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As Interest Rates Rise, Capital Preservation Takes Center Stage

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While the ultimate goal of investing is to grow wealth over time, preserving capital is an equally vital objective on the road to creating wealth. This is true at all times, but especially when stocks and bonds are as volatile as they have been over the past few years. From the start of 2018 until now the securities markets have been buffeted by tariffs, a pandemic, inflation, war, and rising interest rates, all of which emphasize the need to invest with an eye on protecting and preserving wealth.

Capital preservation is as important to good investment returns as is picking the next blockbuster technology stock or the next high flying IPO. It is one of the hallmarks of a conservative investing mindset. Through the ups and downs of the markets protecting what you already have allows you to keep your investment portfolio on-course and heading steadily toward your financial goals.

Preserving Capital is Sound Investment Strategy

A capital preservation strategy for a portfolio of stocks and bonds needs three key things to be effective.

First, it requires a focus on building portfolios comprised mainly of good quality stocks. Stocks are the primary holdings in most U.S. investment accounts since they are vehicles of long-term growth. They usually make up anywhere from 50% to 100% of most portfolios. High quality stocks would include companies that have a history of paying dividends, allocating capital prudently, and offering products and services that consumers find useful and worth buying for many years into the future. It also involves owning high grade fixed income instruments for portfolio stability and income, whether held individually or within mutual funds and ETFs.

Second, it requires a rational approach to weighting each component in a portfolio so that each security has a chance to contribute positively to the portfolio's growth, while simultaneously not being so large as to threaten the portfolio's viability. It is not uncommon to come across self-managed portfolios where, for example, the do-it-yourself investor has purchased a 20% stake in stock A, while holding only a 0.5% stake in stock B.

Ironically, the investor's expectation may be that both stocks are potentially big winners, yet this allocation imbalance means that only one stock, A, could be a meaningful contributor. The risk in that approach is that if B is the more successful stock from a price appreciation standpoint, then the investor has missed a chance to make a good profit. If on the other hand, things don't go well for stock A and it falls in price, at a 20% weighting it could seriously damage the whole portfolio.

My own approach is to equal-weight all stocks as much as possible at the time of purchase and to keep them more or less in balance as time goes on. This minimizes risk to the portfolio while still allowing good stocks, and the portfolio as a whole, to rise over time.

And third, capital preservation requires a willingness to see the value in holding cash as both a hedge against a downturn in the markets, and as a reservoir of buying power for future opportunities. Cash is often maligned during roaring equity bull markets of the type we had between 2020 and 2021, but it is a critical asset that allows us to benefit from future buying opportunities and future portfolio growth.

Rising Inflation Weighs on Both Stocks and Bonds

Throughout 2022, the most pressing issue on the minds of investors was inflation and how to best position portfolios to counter its effects. The national inflation rate peaked at 9.1% in June, later falling to 7.1% by the end of November. In response, the Federal Reserve raised the nation's base interest rate seven times from a low of 0.25% to as much as 4.5% by year's end. That was all in an effort to reduce inflation to a more manageable 2% rate, which is the Fed's long-term target for sustainable economic growth. We may see that target achieved in 2023 or 2024.

The goal of preserving capital was in full focus in the months leading up to October 2022, which marked one of the worst periods for the stock market since 1928. The bond market often acts as a hedge against the volatility of stocks, but not this time. Bonds also declined as stocks fell, offering virtually no portfolio protection.

Bonds registered one of the worst years in living memory for their asset class, falling -15.2% on the broad-based Vanguard Total Bond Market ETF (BND). Investors seeking the higher yields available to them on newly issued long-dated bonds abandoned lower yielding existing bonds, thereby sending bond prices plunging and yields soaring. As a reminder, bond prices and bond yields move in opposite directions - when bond prices decline, bond yields rise, and vice versa.

For the full-year 2022, the S&P 500 Index, which measures the price movements of the 500 largest American companies, declined by -19.4%. The Dow Jones Industrial Average was down -8.8%, and the NASDAQ Composite, which is heavily weighted in technology stocks, lost -33.1% of its value in the same timeframe.

