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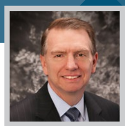

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What Do Rising Interest Rates Mean for Equity Investors?

Investors are experiencing a prolonged period of historically low interest rates in the wake of "The Great Financial Crisis." While the Federal Reserve has been pursuing a gradual hiking trajectory since December 2015, except for a brief spike in late 2016, longer-term rates have essentially remained range bound against a backdrop of tame inflation. However, with the 10-year Treasury yield recently breaking through the 3% barrier, many advisors and clients may be pondering the impact on equity valuations should rates continue to rise out on the curve.

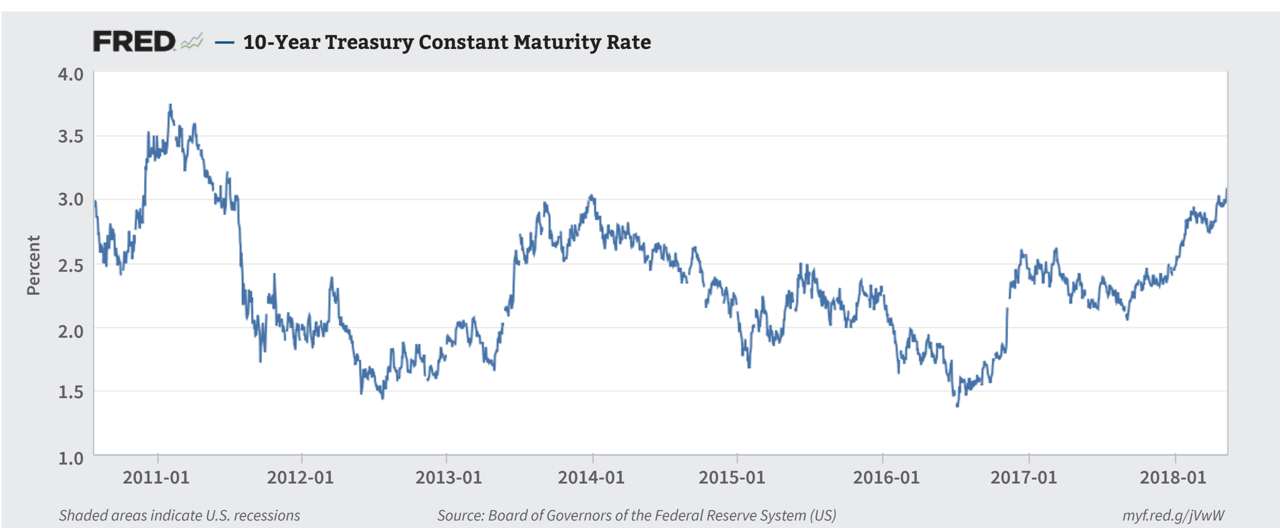
Indeed, while the market maintained its relentless upward trend to open 2018, stocks moved sharply lower upon the release of January employment data as wage growth surprised to the upside, raising the specter of accelerating inflation and higher interest rates. This signaled that — after a 2017 in which stocks more or less ground steadily higher — volatility has returned to the forefront.

Day-to-day market movements aside, what are the implications for equity investing should we see a continuation of the upward movement in rates? For starters, we view market timing as an exceptionally difficult exercise and would not advocate a broad-based exit from (or piling into…) equities. That said, our analysis suggests that there may be opportunities to position client portfolios for potential success if we experience a sustained rise in longer-term rates.

Recent Performance by Market Cap in Periods of Rising and Declining Rates

Regardless of how you slice the data, large-cap stocks have experienced an extended period of outperformance going back several years. However, the experience has been that small- and mid-sized companies have led performance during intervals of rising interest rates from August 27, 2010 through May 15, 2018.[1]

While interest rates have been low for several years, there have nonetheless been peaks and valleys over this stretch. This chart utilizing Federal Reserve Economic Data (FRED) shows the level of the 10-Year Treasury bond yield from August 1, 2010 (thus capturing the last time the 10-year yield exceeded 3%) through May 15, 2018.



Past performance does not indicate future results. | *FRED® Graphs ©Federal Reserve Bank of St. Louis. 2018.*
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[1]Source: FactSet

As the FRED chart shows, there have been several periods of both rising and declining rates in recent years. Specifically, since the beginning of 2010, we assess that there have been five time periods when rates displayed a meaningful upward trend and six when rates displayed a meaningful downward trend. We studied the performance of small, medium, and large company stocks through these ups and downs.

The table below summarizes the performance of all three market cap segments across periods of rising and declining interest rates (as reflected in negative and positive performance, respectively, for Treasuries).

Equity Performance by Market Cap: Rising and Falling Rates* August 1, 2010 – May 15, 2018

Interest Rates **UP** (Average Equity Price Returns)		Interest Rates **DOWN** (Average Equity Price Returns)	
iShares 20+ Year Treasury Bond ETF	-15.4%	iShares 20+ Year Treasury Bond ETF	27.4%
SPDR S&P 500 ETF Trust	15.9%	SPDR S&P 500 ETF Trust	5.6%
iShares Russell Midcap ETF	18.6%	iShares Russell Midcap ETF	2.9%
iShares Russell 2000 ETF	23.9%	iShares Russell 2000 ETF	-2.2%

* *Excludes dividends and interest.*
Source: FactSet

Past performance does not indicate future results.

As we can see, the data clearly indicate two things:

1. *Equities, in general, experienced stronger performance when rates were rising during this period.*

2. *While large-cap performance held up better when rates declined, smaller companies provided a comparable performance advantage when rates were on an upswing.*

While past performance is no guarantee of future results, we believe this information is at a minimum food for thought for advisors who anticipate a period of rising interest rates as they position client portfolios.

From the FAM perspective — we focus on quality companies and our value-oriented selection discipline regardless of the macroeconomic backdrop. That said, should the interest rate environment normalize, we believe a portfolio of well-managed businesses that do not carry excessive debt could be positioned to provide attractive relative performance.

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