Today we’re going to continue our discussion of investing in an inflationary environment. Here’s Brandon…

—

“**What would be the worst investment to make during periods of high inflation?”**

The “worst” high-inflation investment would look something like this:

- Low gross and operating margins
- Most (if not all) of its COGS are highly anchored to inflation rates
- Cannot raise prices without severe customer substitution/trade-off
- Won’t generate cash flow until years into the future
- Requires additional (higher cost) capital to survive
- Product/Service is a discretionary purchase

These are your loss-making, nice-to-have software management tools (ASAN, EXFY, etc.), your furniture retailers (RH), restaurants with commodity-driven variable cost structures and operating leases, and fast-growing companies with promises of distant free cash flow generation.

As we’ll see below, you **do not** want to own companies in these industries during high inflation:

- Retailing
- Household/Personal Products
- Telecom
- Food Beverage
- Biotech and Life Sciences

I want to say something important here. It’s not that these aren’t good businesses. Some of them will become great, cash-gushing money printers. But they’re not great for the high inflation environment we’re in and might be in for the next decade.

So, <u>what do you want to own</u>?

Something like See’s Candy, a confectionery company. Let’s go back to Buffett. Listen to how he describes See’s Candy and why it’s a great asset to own during high inflation (emphasis added):

> “See’s Candies **does not take much in the way of expenses to operate**, and **doesn’t require heavy capital expenditures** in order to consistently grow its profits every year.

Because consumers are loyal to the See's brand, they **eagerly absorb any pricing increases** even during economic uncertainty and/or inflation.

With that valuable asset which is not accounted for on the balance sheet, See's Candies is able to see its **revenues grow as it increases prices while other expenses also rise**.

But because those expenses are minimal, and See's doesn't take much capital to continue to mint free cash, **its damages experienced from inflation are minimal, and the company is able to earn fantastic compounding rates of return for investors.**"

See's relied on three main factors:

- A capital-light operating model with minimal capital required to expand revenues
- Price inelastic customers willing to absorb price increases (brand power)
- Revenues rise with expenses resulting in minimal inflation damage

We can further extrapolate See's success to identify characteristics that increase odds of survival (and even *thriving*) during high inflation environments:

- Non-discretionary good or service
- Currently generates positive free cash flow/earnings
- Mid-to-high gross and/or operating margins
- Subscription/recurring revenue model businesses (must be non-discretionary!)
- Some real asset attributed to the business (real estate or commodity)
- Value-biased businesses

We want to invest in businesses with high margins and COGS that aren't tied to inflation. They should also have an ability to raise prices without consumers noticing/complaining/trading-down.

These businesses need to generate cash today and trade at a modest-to-cheap valuation.

Additionally, we want to invest in businesses that sell/leverage hard assets (like oil or real estate) — basically any business that sells the high-inflation COGS in another business's expense line.

A Quick Word on Subscription/Recurring Revenue Models

Recurring/subscription-based businesses are only great inflation hedges if consumers deem it a non-discretionary purchase decision. In fact, the best subscription businesses are stickier than long-term debt.

Vista Equity Partners CEO Robert Smith calls these recurring revenue companies "better than first-lien debt."

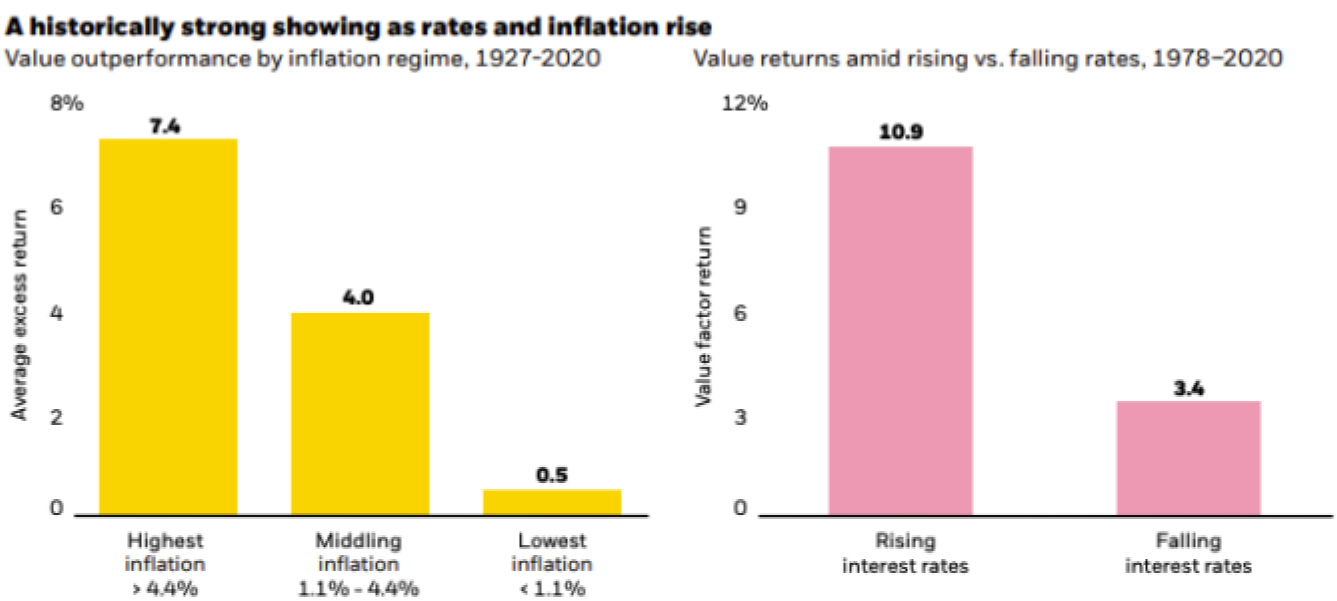
Smith continues his analogy, saying (emphasis added):