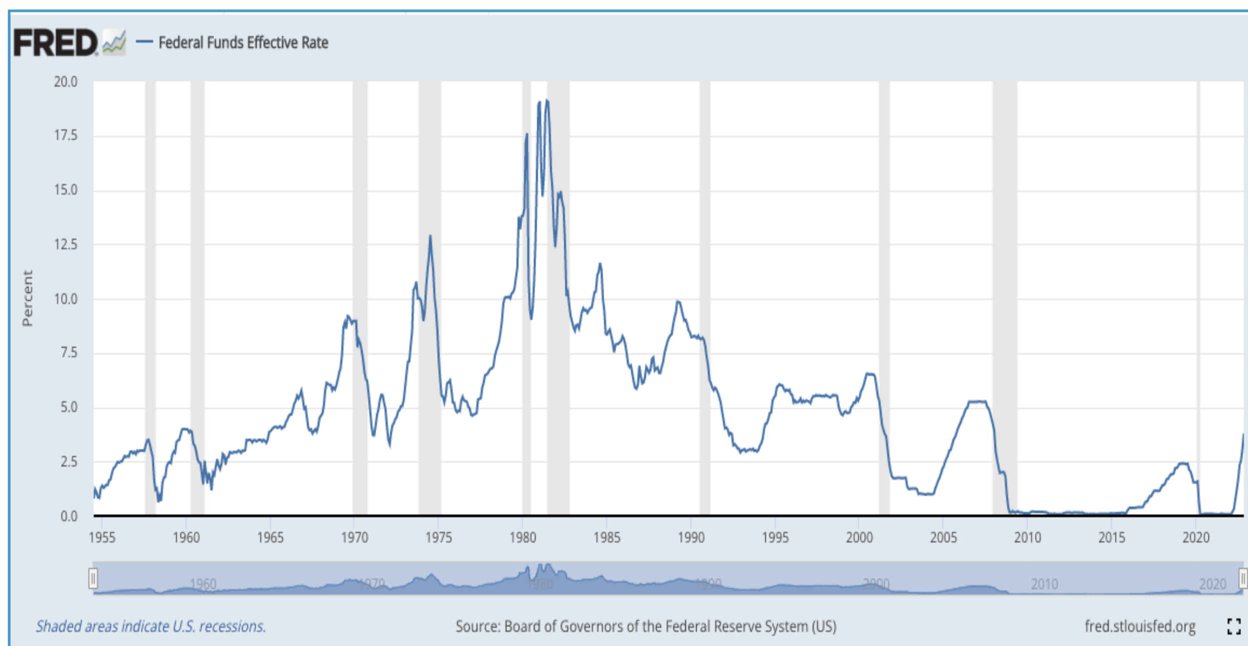
More dramatically, from intraday peak to intraday trough, the NASDAQ Composite had the worst performance of the three indices, falling by -36.1% from its intraday high on December 31, 2021 to its intraday low on October 13, 2022. The technology sector is heavily reliant on borrowing in order to fund future growth – any rise in interest rates is bound to hamper growth prospects for the sector.

Beyond the performance of the three major market averages, portfolios that allocated to bonds in addition to stocks, also did not fare well. The traditional 75/25 model portfolio with a 75% weighting in the S&P 500 and a 25% weighting in the Vanguard Total Bond Market ETF, was down -18.4% for the year. Both equities and fixed income registered declines. A more conservative 60/40 model portfolio did not fare much better, falling by -17.8%.

Investors were right to focus on inflation and interest rates as threats to their wealth.

Looking back forty-plus years for perspective on a period of high inflation and high interest rates, 1979 saw U.S. inflation peak at 13.3%. Famously, that prompted the Federal Reserve Bank under Chairman Paul Volker to raise the country's base interest rate, the Federal Funds Rate, to 20% by June of 1980. Volker's shock therapy worked as intended, but it did so by triggering one of the worst recessions since World War II. His actions set into motion a secular decline in interest rates that lasted for the next four decades.

In 2008 interest rates finally hit rock bottom, reaching 0.25% on the Fed Funds rate in December. They stayed there from 2008 to 2016 when the Fed's decision makers tried to raise rates to more normal levels. Instead, they found themselves having to cut rates again as a looming recession in 2019 and then the 2020 Covid-19 pandemic prompted a more dovish stance. The graph below illustrates the history of the Fed Funds Rate back to 1955. The grey bars indicate recessions.



Last year, the Fed reversed that multi-decade Volker-induced downtrend in interest rates and began raising rates in 50 and 75 basis point increments to contain the sharp and broad rise in the price of goods and services. Ironically, the Fed's own actions over the past decade were in large part responsible for the highest level of inflation we had seen since the Carter and Reagan administrations.

Having kept rates too low for too long, and having increased the money supply in order to bolster the economy during Covid-19, the Fed now found itself having to backpedal in an effort to tamp down inflation. Unlike Volker's jarring interest rate hikes 40 years earlier, the current Fed chairman, Jerome Powell, appears to be taking a more incremental approach to lowering inflation. Nevertheless, the Fed's actions are likely to slow the economy over the course of this year, and possibly into next year. A recession is a possibility.

