ROGER MONTGOMERY

Re-inventing the way you invest

A Montgomery Thought Piece

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Interest Rates

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Interest rates have been a common subject in the media throughout the year, and in the lead-up to Christmas many commentators are forecasting further rate cuts for 2013. At Montgomery Investment Management, we do not speculate on the direction of interest rates, remembering that for many decades they have been changing and yet vast fortunes have been made from long term stock market investing.

We simply invest in undervalued companies that have the ability to earn sustainable, excess returns over any period of the economic cycle.

It is, nevertheless, important to understand the function of interest rates in the economy as well as their underlying impact on businesses and our investing.

Everyone is acutely aware of the impact of low interest rates on deposits. Long gone are the days when working for a lifetime and saving a million dollars meant you were financially secure. Now a million dollars in the bank earns about $40,000 a year. This compares to the minimum wage of $31,000 and the Newstart allowance (the dole), which is $12,700. Being a millionaire isn't what it used to be.

But the subject of low rates adversely impacting the income of retirees has been covered extensively here and in the media.

What we'd like to do today is explore the function of interest rates in the economy, their underlying impact on businesses and how interest rates impact the investment decision.

Interest rates have an impact on a household or business's willingness to spend or to save. Put simply, interest rates reflect the opportunity cost of money, where higher rates encourage bank deposits and deter borrowings, while lower rates encourage spending and accumulation of debt. If this is the case, then why has there not been record amounts of spending and borrowing during this period of historically low cash rates?

This relationship is influenced by the outlook for the economy. Households will not be willing to draw down on their savings while the economy looks grim, even if interest rates are at low levels that would normally encourage spending. In the current climate, investors are cautious about taking on high levels of borrowings, given the implications of having cash rates at the same level as the emergency cuts at the peak of the Global Financial Crisis (how to stimulate the economy is a discussion for another day…)

It is also reasonable to assume there is a diminishing marginal utility associated with declining rates. In other words, all things being equal, a decline in rates from 10% to 5% is likely to have a bigger influence on borrowing decisions than a drop from 5% to 2.5%. If you weren't going to borrow a ton of money at 5% you aren't likely to do so at 2.5%.

Let's have a brief look at three aspects of a business that can be impacted by the current interest rate climate; revenues, currency exposure, and capital structure.

Revenues - As discussed above, earnings in some industries will be impacted as consumers are unwilling to spend their money until prospects improve. While extraordinary companies are not immune to a downturn in the economy, their competitive advantages should shield them to some degree in this environment. What you must be wary of is management who consistently blame external factors for not being able to meet growth expectations.

Exposure to currencies - Australia is in a unique situation where the cash rate is falling, and yet the Australian dollar has remained strong due to most major economies having rates that are virtually zero. This sustained strength is great for importers, but not so good for exporters. You should consider a company's hedging policies, and ensure that profit growth is due to fundamentals of the business rather than foreign exchange fluctuations. It is also wise to consider the future impact of changes to exchange rates as the major economies emerge from their current malaise.

Capital structure - A lower interest rate environment is more attractive for leveraged companies to restructure their debt. It is no coincidence that many leveraged companies are issuing hybrids and bonds to reduce their interest rates and extend their term structure (borrow for longer).

Low rates can also incentivise companies to go on the acquisition trail. While we are cautious of companies that take on leverage for growth, having a low interest rate environment does not mean that management have to sit on their hands and wait for the economy to improve. If there are attractive opportunities and if modest debt-funded acquisitions can be earnings accretive (provided they also enhance return on equity once the debt is paid off), then this should create value to shareholders in the very long-run.

Finally we come to the impact of rates on another part of the investment decision - valuation. Many investors are aware of the inverse relationship between bond prices and rates. When rates decline, bond prices go up. A ten year bond issued for $100,000 paying a 10% yield will pay a coupon of $10,000 a year for a decade and then pay the holder the $100,000 face value at maturity. If, during the period, the interest rate were to rise for example to 15%, then the market price of the bond would need to fall such that a subsequent buyer of the bond would receive the equivalent of a 15% per annum yield when they pocket the $10,000 coupon each year.

But this 'gravitational effect' of interest rates on an asset is not exclusive to bonds. The values of all assets are impacted the same way. Investing is simply about exchanging a lump sum payment for a future cash flow. The discount rate used to measure the value of that cash flow (the interest rate) permeates all asset classes. If interest rates rise the discount rate applied to those future cash flows goes up and the value of those future cash flows declines. And so the value of the asset and therefore the price an investor would rationally pay for the asset must decline.

ANZ have forecast interest rates will fall to 2 per cent in 2013, which of itself suggests that the economy is not set to ìtake-offî any time soon.

You should be very cautious in letting market commentary guide your investment decision for two reasons. Firstly, economic forecasts are not specific to individual companies, and value can still be found in an economy with grim forecasts. Secondly, you should not hold off on making investments simply because you think the market will 'turn'. We do not let speculation about that which is cannot be known, effect our decisions when we are presented with facts that are 'known'. In other words we don't let speculation about what the market or the economy will do dramatically impact our investing activity.

Exercise your patience when superior companies are overvalued and be impatient when they are undervalued.

All of us at Montgomery Investment Management wish you a very Merry Christmas, and a prosperous New Year. And many, many happy returns!