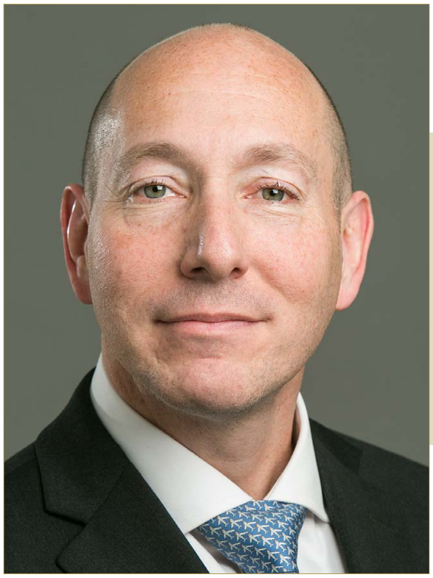
How to Position Equities for Rising Rates

By Robert Huebscher
April 11, 2022



Simeon HYMAN

Global Investment Strategist

Head of Investment Strategy Group at ProShares

Simeon Hyman, CFA, joined ProShares in 2013 as Global Investment Strategist, and head of the investment strategy group. He leads ProShares' team of investment professionals engaged in portfolio analysis, product research and development, education and the delivery of investment strategies using the company's ETFs. Hyman earned bachelor's and master's degrees in economics from the University of Connecticut, and an MBA from Columbia Business School. He holds Series 7, 24, 63 and 66 FINRA designations.

I spoke with Simeon on March 24.

Bob: The conventional wisdom is that the U.S. is heading for a rising-rate environment. Is that your view?

Simeon: For sure, it is. The interesting situation that we're seeing is not just one of inflation, not just one of potential rate hikes from the Fed, but very critically the unwinding of quantitative easing and, in fact, quantitative tightening, The Fed is removing the artificial suppression of longer-term yields. That's why we expect to see rising rates across the yield curve, not just the short or long end. We expect continued rising rates across the entire yield curve as we remove the artificial constraints around the bond market.

Bob: Let's start with the short end of the curve. Most people expect multiple rate hikes from the Fed this year. What's your forecast?

Simeon: We typically don't forecast rate hikes at ProShares. We certainly are in the camp of seeing several more hikes, but we don't know if the number is four, five or six. I continue to harp on quantitative tightening. That was the most important thing we heard from Chair Powell over the last several comments that he has made formally to Congress and in other business meetings he's had. It is that shrinking of the balance sheet that will continue to drive rates higher, even as inflation comes down.

Let's just assume that the hikes do their job and inflation comes down. Remember we still have negative real yields just about everywhere. This is not what we experienced in the early 1980s when the Fed funds rate went to the moon, ultimately bringing down longer term rates. Not this time around—it will be normalization of long-term rates in conjunction with rate hikes on the short side.

Bob: Do you expect inflation to subside? What about the other drivers that will cause rates to rise, as you predicted?

Simeon: As for the inflation story, we know there are some short-term price increases. Nobody wants to use the "transitory" word anymore because it meant a quarter or two. No one is talking about that. Our hearts go out to the people of Ukraine, and the war has caused commodity prices to go through the roof. We also have those supply-chain issues that are still on the mend from the end of the pandemic—or I hope the end of the pandemic. But there are signs that inflation pressures are mitigating. One of my favorites is the Baltic Dry Index, which is the cost of shipping containers going around the world. They were a little higher than they were a couple of years ago, but they're down over 50% from their peak last October.

We also saw producer prices come down in some of the latest government data on inflation. There are some signs of mitigation. We are a long way from the 2% target for inflation and the 8% readings we've seen.

Somewhere in between is a likely outcome. But there is lots of room for Treasury rates to rise, even as we get some mitigation of high inflation.

Bob: How can investors protect against rising Treasury rates? ProShares has an ETF, the ProShares Equities for Rising Rates ETF (ticker, EQRR). It was designed for a rising rate environment. What led ProShares to create and launch that product?

