GROWTH, GROWING AND GROWN UPS: MATURE INVESTMENT IN A RISING RATE WORLD

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May 02, 2022 11:59:18 PM | 7 MIN READ

It may sound like a bad joke: “What do prisoners, senior citizens and market investors all have in common?” But for a certain subset of each, the answer is very real: *Chronophobia*, or fear of the future. Classified in the DSM-5, its sufferers are often characterized by acute anxiety or distress when pondering future events. Prisoners might understandably suffer from it due to the length of their prison sentences and senior citizens, sensing the impending end of their time on earth, might also be justified. Market investors and their irrational fear of rate hikes, however? They simply need to *grow up*.

Growth vs. Growing

Part of the problem, in our opinion, is a misunderstanding of how interest rate increases operate in the real world. Common perception is that higher interest rates make credit more expensive and, therefore, act as a tax on a borrower’s profitability. While this is largely true in the short term, it causes people to jump to a conclusion that is far from a logical tautology. You see, many investors see rising interest rates as a signal to shift from growth to value-style companies. They believe that the so-called “blue chips” are steeled against rising rates and, therefore, are more secure. And they knock growth stocks on the basis of higher loan servicing and related costs.

At New Age Alpha, we contest this notion. We believe there’s a chasm-wide difference between “growth” and “growing.” Over the long term, the impact interest rates have on valuation is a much stronger force than the cost of credit. This is because stocks are worth the present value of their future cash flows. But what does “present value” mean? It means the amount of the future cash flows discounted by the interest rate (sometimes called the "discount rate.") In other words, as interest rates go up, so too does the discounting of future cash flows, making those future cash flows now worth less. And also, the stock.

Don't Cry Over Spilled Milk

For a long time, it felt like the market was only asking one question regarding interest rates: "will they?" or "won't they?" But this type of market forecasting didn't account for what may actually happen *after* such increases. This is where we find ourselves now, amid a very large rotation from growth to value stocks. In this case, investors anticipated the rate change and effectively repriced stocks before it even occurred. This drove the price of value stocks higher while beating down growth stocks, meaning the former now required *more* growth while the latter required *less*. And who do you think is going to win that race?

Worse yet, this macro-movement ignored research showing little relation between interest rates and the ability of value to outperform growth. For example, Thomas Maloney and Tobias Moskowitz, in a 2020 working paper, argue that the relationship between rates and value stocks is too complicated to pin down and any observed correlation is likely random variation.

In essence, the best-case scenario for those investors flocking to value is that interest rates do, in fact, impact growth stocks and they merely overpaid for safety. But if interest rates do not have such an effect? They may have sold growth at a loss and paid a premium for value.

Because, you see, that's the most important question to ask: What is the probability a company will fail to deliver the growth implied by its stock price? A great company at a bad price can actually be a terrible investment. Meanwhile, a so-so company bought as a bargain can be a slam dunk. That's why it's so important to focus less on scary macro-market movements and more on a company's probability of delivering growth.

Responsible Adults

At New Age Alpha, we put a number to this probability. It's called the H-Factor. It's New Age Alpha's proprietary methodology designed to systematically measure the amount of vague and ambiguous information impounded into a stock's price. By putting a number to this risk of human behavior—the Human Factor—we believe we can measure it and avoid it. In this way, we believe we can produce a differentiated source of outperformance in any investment universe by aiming to simply avoid the losers.

As we showed recently in a companion piece about interest rates, the link between rates and future stock returns is distorted at the very least, if not utterly uncorrelated. This makes certain investors' Chronophobia all the more bewildering. Just as most grown-ups know the boogie man isn't real, so too do they recognize that a single action often results in varied, unpredictable actions a la The Butterfly Effect. In a complicated market full of unintended consequences, rising interest rates are merely a single action bound to result in myriad reactions. It's downright childish to think otherwise.

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Bibliography

Thomas Maloney & Tobias J. Moskowitz, “Value and Interest Rates: Are Rates to Blame for Value’s Torments?” https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3608155, SSRN. 6/16/2020. Access Date: 4/25/22

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