> *"You realize a **company will not pay the interest payment on their first lien until after they pay their software maintenance or subscription fee**. We get paid our money first. Who has the better credit? He can't run his business without our software."*

However, as Gavin Baker of Atredis Management explained in his 2020 Medium post, *"There is no such thing as truly recurring revenue. Some revenue is just more recurring than other revenue."* Double-check to see if that subscription really is a mission-critical/non-discretionary expense.

Data Tells All: Value Outperforms During High Inflation

BlackRock published a report highlighting the importance of buying value over growth during high inflation periods:

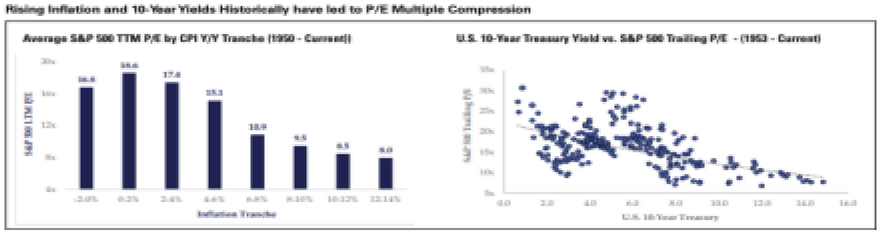


As BlackRock notes, Value dramatically outperforms during high inflation and rising interest rate environments.

One reason for Value's outperformance is the fact that high inflation periods bring multiple compression (P/E ratios shrinking). Boston Partners highlighted this correlation in an inflation whitepaper ([read here](#)).

Figure 2:

Rising Inflation and 10-Year Yields Historically have led to P/E Multiple Compression



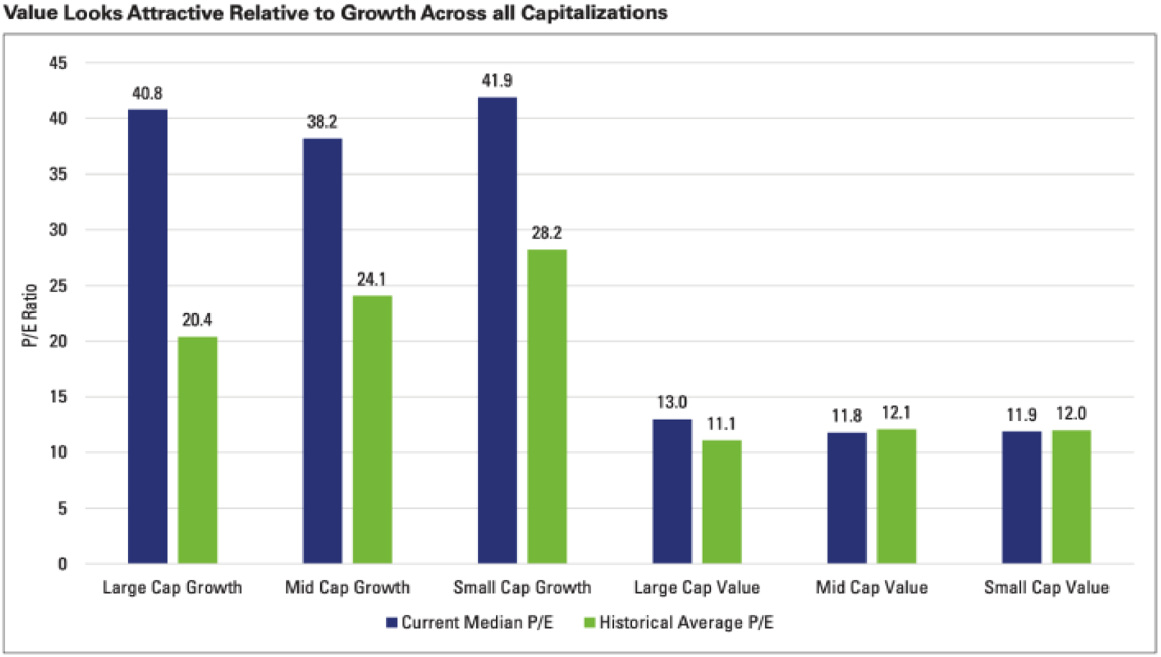
Data as of December 31, 2021.
Source: Strategas.
TTM = trailing 12 months. Past performance is not an indication of future results. Please refer to the last page for other important disclosures.

