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The Rising Tide of Equity Duration

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Anu Rajakumar: The concept of duration, a measure sensitivity of a bond's price to changes in interest rates, is one of the most important factors in the risk profile of any fixed income investment. But with rising rates expected going forward, the concept of duration is being explored beyond fixed income. My name is Anu Rajakumar, and on today's episode of Disruptive Forces, I'm joined by Will Hunter and Sandy Pomeroy, portfolio managers in the messenger group at Neuberger Berman, to explain the concept of equity duration, its effectiveness and its risks, as well as how this concept plays into the growth versus value debate. Sandy and Will, thank you so much for joining me today.

Sandy Pomeroy: Thanks, Anu. Great to be here.

Will Hunter: Thanks for having us, Anu.

Anu Rajakumar: So, Sandy, let's start with the basics. Give our listeners a primer for what duration is and how it can be applied in an equity context.

Sandy Pomeroy: Okay. Well, let me first explain why the concept of duration is relevant today. Over the last six months, we've seen interest rates rise sharply, leading to a sell-off in the bond market. And, when interest rates rise, investors want shorter duration securities. In financial markets, Duration represents the time it takes to recoup the original capital that you put into an investment. This concept holds true for both bonds and stocks. And we've seen the effect of this play out in both the equity and fixed income markets. Shorter maturity bonds have gone down less than longer maturity bonds,. And in equities, value stocks, meaning stocks that are cheaper, and many of which have good divided yields, have done better than the S&P 500 index.

Will Hunter: Yeah. You know, Anu, I've been thinking a lot about summer recently…

Anu Rajakumar: Haven't we all?

Will Hunter: Yeah, and so, you know, I was trying to think about an analogy for duration. And it sort of is like the tide on the beach. You can think about low tide is associated with low interest rates. The beach is very long, you have to take a long walk in order to take a swim. It's a very long duration. Contrast that with high tide or high interest rates, the beach is very short. You just get out of your car and you hop right in the water. I just think it's sort of a good visualization for duration on a cold spring day like today. Now, the concept of duration, like Sandy said, is really straight forward for bonds. It's a defined set of cash flows with a maturity date. But calculating duration for equities is a little more problematic. It requires making assumptions about the growth of future cash flows, as well as discount rates. But the key thing to remember for equity duration is high free cash flow is associated with shorter duration. Low free cash flow is associated with longer duration. So when thinking about duration in your portfolio, considering the duration characteristics are important even for an equity portfolio.

Anu Rajakumar: Terrific. Well, thank you. I think you've got us all longing for summer beach days now. Now, you did mention that the calculation for duration in equity context can be problematic. Let's dig into that a little bit. Maybe, Sandy, explain some of those nuances between calculating duration between a stock versus a bond?

Sandy Pomeroy: Yes. As Will mentioned, uh, when you calculate, uh, duration for bond, it's pretty straightforward. It's pretty much a mathematical equation. And to apply that to real life, uh, if you look at the recently issued 30-year treasury bond issued a few weeks ago, today it would have a duration of about 22.2 years. This takes into account the 1.78 percent coupon that you, as the investor, are going to collect two times a year, and then the thousand dollars you're going to put in your pocket when you receive a debt maturity in 30 years. However, if you looked at that same bond instead as a 30-year zero coupon bond, what they call a strip, where you as the owner would get no coupon payments at all during that entire time period, like get your thousand dollars back at maturity – the duration would be about 29 and a half years. So quite a bit longer. The point being is that when you get a higher coupon you're getting more of your money back sooner and you actually shorten the duration of the bond. And since I want to talk about summer too, in Will's example, it's like you go to the beach and the tide water is much closer to the beach parking lot so you don't have as far to go to drag your chairs to get to the beach and the water.

Will Hunter: So now the question becomes a little more theoretical when you're comparing bonds versus stocks. Stocks have no set maturity date. In our duration analysis, we selected free cash flow as a proxy for the cash coming to the investor and the starting stock price as the initial investment. So, to illustrate this example we'll use a long-duration security and a short-duration security. For the long-duration equity, let's pick Netflix. We don't happen to own Netflix, but I think it's a good example. A lot of people know the company especially well right now. So when you buy Netflix stock, you're getting about a one percent free cash flow yield. Wall Street estimates are that that free cash flow is going to grow at very high double digit rates for the next several years, but the fact is that even at those high growth rates and using a reasonable discount rate, you'll only get about 20 percent of Netflix share price in free cash flow over the course over the next 10 years. The rest of the value of Netflix stock is very long-duration; it comes after those 10 years. Now, contrast that with a shorter-duration stock. In order to watch Netflix, you have to go and buy a tablet or a TV. And you may want to go to, say, Best Buy in order to purchase that tablet or television. Best Buy happens to be a stock that we own. Best Buy has about a seven percent free cash flow yield and high, single-digit free cash flow growth, so pretty decent growth. If you look at the free cash flow over the course over the next 10 years, you get about 65 percent of that share price in free cash flow over the next 10 years and only 35 percent comes after that. So you get more of that cash generated and, by the way, Best Buy also pays a dividend. So you get more in cash in your pocket and to redeploy as you see fit.

Anu Rajakumar: Absolutely. And the key is that you get to redeploy at the higher interest rates that the market is expecting going forward as well.

Will Hunter: Exactly, exactly.

Anu Rajakumar: So yeah. Thank you for that example. I think that's very helpful. Now, of course this is just one tool in an investor's toolbox, right? There're different ways to think about different equity investments. And with any tools there are risks in every approach as well. So what are some of the risks that investors should be aware of when thinking about using equity duration to select their stock investments?

