THE NEW RATES REGIME IS A VALUE REGIME

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We have heard a thousand times that a stock is worth the present value of its future cash flows. But I think no other period in my career has witnessed this concept become so important in the stock market's calculus as this one.

"High growth stocks such as tech have been pummeled this year as a result of traders adjusting for the higher interest rate environment…"[1]

I pulled that from the first article I found in a Google search for the keywords "interest rates growth stocks."

Rest assured, a sentence like it appears in just about every other daily write-up that discusses the day's market action.

The S&P 500 Growth Index is down 25% in 2022, a loss far more harrowing than the 8% decline in the S&P 500 Value Index. In the market's eyes, the primary driver of the performance disparity is the big spike in yields: the 10-Year Treasury note yield has run to 2.82% from 1.50% at 2021's close.

Figure 1 shows the market's general reaction.

Figure 1: Growth vs. Value with Interest Rate Moves

	Stocks to Favor	Stocks to Avoid
Falling Rates	Stocks With Cash Flows in the Distant Future (Growth Stocks)	Stocks With Cash Flows in the Near Future (Value Stocks)
Rising Rates	Stocks With Cash Flows in the Near Future (Value Stocks)	Stocks With Cash Flows in the Distant Future (Growth Stocks)

Source: WisdomTree. For illustrative purposes only. Does not represent any specific investment.

Take two hypothetical companies: ValueCo and GrowthCo.

The former pays a steady dividend, while the latter has no dividend but offers the prospect of a promising future, with rewards that may arrive down the road.

Consider how we produce a fair stock price for ValueCo. For a chunk of last year, the prevailing default risk-free Treasury yield was around 1%. Add an equity risk premium to it—we will go with 5%—and we can discount ValueCo's cash flows at 6%.

Figure 2: Discount Rate on ValueCo

	Risk Free Rate (Treasury Note)	1.0%
+	Equity Risk Premium	5.0%
=	Discount Rate (Required Rate of Return)	6.0%

Source: WisdomTree. All numbers are hypothetical.

Keep it simple. Suppose we anticipate ValueCo will pay a $1 dividend each year to 2033, at which point the firm will be liquidated for $10/share. At that discount rate—6%—our "model" says ValueCo should trade for $13.63 right now.

Figure 3: Valuing ValueCo, 6% Discount Rate

Summary of Payments Expected		Nominal Amount	Present Value (at 6.0%)
The Dividend Paid Mid-Year, 2022		$1.00	$1.00
The Dividend Paid Mid-Year, 2023		$1.00	$0.94
The Dividend Paid Mid-Year, 2024		$1.00	$0.89
The Dividend Paid Mid-Year, 2025		$1.00	$0.84
The Dividend Paid Mid-Year, 2026		$1.00	$0.79
The Dividend Paid Mid-Year, 2027		$1.00	$0.75
The Dividend Paid Mid-Year, 2028		$1.00	$0.70
The Dividend Paid Mid-Year, 2029		$1.00	$0.67
The Dividend Paid Mid-Year, 2030		$1.00	$0.63
The Dividend Paid Mid-Year, 2031		$1.00	$0.59
The Dividend Paid Mid-Year, 2032, and also…		$1.00	$0.56
Liquidate Assets, Mid-Year, 2032		$10.00	$5.27
Value of Stock Today	**=**	**Sum of Present Value of Flows**	**$13.63**

Source: WisdomTree. All numbers are hypothetical.

Now play around with interest rates. Say the Treasury rate increases from 1% to 2%, causing the discount rate to change from 6% to 7%. As a result, ValueCo's stock falls from $13.63 to $12.77. The present value of ValueCo's future dividends is worth 6.3% less right now because of the new interest rate regime.

A tough situation, but not as bad as what happens to GrowthCo.

