



IMPACT OF **HIGH INTEREST RATES** ON VALUATION FOR ALTERNATIVE INVESTMENTS



JCSD CAPITAL, LLC

OUR FEATURED PANELISTS



Muhammad Akram

AKRAM & ASSOCIATES



Steve Rosen

SPEAKER



Kamil Homsy

GLOBAL REALTY CAPITAL LLC



Jeff Miller

JCSD CAPITAL LLC

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Program level : Basic
No prerequisites are required
No advance preparation is required

For more information please contact:

Muhammad A. Akram - CPA and Founding Member Toll-Free: 844-386-3829 | makram@aifundservices.com

ABOUT



AKRAM & ASSOCIATES IS A FULL-SERVICE ACCOUNTING FIRM PROVIDING ASSURANCE, ADVISORY, AND TAX SERVICES FOR THE FINANCIALLY SAVVY, ESPECIALLY HEDGE FUNDS & CRYPTOCURRENCY FUNDS.

The logo for GLOBAL REALTY CAPITAL. It consists of a solid blue square with the words 'GLOBAL' and 'REALTY CAPITAL' in white, stacked vertically in a sans-serif font.

GLOBAL REALTY CAPITAL IS THE ONSHORE ARM OF THE GRC INVESTMENT GROUP, A FAMILY OFFICE LOCATED IN DUBAI/UAE. PROVIDE STRATEGIC ADVISORY SERVICES TO HNW FAMILIES AND GROUPS.

JCSD CAPITAL, LLC

JCSD CAPITAL, LLC OPERATES AS AN INVESTMENT ADVISORY FIRM. THE COMPANY OFFERS PORTFOLIO MANAGEMENT SERVICES.

INTRODUCTION

The Federal Reserve has been hiking interest rates to tame high inflation.

Hiking rates too high, too quickly could tip an already cooling economy into recession. On the other hand, not raising them enough may perpetuate higher prices that have been weighing on consumers and companies.

It is more expensive to borrow money, from mortgages to auto loans to credit cards. Businesses also pay more to borrow the money they need to grow their operations. That's why, in response to rising rates, both consumers and businesses tend to rein in their spending, which slows economic growth and eventually lowers the prices of goods and services.

INTEREST IMPACT ON BONDS

The Fed sets the federal funds rate, which is the interest rate commercial banks charge each other to borrow money for a very short term. Higher yields also tend to make bonds more attractive relative to riskier assets like stocks.

AVAILABLE FOR SALE AND HELD TO MATURITY BONDS

For investors looking to sell a bond before it reaches maturity, a rise in rates may mean they need to sell at a discount to face value to compete with newer, higher yielding bonds coming to market. However, if you buy and hold individual bonds to maturity, rising interest rates may be less of a concern, as you'll receive your full principal back at maturity, provided the issuer doesn't default.

For investors whose primary objective is income, rising rates mean some fixed-income assets may offer attractive yields. Higher yields also tend to make bonds more attractive relative to riskier assets like stocks.



POLLING QUESTION

WHAT IS THE POTENTIAL IMPACT OF HIKING INTEREST RATES TO TAME HIGH INFLATION?

- a) Boosting economic growth and consumer spending**
- b) Maintaining stable prices for consumers and businesses**
- c) Potentially tipping a cooling economy into recession**

INTEREST IMPACT ON STOCKS

Rising interest rates tend to weigh on stock valuations, as they can drag on corporate profits and growth potential.

GROWTH STOCKS:

When interest rates are trending higher, it can clip the wings of pricey growth stocks, whose valuations are predicated on future returns. The valuation of future earnings for stocks through present value calculations relies on assumptions regarding interest rates and inflation. If investors expect an increase in rates down the line, it diminishes the present value of future earnings for stocks, consequently putting more downward pressure on stock prices.

INTEREST IMPACT ON STOCKS

DIVIDEND PAYERS:

With bonds now offering investors potentially higher coupon rates and less risk, dividend payers may need to increase their yield to compete.

When interest rates rise, the dividend yield of a stock faces downward pressure, requiring companies to increase dividends to maintain a similar payout level in relative terms. A similar situation arises with bonds, where increasing rates result in a decline in bond values.