Sandy Pomeroy: Well, I think that the key to think about here is many investors in the bond market are really there for both income and stability. And with interest rates so low and spreads in the bond market being so tight, a bond portfolio alone is challenged to provide the three to five percent yield that many investors are seeking. We also have seen recently that fixed income securities are vulnerable to increasing interest rates and rising inflation concerns. As the inflation goes up, the inflation rate goes up or expectations of inflation go up, the value of the current and future income stream of a bond or any other cash-flowing investment goes down because the cash you receive in the future is less valuable than the cash in your pocket today. This is reflected in the price of bonds right now, where we saw a long-dated, 30-year bond issued in January at $1,000 par value, and it's currently priced at $790 today. So this is why duration is so important in the fixed income markets, especially in a very, very low rate environment. However, if you contrast that to equities, equities should be able to offer some inflation protection because companies typically have the ability to pass through price increases to offset at least some of the rise in costs. And this should be reflected in higher corporate income and cash flow in the future. However, I would note that there are some dividend-paying equities, especially higher yielding ones which have very little ability to grow earnings and dividends. Many of these types of dividend paying stocks have been declared bomb proxies and have exhibited a much higher degree of correlation to the bond market. We believe this category of dividend payers is much more challenged in a rising rate environment.

Anu Rajakumar: All right, terrific. Now, I think lots of our discussion so far has been centered around the US interest rate environment. Would love to look outside of the U.S. and sort of beyond, across the globe. How does equity duration apply outside the U.S.?

Will Hunter: Yeah, I think what's interesting, Anu, is that in Europe it's experienced some of this, but there are a couple of distinctions here, and I would just make two. One is in particular around the continent. You've had a much smaller increase in long-term interest rates, and so you don't get quite the same effect that you've seen in the U.S. and maybe to a lesser extent in the U.K.. The second distinction that I make is that the indices in Europe tend to be less weighted towards the traditional low duration, growth-oriented equities. And so if you look at it on an individual security level, you may see some of this play out. But on a high level, I think that the European markets are potentially in the near-term at least less susceptible to some of those risks that long-duration securities may have.

Anu Rajakumar: Terrific. Thank you very much. Now, a hot topic for investors in 2021 has, of course, been value versus growth. We did a podcast a few weeks ago focused on the case for value stocks. And so I just wanted to ask you both, you know, where do dividend-paying stocks sit on the spectrum of growth to value investing and can you apply this duration methodology both to growth and to value?

Will Hunter: So I'll take the second part of your question first, which is yes, absolutely, this should be applied to both growth and value equities. If you just looked at correlations, for example, you would've believed that growth stocks didn't have strong correlations with interest rates over a shorter period of time, but now they do. In fact, if you look at the last six to nine months, growth stocks have had the strongest negative correlation they've had to 10-year treasuries in the last 50 years. So this relationship makes sense if you think about growth stocks as being very long-duration assets, very long beach. When you contrast that with value stocks, as Sandy was talking about, you would have thought that they were inversely correlated to, with interest rates. But now they're actually doing well in a rising rate environment. In particular those stocks that pay dividends have done exceptionally well since interest rates started to rise in the back half of last year.

So correlations have shifted, and we need to start using a different tool for understanding the performance in a different environment. As it relates to dividend-paying equities, for investors seeking income, we think that yield stocks, especially those that have attractive growth rates, can help insulate investors from the potential risks of longer-duration securities. So in order to get a comparable yield, investors have to take on a lot of duration risk in the fixed income market. Let's take for example the Coca-Cola bonds that were issued a couple of weeks ago. These were 30-year bonds with a three percent coupon – very long-duration asset. Compare that with the equity, where you can get a three percent dividend yield, which by the way may rise over time, that potentially could help to mitigate some of the duration risk that you would get if you were buying a fixed income security. We happen to not own Coca-Cola, but I think that comparison is a really good example. So if you believe that the interest rate tide is rising, we think that you should look at shorter duration equities and in particular those equities that pay dividends.

Anu Rajakumar: Yeah, absolutely. And I think as investors continue to seek durable income, I think these are some important concepts to be familiar with. You know, as we wrap up here, Sandy, would love for you just to talk me through some of your key takeaways that you want our listeners to walk away with today.

Sandy Pomeroy: Well, I think Will's analogy with Coke is a great example of the duration risk investors seeking income may be taking on in the current markets. We think focusing on dividend-paying stocks with good yields and dividend-growth potential – and this is the key – dividend-growth potential. It's a way to get income without risking the stormy seas of excessive duration. And so that would be my big takeaway for investors - avoid the stormy seas, think about growth but think about it in the context of growing income because that could be the best thing to mitigate that risk.

Anu Rajakumar: Perfect, excellent. Well, with that and some wonderful summer beachy analogies, I think we'll end today's conversation. Really appreciate hearing how the understanding of equity duration could be helpful to investors and advisors alike. Sandy and Will, thank you again for joining me today.

Will Hunter: Thanks, Anu. We'll see you at the beach.

Sandy Pomeroy: Thanks, Anu.

Anu Rajakumar: Sounds good, Will. And to our listeners, if you've liked what you've heard today on Disruptive Forces, you can follow and subscribe to the show via Apple Podcast, Google Podcast or Spotify. Or you can visit our website, www.nb.com/disruptiveforces for previous episodes, as well as more information about our firm and offerings.