Boston Partners also explains how interest rate changes disproportionately affect growth stock valuations*: "Growth stocks are longer duration assets compared to their value counterparts as a significant portion of growth company cash flows are further into the future. Like the bond market where 30-year bonds will lose more value if rates rise 1% compared to 1-year notes, growth stocks will lose more value relative to shorter duration value stocks in a rising rate/inflation environment."*

Boston Partners also found that the "Value over Growth" dynamic applied across all market capitalizations (see below).

Figure 4:

Value Looks Attractive Relative to Growth Across all Capitalizations



If you believe in base rates, the above chart should scare you away from investing in high multiple businesses during inflationary environments.

What Industries Offer The Best Returns?

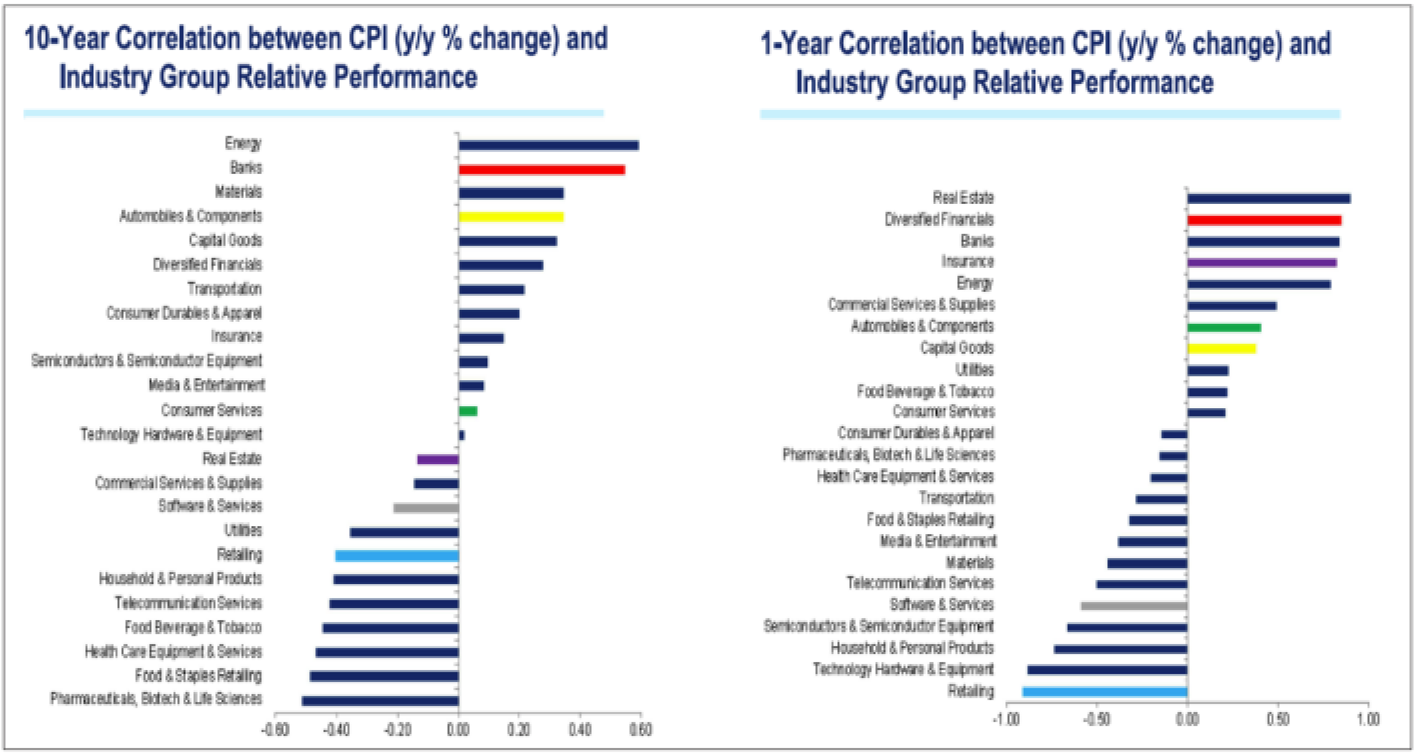
BlackRock noticed that three industries outperformed all others during high inflation periods: **Energy**, **Financials**, and **Healthcare**.

