Let’s say you were thinking about buying a rental property. If rates are low, like there are today, your cost to borrow the money to purchase the property would be lower than at other times in history. Because of the low rates, there are not as many properties on the market as one might like so prices are a bit high, but that can be made up for since you will be able to charge rent at a high enough level to cover that acquisition cost. Supply and demand dynamics and the frictional cost of capital combine to form an equation which allows you to make a rationale decision about whether to get involved and at what levels.

In some ways, this analogy carries forward to the equity markets and how they are performing. Interest rates at generational (if not all-time) lows are having impact on the calculations one makes when looking at allocation decisions. In the not so distant past, one could have achieved a mid-single digit return in long-term risk free U.S. Treasury bonds. This guaranteed rate of return meant that in order to purchase stocks with no guaranteed return one would need to pay much less today for the potential of future returns in stocks. In other words investors attempt to reduce the risk of not having a guaranteed rate of return by putting less capital at risk up front. This discount would serve to help offset the generally more risky nature of stocks and entice investors to forego the guaranteed rate. With interest rates at current levels the discount that would otherwise need to be present has been virtually eliminated. There is no need to be compensated for giving up a guaranteed return of 1% or 2%…or less.

This view of how the interest rates have affected the current value of future cash flows generated by stocks can help explain why the market has generally gone up over the past several years despite a noticeable decline, or at least slowing of earnings being generated by these companies. Like the rental example above there are not enough stocks to absorb the cash chasing them so the prices are rising. Investors that had been bond buyers are now engaged in buying stocks. With this increase in demand stocks are selling for higher prices relative to what they earn than they have in the past. Some call this phenomenon a “pulling forward” of future earnings.

Our concern is simple. When rates begin to rise, won’t the same logic work in reverse? When rates increase investors would need to buy those stocks at lower prices than before in order to compensate him/her for the extra risk relative to the prevailing guaranteed rate. As rates increase many equity investors will re-work the math on their plans and opt back into fixed income…selling stocks to do so. These price pressures might be offset to a degree if company earnings are also increasing, but so is the cost of doing business. In the end we would argue that it is possible that we enter a period of rate increases in which companies actually have good or growing earnings, but their prices decline…the opposite of what we have been experiencing. In other words, we believe that ultimately the price paid relative to actual earnings will revert to the long term mean.

If our view has merit it stands to reason that rising rates would have to create an off-setting event for the markets to eventually balance. This decline could be even more pronounced for specific companies if they had too much reliance on debt or were selling with too much hope pinned to future growth. It is a difficult situation because for nearly all of us some level exposure to equity markets is required in order for us to attain our goals. This makes it all the more important that any investments in equities be made with an eye keenly focused on old-fashioned fundamentals. In our view, possible future earnings and potential new products should be a secondary consideration to actual earnings, cash balances, and so forth. As usual, fundamentals matter most when most are disregarding them.

As always, thanks for your time and your trust. Please call on us anytime.
Mail, mail, and more mail...

Many people have recently commented that it seems that there has been an increase in the volume of mail received from us. We have no way to measure that to confirm, but as clients ourselves we would say that we agree. Unfortunately, much of the mail sent to clients is mandated via some regulation. While we do believe the intent of most of these requirements is to provide more transparency and clarity regarding financial institutions, it seems the result for many has been more confusion and frustration. We apologize if you have experienced those emotions, but we must say that it is something we have precious little control over.

One of the items in particular that gets referenced in conversations on this topic is the material we call “security litigations”. It does seem as though the frequency of these is increasing as shareholders appear to becoming more aggressive in questioning management decisions, often resulting in these class actions litigations towards public companies. Adding to the confusion and frustration is the fact that clients will often receive this material even though they did not own the particular stock during the specific time period covered by the action. If you get these items and do not notice that there is a place for a signature you can be assured that it is simply an informational piece and does not require further action on your part. If you get one and notice there is a place for a signature please forward it in to us and we will research it to see if you are an eligible participant. If so we will provide the necessary documentation and return it.

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