Simeon: We saw an investment landscape that focused on fixed income solutions for rising rate environments. If interest rates are rising, then you have exposure in Treasury and corporate bonds. If yields go up, prices go down and there's an appropriate focus on your bond portfolio.

But there are important implications for the equity markets. We saw an opportunity to launch this ETF, EQRR, Equities for Rising Rates, because we saw a misapplication of bond math to equities. Folks want short-duration equities like they want short-duration bonds in a rising rate environment. But from our perspective, that's quite misguided.

Even a stock with a P/E of 10—a very cheap stock—has a duration of almost 11. That's twice the aggregate bond index. There's no salvation in bonds from trying to find things that aren't growing in the equity markets, and growth is what you need in equities.

The reason that equities are a good place to be when rates rise is the power for them to grow their earnings, cash flows and dividends. Very specifically, with Equities for Rising Rates, we found the opportunity to focus on the sectors and the stocks within those sectors that have historically performed well when interest rates rise.

This is an equity ETF that is designed to perform well in a rising rate environment.

Bob: What index does it track? How is it constructed? How do you select the sectors and the stocks that it holds and how is it rebalanced?

Simeon: The ETF follows the Nasdaq US Large Cap Equities for Rising Rates index. Like a laser, it focuses on those sectors and stocks within them that have outperformed when interest rates have gone up.

If you look at this ETF today, you'll see that this is not an index hugger. It doesn't look like the S&P 500. It has a dramatic overweight to sectors like financials, energy, and materials, which is very intuitive. Financials make more interest margin when rates rise; energy—we know what's been going on with energy; and the basic materials story is very similar during inflationary periods.

The reason that equities are a good place to be when rates rise is the power for them to grow their earnings, cash flows and dividends.

Sector selection is one component of EQRR, stock selection is the other. It identifies the stocks within those sectors that have historically outperformed when interest rates have gone up. We've found that EQRR has substantially outperformed the S&P 500 since the bottom of rates about a year and a half ago. But that outperformance, based on a formal attribution analysis, came not just from the sector component, but also the stock component. Both of those have been key to driving the effective performance of EQRR as rates have risen, putting a proof point behind the reason we put it together, its structure and its efficacy for investors.

We do this process every quarter and it's a portfolio of 50 stocks. Every quarter we check correlations and line them up and you get 50 stocks. The strategy overweights the sectors with the highest correlations to rising rates.

Bob: How has the performance been over the course of this year? Has it performed the way you expected?

Simeon: So far this year, EQRR has substantially outperformed the S&P 500. The sector and stock selection components have been key drivers of the outperformance, and it's not a surprise to us. Years ago, this would have been the domain of the active portfolio manager who would poke around and say, "Oh, I think maybe there's an opportunity to get an extra couple of bank stocks or maybe a couple of energy stocks." But with the evolution of the ETF landscape, we can deploy a rules-based strategy to achieve those objectives in a disciplined manner. It follows that

Nasdaq Index, so it can't wake up in the morning and change its stripes. That discipline and that effective construction have contributed significantly to its outperformance.

Bob: What if rates don't rise as we expect? What if the economy, for example, falls into a recession and the Fed has to pause or reverse its rate hikes? What should investors expect from EQRR in that environment?

Simeon: I'll answer this in two parts. First, I'll focus on the second half of your question: What if the economy falls into a recession and the Fed has to pause or reverse its rate hikes? I go back to my comments at the beginning of our conversation. Even if the Fed pauses or even reverses its rate hikes, because of the effects of quantitative tightening, it's very likely that interest rates will continue to rise. Remember, a normal 10-year bond yield is 4%. That's 2% inflation and 2% real. Even from here, where we have a 10-year rate that's in the low twos, we could still have another 100 basis points of rising interest rates even if the Fed did nothing and the economy was a little weak. This is an environment where there is a broad range of macroeconomic outcomes that could cause interest rates to rise. That puts an additional tailwind behind the deployment of a strategy like EQRR.