FINANCIALS:

The financial sector is one area where higher interest rates may serve as a tailwind since lenders can potentially earn more on loans. Higher rates can widen net interest margins for financial institutions, boosting profitability. Loan demand may decrease as borrowing becomes more expensive, affecting credit quality and portfolio performance.



POLLING QUESTION

HOW DO RISING INTEREST RATES AFFECT CONSUMER AND BUSINESS SPENDING PATTERNS?

- a) Encourages increased spending and investment**
- b) Has no impact on spending habits**
- c) Leads to a decrease in spending, slowing economic growth and lowering prices**

THE EQUITY RISK PREMIUM

Equities are not priced in a vacuum; they are always compared to other alternatives. Suppose you could get a **4.5%** annual yield on a **10-year** Treasury note, and annual inflation is about **3.5%**. You're making a positive **1%** real yield, which is great for a risk-free investment. What would it take for you to buy, say, a dividend stock instead?

In fact, over the past two decades, this risk premium has sat between **300** and **350** basis points; currently it's at **167**. This isn't much different from what an investor might expect to earn from investment-grade credit, which generally is considered less risky than stocks. What's more, the S&P 500's dividend yield is just **1.7%**, compared with the 6-month Treasury bill, offering a yield greater than **4.5%**.

**INTEREST RATE
IMPACTS ON GROWTH**

VS

VALUE COMPANIES

Some companies are disruptors, with new products or services, and are growing rapidly. Investors naturally pay a higher valuation for them.

Other companies are mature cashflow-generating businesses, typically with significant dividends, that trade for lower valuations. While some of them are being disrupted, other ones are doing fine, and just happen to exist in mature industries.

Valuation differentials are a key variable; if there's a bubble in one of the factors, the other factor will likely do better in the subsequent years.

**INTEREST RATE
IMPACTS ON GROWTH**

VS

VALUE COMPANIES

In 2000, there was a bubble in growth/tech stocks, so value stocks outperformed from that peak. In 2007, there was a bubble in value/bank stocks, so growth stocks outperformed from that peak.

Changes in interest rates are the other variable, in large part because they affect valuation differentials as one of the underlying causes. How a Discounted Cash Flow (DCF) model has an impact to determine fair value for a value vs. growth stock?



POLLING QUESTION

HOW DOES THE EQUITY RISK PREMIUM IMPACT INVESTMENT DECISIONS?

- a) It has no influence on investment choices**
- b) Encourages investors to choose risk-free investments**
- c) Affects the attractiveness of dividend stocks compared to risk-free investments**

IMPACT OF INTEREST RATE ON REAL ESTATE

The U.S. housing market continues to face challenges due to today's higher interest rate environment. Demand for housing slowed in recent months, a trend that's reflected in modestly declining home values. The market for real estate investment trusts (REITs) has been even harder hit by the more challenging environment.

Interest rates have a significant impact on commercial real estate markets, whether they're high or low.

IMPACT OF INTEREST RATE ON REAL ESTATE (Cont'd)

When interest rates are higher, investors can expect to see slower growth fundamentals and potentially lower property values during these times due to decreased cash flow opportunities.

However, by being intentional about acquiring properties that generate stable cash flow and are located in markets with strong economic fundamentals (which you can find here from Urban Land Institute), you may be able to mitigate any potential negative effects, at least in the short-term, of increased debt service.



POLLING QUESTION

HOW DOES THE INTEREST RATE ENVIRONMENT IMPACT THE REAL ESTATE MARKET?

- a) Stimulates demand and increases property values**
- b) Has no effect on the real estate market**
- c) Can lead to slower growth, decreased cash flow opportunities, and lower property values**

EVALUATION

- A.** Were the stated learning objectives met?
- B.** Stated prerequisite requirements were appropriate and sufficient?
- C.** Were the program materials relevant and did they contribute to the achievement of the learning objectives?
- D.** Was the time allotted to the learning activity appropriate?
- E.** If applicable, were individual instructors effective?



THANKS FOR LISTENING



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