The Inverted Yield Curve is Hinting at Recession

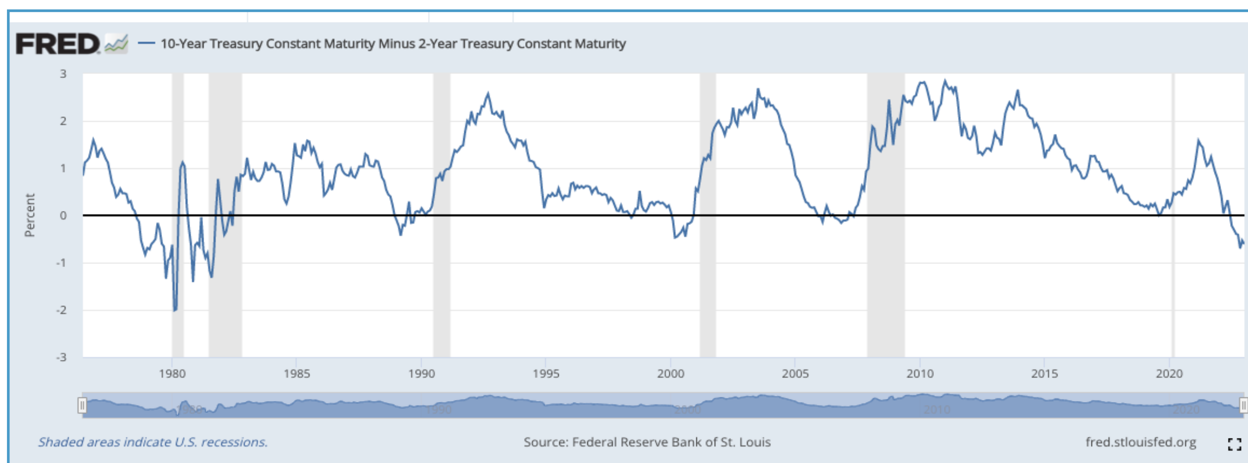
Since March of last year the U.S. Treasury yield curve, as represented by the yields on the 10-year treasury note and the 2-year treasury note, has been inverted. This is a significant hint that a recession may be on the way.

Normally the 10-year treasury note carries a higher yield than the 2-year note to compensate investors for the longer holding period. However, when investors in the U.S. and around the world believe that the U.S. is heading into an economic slowdown, even a recession, they gravitate to the higher yields that longer-dated Treasuries like the 10-year provide.

Since bond prices and bond yields move counter to each other, higher investor demand for the 10-year raises the price of those securities, while lowering their yields. And since investors sell their shorter-dated 2-year treasuries to buy the 10-years, the yield on the 2-year rises. In other words this demand dynamic causes the yield on the 2-year to be higher than the yield on the 10-year, thereby inverting the yield curve.

Historically an inverted yield curve has been a fairly reliable harbinger of recessions 6 to 24 months out. That is a wide timeframe, for sure, and the inverted yield curve is not a foolproof predictor of recessions, but it has been a sufficiently accurate predictor that it is worth keeping it in mind. That would place the next recession sometime in either 2023 or 2024.

The graph below shows all the inversions that have taken place since the 1970s. The inversions are the periods in which the yield line traces below the horizontal zero line. The grey bars are the economic recessions that have followed. We are currently in a period of inversion.



