How will the interest rate shock affect my portfolio?

To fight inflation, the stance of monetary policy has tightened drastically since March of 2022, resulting in a rapid increase in interest rates.

In general, higher interest rates have a negative effect on the value of all companies since a company's future cash flows sets its value, and these future cash flows are worth less today when interest rates rise. However, there is a big discrepancy between the effect higher interest rates have on the outlook for distressed firms versus healthy firms.

What should I be watching out for? The increase in borrowing costs means more companies are in distress, or closer to default. According to a FEDS Note, Washington, From the Board of Governors of the Federal Reserve System written by Ander Perez-Orive and Yannick Timmer entitled "Distressed Firms and the Large Effects of Monetary Policy Tightenings," there have been seven tightening episodes since 1970, and the share of non-financial companies in distress currently has reached a level that is higher than during most previous tightening episodes.

This level of distress could well be due to companies that were recently overly attracted to higher debt levels due to artificially low interest rates. Warren Buffett famously said, *"You don't find out who's swimming naked until the tide goes out*." With rates increasing and loans becoming less available, you need to consider that the odds are that the tide may be going out and you should look at ways to protect yourself from that.

How do I protect myself? One way is to review with your advisor the strength of the balance sheets of the companies you own. What is their credit rating? Well financed companies will have an investment grade credit rating from Moody's or Standard and Poor's ranging from AAA to BBB-, which implies a lower default risk and means they can borrow money more cheaply at more affordable interest rates than their weaker competitors. Companies with credit ratings below investment grade, or below BBB-, represent the great majority of the companies that are in distress.

You should review your portfolio to consider weeding out overleveraged companies, particularly those with loans coming due in the near term. It certainly doesn't mean they will all default, but 37% of non-financial companies are now in a category of higher default risk based on their debt relative to their equity value. A great many companies in distress won't default, but a broad cross section of the ones that survive will have burdensome interest expense due to poor access to credit, and others can be expected to dilute current shareholders with equity capital raises on poor terms.

This number of firms in distress according to the study cited above also suggests that restrictive monetary policies and higher interest rates may contribute to a marked slowdown in investment and employment based on similar periods in the past, which means an increase in the odds of a recession.

Healthy firms versus distressed firms. Standard and Poor's Global did a study that found that, since 1980, there have been an average of 77 global corporate defaults annually but only 2.2 defaults per year by investment grade companies.

Furthermore, the study from the Federal Reserve mentioned above found that investment stayed basically flat for healthy firms for the 10 quarters after a tightening shock, while investment spending dropped 3.7% for the distressed firms struggling with weaker balance sheets and less access to financing

than the healthy firms. The study encompassed non-financial companies representing 60% of total annual investment. It also found that, during the 10 quarters after the interest rate shock, healthy firms increased employment by 1% while distressed firms cut employment by 1.5%.

So, healthy firms not only help insure against default, which is obviously devastating for investment returns, they also have historically gained market share during downturns caused by the rate shocks which helps the healthy firms offset economic weakness and build long term value through their share increases.

We think the higher-than-normal level of distressed firms resulting from the current rate shock will exacerbate the different paths that healthy and distressed firms typically take in the period after dramatic interest rate increases. Importantly, we believe investing in healthy firms is critically important to be a successful long-term investor since it allows you to comfortably ride out economic downturns with companies that tend to gain market share and build long term value during these periods by maintaining strong access to financing rather than struggling with too much debt.

As always, we are happy to discuss what's on your mind.