

Evenlode Investment View

Investing and Inflation – June 2020



After a strong recovery in April and May from the lows of March, stock markets have been more range-bound in June. As I write, Evenlode Income has fallen 8.7% since the start of the year, compared to a fall of 17.6% for the FTSE All-Share for the same period¹.

Investors are still chewing over the progression of the virus, the degree to which the global economy may recover as lockdowns are eased, and the possible effects that the huge fiscal and monetary response from governments and central banks may have on the economy and financial markets.

There are some hopeful signs: global economic leading indicators are improving and suggest that the second quarter may not have been quite as bad as initially feared. Virus cases continue to decline in Europe and remain low in Asia, healthcare systems are becoming increasingly proficient at managing and treating the virus, and there is a reasonable chance that at least one vaccine may be available by the end of this year. However, there are also reasons to remain cautious. Lockdowns in some regions may have been eased too early (cases in some US states, for instance, have been rising) and Latin America has become the new hotspot for the virus. Even in regions that have got on top of the virus, day-to-day life is by no means back to normal. And it is difficult to argue that the levels of debt and psychological scarring that this crisis will leave on the global economy won't be material.

Learning to Live with the Virus

There has been a trickle of news flow from companies over the last few weeks, but at a much lower level than the previous two months. In general we continue to be impressed at how Evenlode Income holdings are adapting to a 'new normal', and there is a sense that - though the short-term impact of the crisis on financial results is clear - market-leading companies will emerge with their competitive positions intact and in many cases strengthened.

Given lingering virus-related uncertainties, many companies are still reluctant to give precise guidance for the full year. However, now that the dust is starting to settle, some companies that initially utilised government aid schemes are now paying this money back. Bunzl, for instance, announced this month that organic revenue is expected to grow at +6% for the first half of 2020, accompanied by an increase in operating margin. Given Bunzl's exposure to lockdown-impacted sectors such as retail and leisure, this performance has been more resilient than management would have initially expected. The company has been helped by its repeat-purchase business model and strong growth in its grocery, healthcare, cleaning and hygiene businesses. Thanks to this resilience, management noted that "the company intends to repay employee-related government support packages and bring forward the settlement of tax deferrals where possible to do so." This move is clearly an incremental positive for Bunzl shareholders and dividend prospects.

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Looking further ahead and past the immediate effects of the pandemic, one legacy of the crisis will be the large amounts of borrowings that will be left on government balance sheets. Given this legacy,

and more generally the huge fiscal and monetary response to the crisis, there is clearly the possibility of higher inflation over coming years, which might help erode the real value of these borrowings. Several clients have asked us how we view this inflation risk, and whether it has any implications for the portfolio or for future investment strategy. I thought it might therefore be worth finishing this view with some brief thoughts on inflation, which may be familiar to regular readers.

Four Factors to Help Protect Savings from Inflation

There is no perfect way of insulating one's savings from an environment in which inflation is rising: particularly if the rise is rapid. However, there are some qualities that we believe provide a company with some very important safety buffers if such a scenario were ever to unfold:

- 1) **Market-leading competitive position:** helps provide a business with pricing power and therefore inflation protection. Pricing power is extremely valuable during an inflationary episode.
- 2) **Asset-light business model:** for asset-heavy business models, rising asset replacement requirements can eat into the spare cash available to shareholders, potentially leading to dividend cancellations and highly dilutive rights issues in extremely inflationary periods, as was seen in the 1970s. Asset-light businesses are better placed as capital expenditure requirements remain low relative to cash generation even when the price level is rising. Warren Buffett was heavily influenced by this 1970s episode, in which these dynamics were clearly demonstrated. As he put it in the early 1980s, *for years the traditional wisdom – long on tradition, short on wisdom – held that inflation protection was best provided by businesses laden with natural resources, plants and machinery, or other tangible assets (“In Goods We Trust”). It doesn’t work that way. Asset-heavy businesses generally earn low rates of return – rates that often barely provide enough capital to fund the inflationary needs of the existing business, with nothing left over for real growth, for distribution to owners, or for acquisition of new businessesⁱⁱ.*
- 3) **Strong balance sheet:** helps insulate a company from the rising cost of debt if, as is likely, interest rates begin to rise, as inflation becomes entrenched.
- 4) **High free cash flow yield:** attractively valued shares offer better protection if higher inflation leads to higher interest rates and bond yields, which provide a headwind to valuations.

Whether inflation does rise to any significant degree in the next few years remains to be seen. Many commentators expected inflation to pick up significantly after the Great Financial Crisis due to the monetary and fiscal response at that time, but it failed to materialise in the following decade. It is quite credible to argue the opposite: that the recent pandemic may provide further deflationary pressures, at least into the medium-term, due to the psychological impact and demand destruction that it has wrought (and bond markets are certainly taking this view at the moment). Demographic trends and innovation also suggest deflationary pressures may persist.

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Either way, those companies (and their shares) benefiting from the above four factors should remain good friends to long-term savers. They help equip a business to grind out an attractive, real free cash flow stream through a wide range of economic conditions.

Hugh and the Evenlode team

29th June 2020

Please note, these views represent the opinions of Hugh Yarrow as at 29th June 2020 and do not constitute investment advice.

ⁱ Source: Evenlode, Financial Express. TB Evenlode Income B Inc shares. All figures total return, bid-to-bid, GBP terms - 31/12/2019 to 26/06/2020. Past performance is not a reliable indicator of future performance.

ⁱⁱ Appendix to 1983 Berkshire Hathaway shareholder letter (<https://www.berkshirehathaway.com/letters/1983.html>).