October 22, 2021

THE SILENT TAX GETS LOUDER

There is an often-quoted truth that if you "torture data long enough, it will confess to anything." When it comes to inflation, the data suffers from a perpetual hostage crisis. For evidence, just consider the mind-numbing array of data points. To begin, you can opt for CPI (Consumer Price Index) or PCE (Personal Consumption Expenditures), and from there economists employ an arsenal of adjustments: headline, core, trimmed mean, median, seasonal, sticky, transitory, etc. Finally, those data sets can be framed year-over-year or sequentially. Before long, any ensuing discussion based on the curation of inflation data may reveal more about the commentator's biases than inflation itself.

The silver lining to today's inflationary spike is that everyone agrees it is high. The debates lie instead regarding its future path and to what extent current economic policies need to be adjusted. Rather than attempt a forecast, or even worse, a policy prescription we will share our analysis of the current inflationary environment, as well as, more practically how we manage inflationary developments and, in many cases, have already benefited.

Perhaps the biggest single problem facing inflation readings today is the damaged global supply chain. However, the supply chain's ineffectiveness stems from a range of issues, beginning with low vaccination rates in key emerging Asian nations to low labor participation rates in developed world nations.

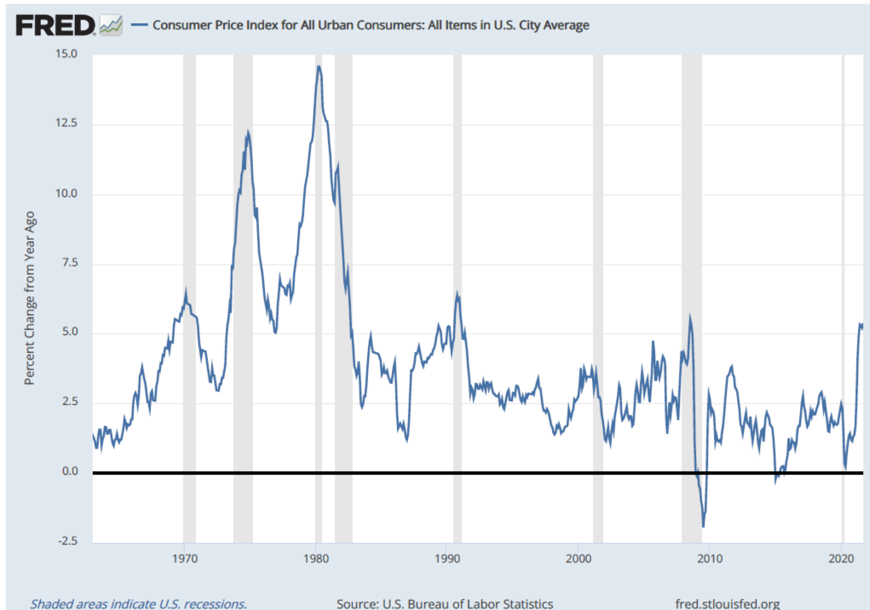
We believe the latter of the two is compounded by the effect of economic stimulus in the U.S., which has led to an excess savings rate (since the pandemic began) that still today drives the consumption of goods at the expense of services. Put differently, fewer people today are comfortable resuming their pre-pandemic spending behaviors towards travel, hospitality, and gatherings. This means that much of the surplus savings have instead been pursuing goods (versus services), thereby creating a heightened demand that continues to strain a feeble supply chain. As we know, when demand overwhelms supply, prices rise, and voila, inflation appears.

As we also have been taught in our introductory economics courses, these types of inflation tend to self-correct thanks to market forces. Capitalists see excess prices (and profit margins) and then mobilize resources to seek extra-normal profits. Supply eventually rises to the point it exceeds demand and prices fall. In other cases of high prices, consumers simply find substitutes or if possible, forgo the purchase altogether. High prices can either lead to new supply, destroy demand, or some mix of both. In any event, deficits between supply and demand find a way to self-correct over time. This logic underpinned the arguments of "transitory" inflation from the

Federal Reserve et al during the past year. To some degree, these effects are taking hold. For instance, lumber prices have fallen over 40% from their May 2021 high, and the odd spikes in apparel, and used autos that erupted in the first half of 2021 are also showing relief. To the extent these imbalances work themselves out across various goods, it will represent a positive mitigating on future inflation readings. Unfortunately, though, there is more to the story.

The murkier issue surrounding inflation appears to be in the labor markets, where labor participation rates are low (e.g., today's 61.6% matches a pre-pandemic low last seen 44 years ago), and employers are therefore increasing wages to attract workers. In time, these higher wage inputs seem likely to be reflected in price increases (and carry inflation higher). Put differently, cost increases due to higher wages and salaries tend to be stickier and represent a more permanent adjustment to a firm's cost structure.

