Stocks Turning Rising Rates into Profits

Description

A few weeks ago I wrote the [first article] in a series based on this [Fidelity Viewpoints article] that will bring to your attention stocks that can outperform during a rising rate environment. Since that time the U.S. Federal Reserve chief announced quantitative easing would continue at its previous pace of $85 billion in bond purchases per month. This decision may put a short-term pause in the upward momentum of interest rates, but at these artificially low levels, investors will be forced to navigate a rising rate environment soon enough.

Stocks can still be a profitable investment during a period of rising rates, but some adjustments to your portfolio may be in order to be in the best position. There are a couple of paths one could follow in order to find companies that are well positioned when the inevitable occurs. The most obvious is to find sectors that will profit directly from higher interest rates. The top fit in this category is most likely going to be the financials. Life insurance companies also tend to be solid performers when rates move higher. If you believe higher rates are a result of an improving economy, you may also want to take a closer look at sectors that will benefit from a better economic environment -these are often times referred to as “cyclicals”.

Rising rates raising the bottom line

The financials are one of the go to investments to protect portfolios from rising rates. However, while investor demand may support or push the stocks of financials higher, the impact to the bottom line of these companies may take time to materialize. As rates rise banks, are certainly increasing the interest on new loans, but they are also paying clients more for their deposits causing short-term pressure on margins. Terms on deposits are generally shorter than those of loans which could cause some margin pain until the banks are able to put on enough loans to outweigh the older loans and the newer deposits.

The **Toronto-Dominion Bank** (TSX: TD) should be able to benefit in a number of ways from a rising interest rate environment. As I previously mentioned, banks will suffer some margin compression in the early stages of the interest rate move, but this should begin to shift as the bank is able to put on longer term loans at higher rates. At current rate levels, Toronto-Dominion President and CEO, Ed

Clark, sees margins stable to improving.

In addition to increasing interest rate margins, TD Bank should also benefit from an improving U.S. economy. Adjusted net income has grown every year since 2007 and 2013 looks to add to that string of success. Another benefactor in the bank's arsenal is it's approximately 42% ownership in **TD Ameritrade Holding Corp.** (NYSE: AMTD). The discount broker should benefit from the large amounts of cash clients have setting on the sidelines earning a very modest rate of return.

Life insurers such as **Great-West Lifco Inc.** (TSX: GWO) should also see improving fortunes as rates continue to rise. While the bond portfolios of life insurers will take a valuation hit, short-term, the long-term nature of these portfolios should mute the impact as rising rates encourage new investment into products such as annuities as rates become more attractive. Adding to the fortunes at Great-West is its recent acquisition of Irish Life for €1.3 billion. The acquisition is expected to add $0.10 to consensus 2014 earnings per share.

Leading sectors in an improving economy

According to another Fidelity Viewpoints article, the information technology sector is one of the better performers during the early stages of an economic recovery. However, the news for this sector just seems to get better as the economy moves into the middle stages of a recovery when the technology sector is generally the best performer.

As businesses begin feeling better about the overall condition of the economy they begin to make improvements to technology that was neglected during the leaner years. This should benefit companies such as **CGI Group Inc.** (TSX: GIB.A). CGI offers technology solutions to customers worldwide which help lower costs and enhance productivity. With a presence in 40 countries, CGI is well positioned to take advantage of increased spending across the globe.

While CGI is a large multinational firm, investing directly into a single technology can carry risks many investors are not willing to accept. For those investors that want a more diversified approach, the **S&P/TSX Capped Information Technology Index Fund** (TSX: XIT) might help ease the diversification concerns. However, this lone TSX traded technology ETF is not as diversified as you might expect. The fund is currently made up of only seven stocks and the top two holdings CGI Group and **Open Text Corporation** account for 47.5% of the total. If more diversification is desired, a global technology fund may be the best alternative.

The Fidelity article also points to the industrials as potential winners in the early and middle stages of an economic recovery. For an early stage pick, trucking companies are a noted beneficiary and companies like **TransForce Inc.** (TSX: TFI) should continue to improve as the economy evolves. Airlines tend to fair better during the middle stage when economic growth becomes more predictable and sustained. Many of the airlines are already trading at 52-week highs and **WestJet Airlines Ltd.** (TSX: WJA) is no exception. A breather might be in order, but many believe there is still wind behind the back of the airline stocks.

Final thoughts

It is important to watch the trajectory of rates. If rates move too high too fast it could spell trouble for interest rate sensitive stocks such as financials and life insurers. Financials will see a rush to higher yielding short-term products while still holding longer term loan products at much lower rates causing swift margin compression. Life insurers could see money flows from spread-based products such as annuities and variable life policies shift to higher return products just as it is taking a hit to its portfolio from falling bond prices.

Lastly, many of these stocks have had good runs so look for pull backs.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:GIB.A (CGI)
2. TSX:GWO (Great-West Lifeco Inc.)
3. TSX:OTEX (Open Text Corporation)
4. TSX:TD (The Toronto-Dominion Bank)

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