I don't want to dodge the question, but if you would've asked me three months ago, "What's the scenario where interest rates don't rise?" I would've almost callously and flippantly said, "Well, if there's a major geopolitical conflict." If you want any more evidence that interest rates are likely to continue to rise, consider that while a major war is underway interest rates have continued to rise. That's not supposed to happen. Wars are exactly when you're supposed to have a big flight to safety and a bond rally. So it's tough to come up with a scenario where interest rates fall, but I promised not to dodge your question.

If rates do fall, this strategy is likely to underperform. This is a great satellite for a rising rate environment. But if in that corner case where rates don't rise, indeed, you'd likely see underperformance.

Rising rates are a direct shot at your bond portfolio. But there's a real opportunity to address your equities and position them optimally for a rising rate environment.

Bob: To follow up on your comment about this being a satellite-type allocation, where have advisors typically taken the allocation from when they've added EQRR?

Simeon: If you are taking it from your equity portfolio, there's nothing wrong with a pro rata allocation. But because EQRR is a higher-octane piece of the equation, you may want to take it from the growthier-side of your equity portfolio.

Perhaps more interestingly, one of the best places to take it from is fixed income. One of the benefits of a strategy like EQRR is that equities can be better positioned for a rising rate environment than bonds. If you had a 60/40 asset allocation, you might want to be 65 or 70% stocks now. A great rebalance idea would be to take five or 10% from your bond portfolio and put it in EQRR.

By the way, you might even have some losses to harvest in bond land, which could make it extra interesting.

Bob: If there's one key takeaway you would like to leave with our readers about the best way to invest in an era of rising rates, what would that be?

Simeon: The message that we want people to hear is don't take your equity portfolio for granted. Rising rates are a direct shot at your bond portfolio. But there's a real opportunity to address your equities and position them optimally for a rising rate environment. That's why we put together EQRR as an ETF solution. It's not just about your bonds; there's an opportunity to position equities for a rising rate environment as well.

ProShares

IMPORTANT INFORMATION

This information is not meant to be investment advice. There is no guarantee that the strategies discussed will be effective. Investment comparisons are for illustrative purposes only and not meant to be all-inclusive.

Any forward-looking statements herein are based on expectations of ProShare Advisors LLC at this time. ProShare Advisors LLC undertakes no duty to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Investing is currently subject to additional risks and uncertainties related to COVID-19, including general economic, market and business conditions; changes in laws or regulations or other actions made by governmental authorities or regulatory bodies; and world economic and political developments.

Investing involves risk, including the possible loss of principal. This ProShares ETF is subject to certain risks, including the risk that the fund may not track the performance of the index and that the fund's market price may fluctuate, which may decrease performance. Please see their summary and full prospectuses for a more complete description of risks. **There is no guarantee any ProShares ETF will achieve its investment objective.**

The fund is designed to provide relative outperformance, as compared to traditional U.S. large-cap indexes, such as the S&P 500, during periods of rising U.S. Treasury interest rates. As a result, the fund may be more susceptible to underperformance in a falling rate environment. There can be no guarantee that the fund will provide positive returns or outperform other indexes.

The fund concentrates its investments in certain sectors. Narrowly focused investments typically exhibit higher volatility.

Carefully consider the investment objectives, risks, charges and expenses of ProShares before investing. This and other information can be found in their summary and full prospectuses. Obtain them from your financial professional or visit ProShares.com. Read them carefully before investing.

Nasdaq® is a registered trademark of Nasdaq, Inc. and is licensed for use by ProShare Advisors LLC. ProShares ETFs have not been passed on by Nasdaq, Inc. or its affiliates as to their legality or suitability. ProShares ETFs based on the Nasdaq U.S. Large Cap Equities for Rising Rates Index are not issued, sponsored, endorsed, sold, or promoted by Nasdaq, Inc. or its affiliates, and they make no representation regarding the advisability of investing in ProShares ETFs. **THESE ENTITIES AND THEIR AFFILIATES MAKE NO WARRANTIES AND BEAR NO LIABILITY WITH RESPECT TO PROSHARES.**