pragmatic view on investing in long-term growth. We believe there is substantial value buying growing businesses and owning them for a long time. But it is important not to over-pay for those expected future profits. Additionally, we have forgone investing in highly speculative companies. Instead, we seek proven, durable businesses with a clear line of sight to future profits (not hype and overpromises). And when it comes to bonds, we build portfolios while considering the risks of both increasing and decreasing interest rates, with a laser-focus on cash flows and quality.

As we've quoted before from Howard Marks: *"You can't predict. You can prepare."*

We'd like to close with some good news!

It is with great pleasure and excitement to introduce two new members to the NPF team: Grace DeMann and Dave Doppel. Grace and Dave will serve on our Client Relations and Operations team, respectively. We maintain our commitment to deliver top-notch service and investment management to our clients, and these two wonderful individuals bring tremendous talent to the table. If you have a chance to speak with either of them, you will certainly find them delightful.

The team at NPF extends our gratitude to our clients, especially as we've navigated challenging conditions for more than twelve months now. It is a pleasure serving as your trusted advisors, and if there is anything we can do to make the experience better, please let us know. As always, feel free to pick up the phone and give us a call if you have any questions or just want to chat.

Sincerely,

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