Figure 4: Valuing ValueCo, 7% Discount Rate

	Risk Free Rate (Treasury Note)	2.0%
+	Equity Risk Premium	5.0%
=	Discount Rate (Required Rate of Return)	7.0%

Summary of Payments Expected		Nominal Amount	Present Value (at 7.0%)
The Dividend Paid Mid-Year, 2022		$1.00	$1.00
The Dividend Paid Mid-Year, 2023		$1.00	$0.93
The Dividend Paid Mid-Year, 2024		$1.00	$0.87
The Dividend Paid Mid-Year, 2025		$1.00	$0.82
The Dividend Paid Mid-Year, 2026		$1.00	$0.76
The Dividend Paid Mid-Year, 2027		$1.00	$0.71
The Dividend Paid Mid-Year, 2028		$1.00	$0.67
The Dividend Paid Mid-Year, 2029		$1.00	$0.62
The Dividend Paid Mid-Year, 2030		$1.00	$0.58
The Dividend Paid Mid-Year, 2031		$1.00	$0.54
The Dividend Paid Mid-Year, 2032, and also…		$1.00	$0.51
Liquidate Assets, Mid-Year, 2032		$10.00	$4.75
Value of Stock Today	**=**	**Sum of Present Value of Flows**	**$12.77**

Source: WisdomTree. All numbers are hypothetical.

For GrowthCo, let's say we anticipate no dividends this decade (because it's a growth stock) and a one-time event in the future: the company gets bought at a price of $100/share in 2032. Two cash flows: the purchase and the sale. Again, keeping it simple. It looks like this:

Figure 5: A GrowthCo Forecast

6/30/2022	6/30/2023	6/30/2024	6/30/2025	6/30/2026	6/30/2027
Buy Stock in Summer 2022	No Dividend	No Dividend	No Dividend	No Dividend	No Dividend
6/30/2028	6/30/2029	6/30/2030	6/30/2031	**6/30/2032**	
No Dividend	No Dividend	No Dividend	No Dividend	**Buyout at $100**	

Source: WisdomTree. All numbers are hypothetical.

Valuing GrowthCo is easy: just discount the $100 to its present value. Using the 6% discount rate, we can say the stock is worth $55.84 today.

Figure 6: Valuing GrowthCo, 6% Discount Rate

Price of Stock	=	Buyout Price in 2032 / (1 + Discount Rate)^Number of Years Until Buyout
Price of Stock	=	\$100.00 / (1.00 + .06)^10
\$50.83	=	\$100.00 / (1.06)^10

Source: WisdomTree. All numbers are hypothetical.

Now change the discount rate from 6% to 7% to account for the higher interest rate regime, as we did with ValueCo. The new present value for GrowthCo drops from \$55.84 to \$50.83, a 9.0% decline (figure 7).

Recall that when we ran the same exercise on ValueCo, the stock fell by 6.3%.

Figure 7: Valuing GrowthCo, 7% Discount Rate

The conclusion: *Rising interest rates hurt GrowthCo more than they did ValueCo.*

It explains why the relentless collapse in interest rates over the last decade brought fame and fortune to growth stocks. Now that the interest rate regime has turned around, growth stocks are the market's problem stocks, while value stocks are serving as the haven.

For investors who anticipate a continued march higher in rates, here are some of our U.S. large-cap value strategies that may help if the stock market continues to be upset about it:

- WisdomTree U.S. LargeCap Dividend Fund (DLN)
- WisdomTree U.S. High Dividend Fund (DHS)
- WisdomTree U.S. Value Fund (WTV)

For investors interested in these Funds' performances, you can visit our Fund Compare tool.

[1] David French, "Wall Street Up Before Fed Meet as Tech Buying Punctuates Volatile Trade," Reuters, 5/2/22.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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DEFINITIONS

Cash flows : a measure of how much cash a business generates after taking into account all the necessary expenses, including net capital expenditures.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

S&P 500 Growth Index : A market capitalization-weighted benchmark designed to measure the growth segment of the S&P 500 Index.

S&P 500 Value Index : A market capitalization-weighted benchmark designed to measure the value segment of the S&P 500 Index.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Dividend : A portion of corporate profits paid out to shareholders.

Discount : When the price of an ETF is lower than its NAV.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term “large market capitalization”. Market capitalization is calculated by multiplying the number of a company’s shares outstanding by its stock price per share.