In its worst form, as seen in the inflation of the 1970s rising labor costs can feed a wage-price spiral. In those circumstances, rising prices spur demand for higher wages to maintain purchasing power and the prior standard of living. The wage increases then have two effects, 1.) the fuel to chase prices higher for goods and services and 2.) the incentive for firms to increase prices further (again) to maintain their profit margins in the wake of rising labor costs. When this process becomes self-reinforcing it creates a wage-price spiral. The good news though is that the current levels of inflation pale in comparison to the 1970s. Importantly, there are critical structural differences between the economies of the 1970s and 2021. To begin, the labor markets of the 1970s were considerably more unionized (e.g., producing strikes, etc.) and the present-day economy features rapid technological innovation that both reduces costs and increasingly replaces labor across repetitive activities. To the extent it is helpful, in the illustration below we can see the year-over-year increase in the CPI dating back to 1963 and taking a closer look we can also see that inflation today is well short of 1970s levels, but still at its highest level since 2008.



As we mentioned earlier, we do not create explicit forecasts for inflation. However, we have always been cognizant, and therefore wary of inflation's impact on our investment portfolio's returns. Therefore, our approach at the research and selection level is to choose companies that can continue growing during periods of inflation, or for that matter even deflation.

The simplest antidote to inflation in an equity portfolio is to own firms that at a minimum can pass along rising costs, but even own those that could benefit from a rising price environment. The ability to pass along rising input costs can rely upon any number of corporate strategies, but often come in the form of strong brand equity, comprising a small percentage of your customer's budget, or having monopoly pricing characteristics (e.g., few substitutes). We believe the majority of our holdings utilize *at least* some of these strategies and/or characteristics, but many more *at best may add value to shareholders* in an inflationary environment.

To understand this last scenario better, we will shift our discussion to an actual longstanding portfolio holding that thankfully demonstrated these concepts through its quarterly earnings report yesterday morning.

On the face of it, Nestle SA appears to be a large, almost sleepy food company with long-term sales growth in the low-to-mid single digits. By the way, this market *perception* is a good thing since it keeps most investors disinterested and therefore the shares attractively priced (e.g., value). However, the company and others like it in the branded consumer space have two important attributes that we believe will increasingly come to light in this inflationary environment.

The first, is pricing power, and the second is operating leverage. Pricing power simply means that when the firm raises its selling prices to recoup rising input costs, there is little corresponding loss in sales volume, and by operating leverage, we mean that increases in revenue create an exponential rise in operating income. When price increases and operating leverage combine, it can lead to earnings surprises and a rising share price (not to mention, increasing dividends, etc.).

Returning to Nestle, our estimate of its historical operating leverage (e.g., median for the past five years) is approximately 2.6x; meaning that on average a 1% sales increase corresponds with a 2.6x increase in operating income. This relationship is determined by the relative percentage of fixed costs in Nestle's operating expenses. The basic idea is that a larger percentage of fixed costs increases operating leverage. Let us clarify with a simple example. If a firm's cost structure contains manufacturing plants or other significant fixed costs, these expense amounts are generally stable over time.

For the sake of illustration let us pretend that a food manufacturer's cost structure is comprised of 50% fixed costs (overhead, plants, etc.) and it earns a 10% operating margin. If that firm passes through a 10% price increase, its sales rise from $1.0M to $1.1M, but its expenses only rise from $0.90M to $0.945M, because only 50% of its expenses are variable. This means that the example firm's operating income increased 55% on a 10% price increase (e.g., 5.5x more than the price increase of 10%). For contrast, let us pretend a software firm with little to no fixed costs (e.g., no manufacturing plants, very little overhead) passes along a 10% price increase to keep its staff content. In this case, sales rise from $1.0M to $1.1M, but the variable cost structure also rose by 10%, and therefore the entire price increase was offset by the corresponding cost increase (and earnings only increase 10%). Therefore, in an inflationary environment a firm with pricing power and operating leverage should be expected to generate faster growth than firms with mostly variable costs. One might even expect the surprise burst of faster earnings growth from the higher operating leverage firm to attract capital away from the relatively slower earnings growth of the asset-light technology firm.

Coincidentally, firms with heavier fixed costs in their operating structure tend to be "old economy" firms that are often associated with "value" investing. Conversely, firms with smaller proportions of fixed costs (including software and software driven technology firms), that are associated with "growth" investing may experience slower earnings growth vis a vis the value names *in an inflationary environment*. The relationships described above help explain why we are increasingly upbeat regarding our portfolio in this environment and illustrate at least one internal method through which we are benefiting from the recent rise in inflation.

As a final example, and to close the discussion, Nestle reported yesterday, third-quarter sales growth of 6.5% versus 3.7% consensus estimates, with a significant contribution from price

increases enacted since the first half of 2021. For instance, the firm's leading growth in Petcare products of 16% in the quarter, included 4.5% from price increases. In turn, management reiterated its 2021 margin and earnings guidance and its confidence that it can succeed passing along rising costs through the end of 2022. While we are optimistic surrounding Nestle's performance in this challenging environment (it represents one of our largest holdings), we are careful to note that another one of our large holdings, Unilever, also reported a surprise earnings beat this morning. We believe Unilever represents another strong consumer products brand producer that surprised the markets with a sales beat thanks in large part to its ability to pass along rising costs through higher selling prices during the recent quarter. In both cases, Nestle and Unilever shares appreciated well above market levels in the trading following their earnings announcements yesterday and today, respectively.

Happy Bargain Hunting!

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