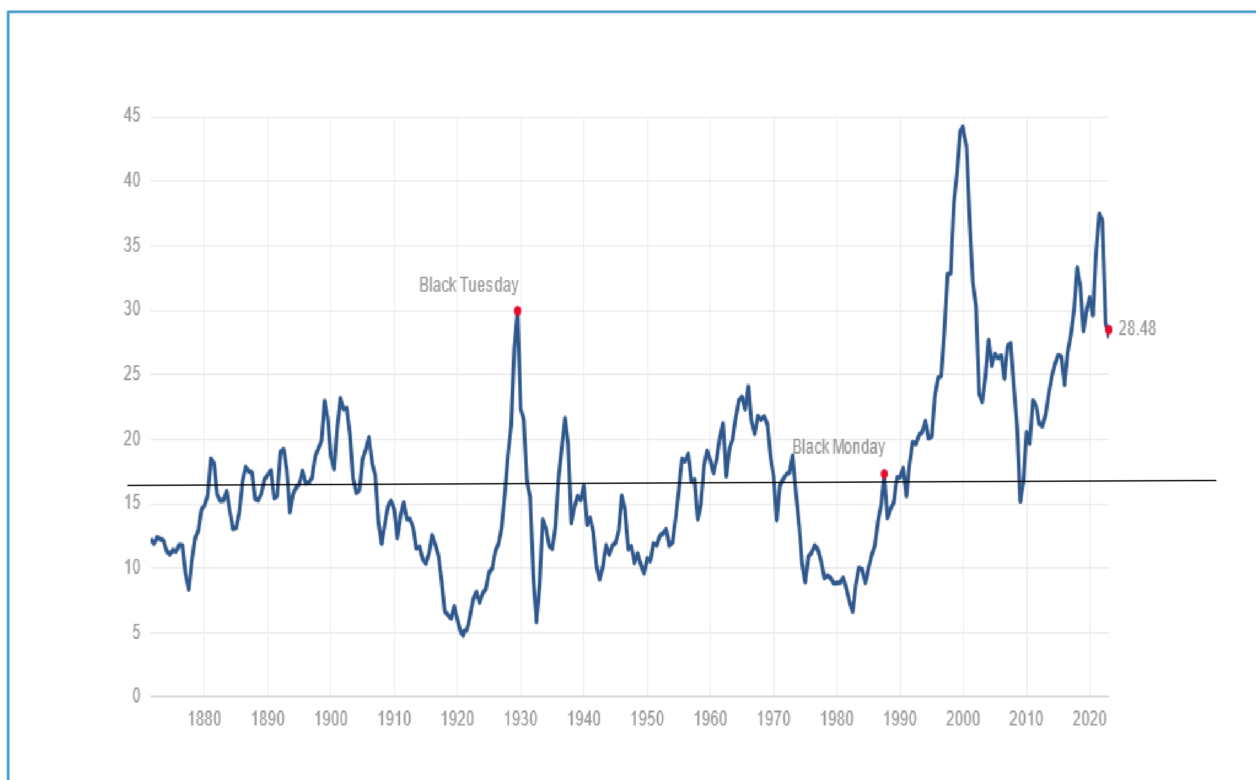
Inflation, Rising Interest Rates, and Decelerating Corporate Earnings

The combination of rising interest rates and rising inflation acted as a significant headwind to the growth of corporate earnings in 2022. At the beginning of the year Wall Street analysts had expected S&P 500 earnings to rise by about +9% for the whole year. While the final 2022 earnings growth numbers for the S&P 500 have not been reported yet, Wall Street analysts now estimate that profits grew by approximately +5.1% for the full year. That is a marked deceleration from their initial projections. For 2023, analysts are currently predicting earnings growth of +5.3%. That figure too is likely to be revised downward as the year unfolds and could add to the downward pressure on stocks.

Stock Market Valuations Have Improved, but Remain Historically Elevated

Stock market valuations are a bit like weather forecasts – they can tell you that conditions are ripe for a rain shower, but not precisely when it will rain. With last year's declines in share prices, valuations have also declined on the S&P 500, although stocks still remain expensive when viewed through the lens of the Shiller P/E ratio. This suggests that more declines are possible for stocks, especially when high valuations are combined with rising interest rates. The timing, however, is uncertain.

The graph below of the Shiller P/E illustrates the extent to which valuations are above their long-term average of 16x (horizontal line). The current value is 28.48x.



Taking the Long View - Investing in 2023 and Beyond

If my expectation for a slowing economy in 2023 or 2024 materializes then we could also expect the stock market to continue on its bearish trajectory for some time yet. The U.S. economy and corporate profits are vitally connected - one feeds into the other. In that environment, capital preservation becomes important to investors as a way to "stay in the game" and to continue investing for the long-term.

Most portfolios are more heavily invested in stocks than in bonds, with stocks being the active portion of most retirement and taxable brokerage accounts.

One of the tenets of successful investing in equities is that individual stocks are at their most attractive when the stock market as a whole is rising. A rising tide not only lifts all boats, it also reveals the most seaworthy vessels that are able to make the long journey to the distant shore. In other words, a rising stock market amplifies the effects of good stock selection.

Conversely, when equities are trending down, as they were last year and as they may again this year, the combination of good stock selection and conservative asset allocation can make a significant difference to an investor's ability to keep investing successfully into the future.

The ultimate goal of investing is to grow wealth over time. Investing for the long-term requires as much of a focus on preserving wealth through the ups and downs of the markets, as it does on picking the next blockbuster stock. Until investment prospects improve, our focus will be on preserving capital, investing cautiously, and patiently anticipating attractive new investment opportunities.

V. Henry Astarjian

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