LORD ABBETT

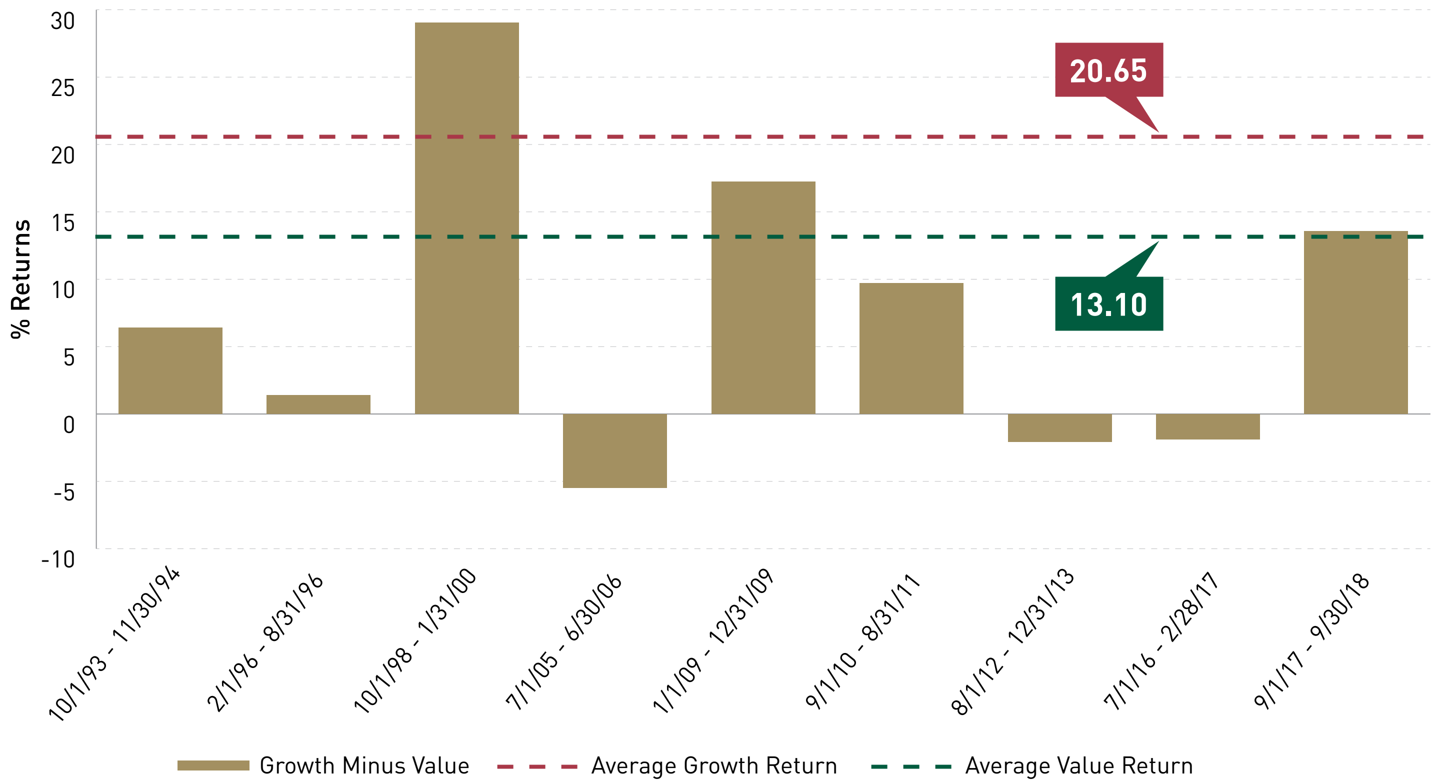
MARKET VIEW

POSITIONING EQUITY PORTFOLIOS FOR RISING RATES

Not all U.S. equities have performed the same when rates rise.
Ignoring that simple fact could have serious repercussions for investors.

CHART 1. HISTORICALLY, THERE HAS BEEN A NOTABLE DIVERGENCE BETWEEN GROWTH AND VALUE STOCKS DURING PERIODS OF RISING RATES

RETURNS (%) OF GROWTH AND VALUE STOCKS DURING NINE PERIODS WHEN 10-YEAR U.S. TREASURY YIELDS ROSE MORE THAN 100 BASIS POINTS



Source: Morningstar Direct. Growth stocks as represented by the Russell 3000® Growth Index. Value stocks as represented by the Russell 3000® Value Index. **Past performance is not a reliable indicator or a guarantee of future results.** For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment

IN BRIEF

- Historically, growth stocks have outperformed value stocks in periods of rising interest rates.
- For investors who rely on an index, or an index-hugging strategy for their growth allocation, this may be a particular concern.
- For example, many companies in the top 20 of the Russell 1000® Growth Index are slow growth and high yielding.
- A prudent investor will want to ensure that their portfolio's growth exposure is actually providing exposure to growth.

