

“In a rising-rate environment, stocks with high dividend yields tend to do poorly. It’s like owning a bond.”

- *The Wall Street Journal*

“Yield equities generally follow the bonds.”

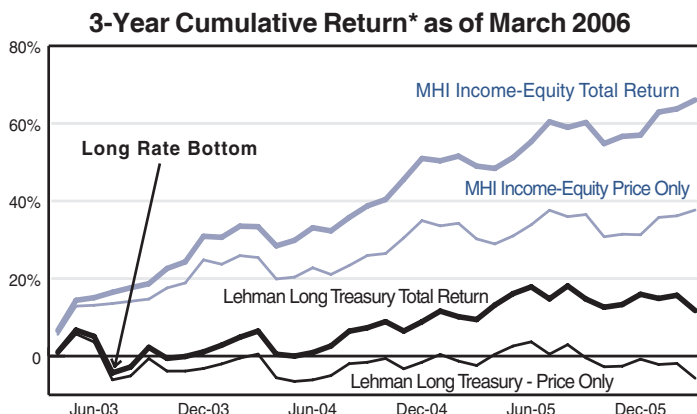
- *Analyst on CNBC*

How do these old wives’ tales get started? We don’t know, but they do, and the notions are constantly re-inforced by naïve commentators and journalists in the media who pounce on one data point that may agree with their received notions and ignore all others. No matter how it started, however, such “wisdom” is found everywhere in investment periodicals and research these days because of two factors: 1) income-oriented stocks have had a spectacular run, and 2) long-term interest rates have been moving up, pushed by the Fed’s hikes to the discount rate. Everyone knows that rising interest rates mean that high income producing stocks will underperform the broader market...don’t they? Actually, both theory and fact show that, if anything, the opposite is true.

To understand why rising interest rates hurt growth stocks more than income stocks we need to look at a bond market measure called duration. Duration measures a bond’s sensitivity to interest rate changes just as beta measures a stock’s sensitivity to changes in the overall stock market. A typical thirty-year U.S. Treasury bond has a duration a little over 14 at this time, meaning that if interest rates rise (or fall) one percentage point, the price of the bond will drop (or rise) about 14%. As even a beginning CFA candidate knows, all else being equal, a bond with a higher coupon rate (annual cash payments) has a lower duration than a bond with a lower coupon rate, and that zero coupon bonds (which are bought at a deep discount to their face amount and don’t pay any annual interest payments) have the longest durations of all. In other words, bonds that pay more cash sooner have less sensitivity to interest rates than do bonds that pay little or nothing in the interim but have a big payout at their maturity. Just as bills fluctuate less than long-term bonds, the more time it takes to get your money, the more changes in interest rates and the compounding effect on those changes affect the price of a security.

Over twenty years ago, a colleague’s firm was, among other things, trying to develop the concept of “Equity Duration”, calculating the effect of changes in interest rates

on stock prices. They found that because of the many factors influencing interest rates, especially economic activity and its effect on profitability, it was very difficult to calculate a concrete number like the 14 for the thirty-year Treasury Bond mentioned above; there are just too many moving parts. However, they did find that Equity Duration was a useful tool to rank stocks from most interest rate sensitive to least sensitive. And they found that, just like with bonds, stocks that pay more cash sooner (income stocks) have less sensitivity to interest rates than do stocks that pay little or nothing in the interim but have a big payout when you sell them (growth stocks). Income stock prices are actually LESS sensitive to changes in interest rates than are prices of growth stocks. Bear in mind here we’re talking about large changes over broad time periods; small changes can always prompt sector rotations which may look like rate-related effects but soon fade.



Income Received on \$1 Mil Investment Since Rate Bottom

Long Treasury**	\$144,000
MHI Income-Equity*	\$208,000

You don’t have to take our word for it either. Last year David Blitzler and Srikant Dash, analysts at Standard and Poor’s, wrote a research paper on equity duration that said in part: “Based on our empirical model, duration (or interest-rate sensitivity) is higher for high-growth stocks” (Blitzler, David M., Dash, Srikant, “Equity Duration – Updated Duration of the S&P 500,” Standard & Poors Company, January 4, 2005, www.standardandpoors.com). Their report confirms what we had learned in the early 1980s.

*Gross of fee performance numbers. Performance and dividend income numbers were taken from an actual representative account.

**Long Treasury rate assumed to be 4.8%.