

Inflation Protection

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The past decade has seen central banks pumping liquidity into the financial system on an unprecedented scale – it has been given the beguiling name of Quantitative Easing. In old coinage, we would call it printing money. This has been with the noble intention of preventing a collapse of the global economy, which would have led to a prolonged depression similar to that experienced in the 1930s. However, now we must begin to ask what comes next, as economic history shows that this type of economic experiment ultimately leads to higher inflation which can reduce buying power for all of us.

Cash and most fixed income holdings do not provide protection during periods of high inflation, particularly when interest rates at the onset of the inflationary cycle are as low as they are today. But what about equities?

Well, different companies are affected in different ways.

Companies with high working capital requirements and large fixed assets (which need replacing periodically) will struggle during bouts of inflation. Cash will be extracted from the company's coffers to spend on acquiring new inventory or on capital expenditure at now inflated prices. These companies need to run fast to simply stand still.

For cyclical companies like the Oil & Gas majors for example, even a normal inflation rate of 3% has a large impact on their financials. Oil & Gas companies making periodic and large capital expenditures will always overstate accounting earnings while understating what actually matters to investors, the free cash flow. If a piece of equipment costs £100 million today, a 3% inflation rate over 20 years will mean when it comes time to replace it, the company will have to pay almost £200 million. By systematically understating replacement costs, they inadvertently overstate the accounting earnings. This is one of the reasons why the normalised free cash flow for the Oil and Gas majors are usually half of their accounting earnings. Higher potential inflation of 4%-5% will only make things worse for such capital-intensive businesses.

Companies with minimal working capital requirements and low fixed assets can thrive in such an environment. First, they have lower capital replacement costs compared to an Oil company and secondly, they can increase prices in line with inflation. Many companies have actually benefitted from higher inflation levels over previous decades as their increase in revenue from inflation-adjusted selling prices helps to offset potentially higher input costs. Interestingly, there are more of these companies today than were in previous economic cycles: these include established tech companies like Apple and Microsoft, and consumer defensive companies like Unilever and Amazon.

At the start of this piece, we said most fixed income holdings do not offer a hedge against inflation. However, some do. We hold inflation protected government bonds across our strategies exactly for this reason. A hedge will appear to do nothing and serve no purpose until it does. The role of a hedge is not primarily to make money but to protect against unexpected and extreme conditions. The 2027 UK Index Linked bond, for example, will not show a day-to-day gain on a valuation, but if inflation picks up between now and its maturity in 2027, investors will be compensated with higher returns. This is an important element of a balanced strategy over the coming years as, if inflation rises, its timing will be unexpected.

Our strategies are positioned very selectively at present, but with one common theme running through them: cashflows that have some positive correlation with rising inflation should that occur over the coming few years, be they equities or government bonds.

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