CONTRIBUTING STRATEGIST

Trent Houston
Product Strategist

TABLE 1. MANY COMPANIES IN THE TOP 20 OF THE RUSSELL 1000® GROWTH INDEX ARE SLOW GROWTH AND HIGH YIELDING

TOP 20 COMPANIES IN THE RUSSELL 1000 GROWTH INDEX BY MARKET CAPITALIZATION, AS OF SEPTEMBER 30, 2018

Holding	Dividend Yield (%)	Historical 3-Year Sales Growth (%)*	Price to Earnings FY1
Apple Inc.	1.2	4.7	19.2
Microsoft Corporation	1.5	5.8	26.8
Amazon.com, Inc.	—	27.4	115.1
Alphabet Inc. Class A & Class C**	—	20.9	29.7
Facebook, Inc. Class A	—	44.9	23.0
Visa Inc. Class A	0.5	13.9	32.7
UnitedHealth Group Incorporated	1.2	15.6	20.9
Home Depot, Inc.	**1.9**	**6.9**	**21.7**
Mastercard Incorporated Class A	0.4	13.5	34.7
Boeing Company	**1.8**	**0.8**	**25.4**
NVIDIA Corporation	0.2	35.4	38.7
Netflix, Inc.	—	29.2	139.4
AbbVie, Inc.	3.5	13.8	12.0
PepsiCo, Inc.	**3.1**	**0.1**	**19.7**
Coca-Cola Company	**3.3**	**-10.2**	**22.2**
Adobe, Inc.	—	23.9	39.6
Amgen, Inc.	**2.5**	**4.1**	**14.8**
Walt Disney Company	1.4	4.3	16.8
Altria Group, Inc.	**4.7**	**1.5**	**15.1**
Salesforce.com, Inc.	—	25.5	63.5

Source: FactSet. *Historical 3-Year Sales Growth data as of 9/30/2018. **Alphabet, Inc. Class A and Class C shareholdings have been combined. Price-to-Earnings FY1 ratio shown is an average of the two share classes.

The historical data shown are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. The information shown is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of investments.

As the U.S. Federal Reserve continues to implement measured, gradual increases of its target fed funds rate, investors have been grappling with the ramifications of these steady rate hikes on their fixed-income portfolios. This is not without good reason, as the inverse correlation between bond prices and yields is a basic investment tenet and, historically, credit has tended to outperform duration as fixed-income yields rise.

However, what is less often considered by investors is the impact rising rates may have on the equity positions in their portfolios. Many investors believe that equities, at least from a broad asset-allocation level, have been a strong hedge against rising rates historically. Certainly, at a high-level, the relative outperformance of equities in periods of rising rates can be validated; in the nine periods over the past 25 years when the 10-year U.S. Treasury yield has risen by 100 basis points (bps) or more, U.S. equities (as represented by the Russell 3000® Index) on average have returned nearly 17%, according to FactSet.

But not all U.S. equities have performed the same when rates rise. Ignoring that simple fact could have serious repercussions for investors.

In particular, historically there has been a notable divergence between growth and value during periods of rising rates. According to Morningstar, as shown in Chart 1, during the nine most recent periods of a more than 100 bps rise in the 10-year U.S. Treasury yield, domestic growth stocks have outperformed domestic value stocks two-thirds of the time, averaging an annualized return of more than 20% and outperforming value stocks by more than 7% in each of the periods on average. This is a substantial performance differential, roughly equal to the long-term average annual return of the S&P 500® Index.

For investors, we believe the implication of this divergence in equity returns should be clear: growth stocks should be a key part of a diversified asset-allocation mix during periods of rising interest rates.

For this reason, a prudent investor will want to ensure that their portfolio's growth exposure is actually providing exposure to growth. This is a particular concern for investors who rely on an index, or an index-hugging strategy for their growth allocation.

A prolonged period of accommodative monetary policy that kept interest rates ultra-low following the global financial crisis led to some notable distortions across the capital markets, including fevered demand for dividend-paying stocks that in many cases yielded substantially more than a 10-year U.S. Treasury. With surging price-earnings multiples, these stocks began to find themselves inside major growth indexes despite having little or no fundamental growth at all. Even as markets have begun to normalize in the years following the end of quantitative easing, many of these slow-growth high-yielding stocks still can be found at the top of these growth indexes, which may come as an unfortunate surprise for investors seeking growth specifically as a hedge against rising interest rates.

To be sure, both value and growth strategies can play an important part in equity portfolios, as each possesses characteristics that make them potentially well-positioned for varying market and economic environments. For investors seeking growth as a way to capitalize on the current rising-rate environment, utilizing a strategy that is focused on identifying stocks exhibiting true fundamental growth may be a preferable option that is more accurately aligned with their desired outcome. ■

GLOSSARY

One **basis point** is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.

A **Dividend yield** refers to a stock's annual dividend payments to shareholders, expressed as a percentage of the stock's current price.

The **price/earnings ratio** (often shortened to the **P/E ratio**) is the ratio of a company's stock price to the company's earnings per share.

Quantitative easing, also known as large-scale asset purchases, is an expansionary monetary policy whereby a central bank buys predetermined amounts of government bonds or other financial assets in order to stimulate the economy and increase liquidity.

The **Russell 1000® Growth Index** measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 3000® Index** measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

The **Russell 3000® Growth Index** measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 3000® Value Index** measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

Lord, Abbett & Co. LLC | 90 Hudson Street | Jersey City, NJ 07302-3973 | T 1.888.522.2388 | lordabbett.com