



Gaia Capital Management, Inc.  
Registered Investment Advisor

James C. Pursley  
Vivian J. Lopez  
Investment Advisor Representatives

## Saturdays with Jim: Worried About Rising Interest Rates? Don't Be.

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### Saturdays with Jim

By Jim Pursley  
President and CIO, Gaia Capital Management, Inc.  
[www.gaiacapital.com](http://www.gaiacapital.com)  
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We've completed a full cycle of declining interest rates. From 1981, when the overnight Federal funds rate stood at 19% to today at 0.23%, we've had a strong market tailwind. Why? Declining rates make borrowing cheaper, provide capital gains to bond holders and make stocks more attractive than bonds (lower bond interest rates provide less competition for stocks). Stocks tend to do well in periods of declining interest rates, in part due to the above mentioned factors, and in part due to the general feeling of economic buoyancy that declining interest rates bring. Is the opposite true? Yes.

Rising rates suck money from consumers and companies in the form of higher loan payments, hurt stocks because a higher interest bond is more attractive than a lower interest bond vis a vis stocks and, last but not least, higher rates dull the economic mood of the country. When the Federal Reserve wants to release the "animal spirits" of investing, they lower rates and vice versa.

It is not axiomatic that rates will rise steeply any time soon, the last three weeks notwithstanding. But rates are not likely to go any lower than we have seen them for the last three years. Rising rates, then, appear to be in the cards for the next 25 or so years, according to the 54 year bond cycle. Fortunately, rates don't usually spike seriously until later in the cycle, perhaps around 2025. But we should be prepared.

Rising rates are good for those dependent on interest payments for a living but the added income comes at a cost. If savers are invested in stocks, they may see the value of those stocks threatened if rates rise precipitously. Furthermore, they will see the market value of their bonds drop as new bonds issued with the new, higher rates provide competition. Older, lower rate bonds must drop in price for them to be attractive against the newer issues. But does all of this description really hurt a portfolio? Can a bond and stock investor get through a period of rising interest rates (generally caused by increasing inflation) without suffering serious financial loss? Can an investor ignore the market price of her bond, knowing that it will pay the face amount when it matures? We studied the 10-year performance of the Standard and Poor's 500 Index, The Investment Company Of America (a stock mutual fund) and Fidelity Investment Grade Bond (a bond mutual fund) from August 1971 (the bond fund's inception) to August 1981. Were there rising rates? The Federal Funds interest rate, perhaps the most sensitive of them all, stood at 5.5% in August 1971 and at 17.8% in August 1981, a rise of 12.3% that more than doubled the 1971 rate. With such an ugly backdrop of rising interest rates, you'd expect that bonds and stocks would be hard hit, suffering significant losses.

Surprisingly, disaster was not the case at all. The results are shown in the table below.

10-Year Performance Comparison Data from August 1971 – August 1981	
Interest rate rise:	12.3%, 223% of initial 5.5% rate
Stock fund performance:	\$10,132 to \$23,483, a gain of \$13,351 or 132%
Bond fund performance:	\$10,000 to \$15,236, a gain of \$5,236 or 52%
S&P 500 Index, dividends reinvested	\$10,002 to \$19,236, a gain of \$9,234 or 92%
S&P 500, no dividends reinvested	Index value 99 to 123, a gain of 24%
<i>Source: Federal Reserve, Morningstar.com, Google.com and MSN Money</i>	

### Discussion

Interest rates more than doubled to a prohibitively high 17.8% from a moderate 5.5%, yet the stock fund still gained more than 132%. We believe that there are two main reasons for the success of the stock fund:

- It reinvested dividends
- It chose stocks relatively unhurt by inflation and rising rates

The biggest surprise from that data was the 52% gain of the bond fund. Arguably, this performance barely kept up with inflation and, if dividends were taken in cash to support a retiree's income, an account holder would have actually lost ground in the bond fund. Still, the results are far better than we would have guessed.

Another surprise: The return of the S&P 500 with dividends invested dwarfed that of the S&P 500 price only index. Actually, the S&P 500 with reinvested dividends has a credible performance, almost doubling and beating the 6% annual inflation of the period. Using the S&P 500 price only index as a guide, investing in stocks with no dividends during that period would have cost an account holder dearly in inflation-adjusted terms. The price only nominal gain was merely 23% over the entire 10 years.

### Concluding

A decent middle-of-the-road stock fund handily beat the S&P 500 Index and inflation over the 1971 to 1981 period that we selected. But the ride was not pretty. Stocks lost over half of their value in the bear market of 1974 and again lost plenty in the second oil supply crisis of 1979 following the Iranian revolution. For the sturdy person who remained in stocks with dividends reinvested, the period 1971 to 1981 was a winner. And we all know that beginning in 1982 we saw the rise of the greatest bull market in history. It can be said then, that waiting out the inflation of the 1970's with strategy intact prepared the investor for the eventual "new dawn," when the headwinds of the past cycle became tailwinds. At this point in our cycle, after ten years of substandard market performance, we may look to another "new dawn." But you can be sure of one thing - few will recognize it.

Thank you for investing with us.

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