	Annualized return, 1968-1981	Outlook for this time	Why (what's different)?
Energy	14%	−	Supply is more disciplined, but energy transition lowers multiples/ terminal value
Utilities	5%	+	More automatic fuel inflation adjustment today
Materials	6%	+	Greater demand for energy transition metals; more disciplined producers
Technology	5%	+/−	Software nascent in 1970s, bigger today; hardware mature, less pricing power
Communications services	7%	+/−	More competitive U.S. telecom market today; new business models and less regulation
Consumer discretionary	3%	−	Greater pricing transparency today with eCommerce. But sector is fairly heterogeneous; stock selection matters
Consumer staples	6%	−	Price controls less likely, but pricing power weaker with more consolidated retailers
Financials	8%	+	Stronger capital position/balance sheets
Industrials	6%	+	Lower labor cost pressures today given automation, lower unionization rate
Healthcare	8%	−/+	Pricing power more critical to pharma given slower growth; med-tech less cyclical and has COVID recovery potential
S&P 500	7%		

Boston Partners confirmed this data, highlighting Energy, Banks, and Materials as the three highest-returning industries based on CPI correlation (see below).

Figure 3:

Industry Sensitivity to Inflation



Data as of May 31, 2021

GMO takes this analysis a step further and suggests that there are only three main drivers of investment outperformance during periods of high inflation:

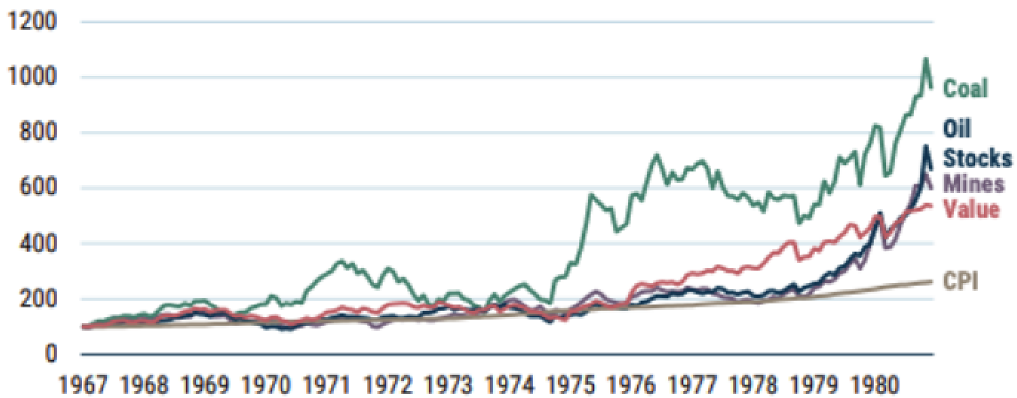
- Cheap real assets (think value stocks)
- Oil (and oil stocks)
- Coal (and coal stocks)

Here's a quote from GMO the whitepaper titled Part 2: What to Do in the Case of Sustained Inflation: What if We're Wrong? (emphasis added):

> "During the last bout of significant inflation, **commodity equities were a good store of value** (unlike the underlying commodities), and **so were value stocks in general**. Why? Effectively, **you were buying cheap real assets**. This is **like being offered inflation insurance at a discount**. So if you are worried about inflation and looking for a store of value, or you are trying to build a robust portfolio that can survive lots of different outcomes, **then buying cheap equities looks like a great place to start.**"

They also have the performance data to back it up (see below)

EXHIBIT 11: COMMODITY EQUITIES, VALUE EQUITIES, AND INFLATION



Source: Ken French, Global Financial Data, GMO

What worked over the past ten years may not work for the next ten. Our job as investors is to align our approach with the regime. And to do that we need to know what approaches work in which regimes.

Hopefully this short primer helps you be a little bit better at both.

Your Macro Operator,

Alex

P.S: If you have questions on any of this, or if you want to skip ahead, **check out our FAQ here.**