The Risks and Rewards of Long-Duration Stocks

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This year we've seen a lot of attention paid to higher inflation and, along with it, higher interest rates. The stock market has generally responded negatively to the risk of both, but nowhere has the response been stronger than aspirationally-valued technology stocks.

Interest rates have a significant effect on stock prices due to the Discounted Cash Flow (DCF) valuation method. Fundamentally, DCF attempts to normalize future earnings by discounting them at a rate that compensates for both inflation and the idiosyncratic risk of those earnings not being realized. As the discount rate rises, it not only has the effect of decreasing each individual period's earnings, but the effect is exponential the further we discount into the future.

The reason why technology stocks have been hard hit by this year's rise in interest rates is because many technology stocks have earnings that are low in the near-term years but are projected to grow rapidly in the out-years. Compare recent IPO (Initial Public Offering) stock ROKU to mature AT&T, for instance. Both are in the telecommunications sector and both participate in the creation and distribution of media content. Here are the profiles for their earnings over the next few years:

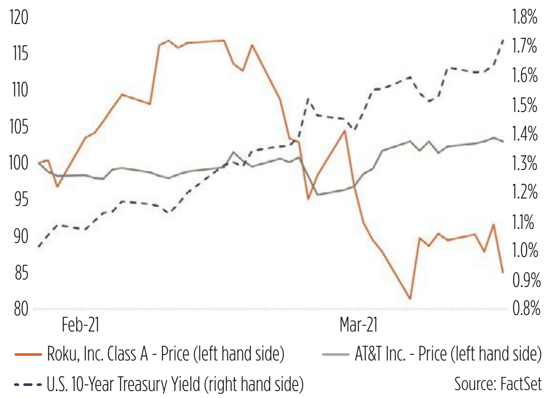
	2021	2022	2023	2024	2025
AT&T	$3.16	$3.15	$3.19	$3.14	$3.42
Roku	$0.31	$1.01	$2.74	$4.90	$11.02

Source: FactSet

Roku's earnings are projected to occur mostly in year four and beyond. The $11.02 of estimated 2025 earnings gets discounted back by the 4th power of (1 + the discount rate). The slightest rise in the discount rate will have an outsized effect on these 2025 earnings, which represent the bulk of Roku's value.

By comparison, AT&T's earnings estimates are far more stable and therefore derive more value from their current and nearby years' earnings. Thus, AT&T is not as affected as Roku when interest rates rise. As the 10-year treasury rate rose from 1.01% on January 27th to 1.73% on March 18th of this year, here is how these two stocks responded. AT&T barely budged while Roku dropped significantly.

The Effect of Rising Interest Rates on Stocks in 1Q 2021



Source: FactSet

And Roku isn't an isolated case. Various tech, IPO, and SPAC companies faced similar headwinds—and similar performance characteristics—during the 1st quarter's bout with rising interest rates.

It should be recognized that interest rate moves and their effects on stock prices are transient. Enduring share price movements come from the size, stability, and reliability of company earnings. While this article has focused on technology stocks and the outsized effects of interest rate movements on their share price, these are often the same companies that are building lasting earnings power through disruptive, novel technologies.

Understanding the effects of interest rates on share prices via the DCF model can give comfort during periods of market volatility. The ultimate decision to buy, sell, or hold individual stocks is more appropriately gauged considering a company's long-term earnings power.

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