Rising rates don't have to hurt your portfolio

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It's a little known secret but interest rates are perhaps the single most important determinant of the returns your investments will generate in coming years.

And with so much of the world's uncertainty and the market's volatility centred on this variable, it's worth exploring just how they work to impact on your performance.

Many investors appreciate that an inverse relationship exists between the interest rate on a bond and the bond's price. When a bond is issued, it is done so with a coupon payment fixed until maturity. A $100,000 bond with a 2 per cent coupon will make two six-monthly payments that amount to $20,000.

If, after the issue of the bond, interest rates rise, then any subsequent investor who buys this bond in the secondary market, will want the $20,000 to represent a higher rate of return than 2 per cent. To achieve this, they must pay a lower price. So when interest rates rise, the price and value of the bond falls.

While this relationship in the market for bonds is well known, it comes as a surprise to many that an identical relationship exists between interest rates and all assets. That is, if interest rates rise the underlying value of the asset declines. It matters not whether the asset is a business, a stock, land or any other income-producing asset — when interest rates go up, the value goes down.

Imagine for a moment you had an asset — any asset — and it produces an annual cash return of $1 million for 10 years. Now, you know $1m at present is worth a great deal more to you than $1m in a decade's time, and so we have to discount the future years' cashflows to arrive at a present value. For example, adopting a 2 per cent interest rate as our discount rate, we find $1m in 10 years is worth $820,000 at present. This makes sense: if we had $820,000 now and invested it at 2 per cent for 10 years, we'd end up with $1m.

But if the interest rate we require is higher, say 10 per cent, that $1m in 10 years is worth just $385,543 now.

The value of a future cashflow is lower when interest rates are higher and vice versa. That explains why Warren Buffett likened interest rates to gravity in 2013: "Interest rates are to asset prices what gravity is to the apple. When interest rates are low, there is a low gravitational pull on asset prices."

The intrinsic value of an asset is simply the sum of the present values of all the cash that can be extracted from an asset over its useful life. Add up all the present values of a $1m received every year for 10 years and we arrive at a total of $8,982,585 at 2 per cent and $5,604,264 at 10 per cent.

Once again, we observe that when interest rates are higher the value of an asset is necessarily lower.

So why do we care so much about interest rates and their gravitational effect on an asset's intrinsic values? Because in the long run, market prices follow changes in intrinsic values. You can pretty much forget China, Greece or "Brexit" — these things will have only a fleeting impact on the market value of your investment portfolio. All that will matter in the long run is the change in intrinsic values. And interest rates will matter more than almost anything else.

Right now, interest rates are low and it's reasonable to assume they will stay low for a while.

But what happens to asset prices when interest rates eventually rise again? Let's not be mistaken — they will fall and impact overall returns, and "this time" will not be different.

We can actually see this observed in recent history. In the US, between 1964 and 1981, interest rates rose — materially.

During this period, the average return from the US S&P 500 sharemarket index was in the low single digits — about 3.6 per cent a year. Then,

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between 1981 and 2000, interest rates declined substantially. During that period, the average annual return from the S&P 500 was almost 15 per cent.

And since 2000, interest rates have continued to decline. But when the implied equity risk premium is accounted for, the combined total has remained flat. In this environment the S&P 500 has returned just 2.5 per cent a year.

In summary, when interest rates fall, the sharemarket does well. When interest rates remain flat or rise, it does not do so well.

Interest rates are now at record lows across the globe, and while we might like to wish that will be the case forever, it won't be. Eventually interest rates will rise — and when they do, asset values will not perform as well as in the past.

Of course here we are talking about the broader sharemarket as measured by the aggregate market index. But I don't invest in the index, I invest only in the highest quality companies — and only when they are available at bargain prices.

You should be able to beat the sharemarket by owning a portfolio of extraordinary businesses, those that grow in intrinsic value at a rate that more than offsets the decline from rising interest rates.

So as speculation about a slowdown in Chinese growth and whether Australian property is in a bubble reaches fever pitch, just remember how important interest rates ultimately are in determining long-term returns.

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