

CONTINUOUSLY ASSESS RISK: INFLATION RISK

July 2021

Michael Anderson
Chief Investment Officer

At Hi-Line Capital Management, our intrinsic-value philosophy and decision-making principles drive how we approach investing and provide guard rails for thinking during periods of extreme uncertainty and volatility. Our piece, *Foundational Decision-Making Principles*, details the seven pillars of our decision-making process and its critical function in long-term success and rationality.

ABOUT HI-LINE CAPITAL MANAGEMENT

Hi-Line Capital Management, LLC (“HLCM”), based in Watertown, SD, provides investment management and advisory services for institutional and individual clients. The firm was founded in July 2009, became a registered investment advisor (RIA) with the U.S. Securities and Exchange Commission (“SEC”) in March 2010.

EXECUTIVE SUMMARY

- Inflation, the change in prices, results in the decline of purchasing power.
- Returns should recognize the effects of inflation as “real returns”. Inflation has not been meaningful for years leaving some investors (and speculators) nearly blind to it. However, could change soon.
- Inflation effects are apparent in bonds through changes in the yield and can result in a negative real yield. Stocks have the potential to better hedge against inflation as their business cash flows can adjust to increases in inflation.

INFLATION RISK

Inflation is too much money chasing too few things. Inflation results in the decline of purchasing power of a currency over time and measures the rate which the value of a currency is falling or being debased.

The Federal Reserve has a stated target of 2.0% inflation.....which means the dollar will be worth 50% less over 35 years if the target is achieved. Recently, inflation has been less than the target, which proves the Federal Reserve is unable to control inflation. And since inflation has recently been less than the target..... inflation may exceed the target for an extended period as well.

Most investment returns are expressed as gross returns but returns should be judged in real returns or after the effects of inflation. The primary risk inflation is achieving investment returns less than long-term inflation.

An entire generation of investors (and speculators) have not had to experience meaningful inflation but investors should be prepared for inflation risk which will lower gross and real returns.

INFLATION: HISTORICAL PERSPECTIVE

Since 1950, inflation (as measured by the Consumer Price Index) has averaged 3.5%. On a cumulative basis, the CPI Index has increased from 25 to 261 representing more than a 10-fold increase in 70 years. This debasement of the dollar means that what used to cost \$1 now costs approximately \$10.

In the first 40 years (1950-1990), inflation averaged 4.3% but in the last 30 years (1990-2020), inflation only averaged 2.3%. The last 30 years have been a wonderful period of price stability and declining interest rates which both have contributed to “better than average” returns.

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ASSET CLASS IMPLICATIONS:

BONDS

For the bond investor, inflationary impacts are easy to see. When the value of the dollar deteriorates with time, the security with income and principal payments denominated in dollars will be worth less. To illustrate, a 10-year treasury yielding 1.5% cannot provide a real return if inflation is 2.0%, resulting in a negative real yield. The holder of the 10-year treasury will have less purchasing power as a result of the “investment”. The stated coupon and ensuing payment will erode quickest over time during periods of rising or higher inflation. (Conversely, for the issuer of debt, inflation helps reduce liabilities as debts are repaid with cheaper dollars.)

STOCKS

Stocks or equities have the potential to better protect against inflationary forces. There are 5 economic levers that can increase the economic output of a business. Increasing sales relative to assets, wider operating margins, more leverage, cheaper leverage and lower taxes. And inflationary forces has the potential to negatively impact all 5 levers.

What reduces inflation risk? Several characteristics of business and business models can counteract the deterioration of economics caused by inflation. Companies with pricing power and the ability to increase prices at or above rates of input cost will offer inflation protection. In addition, companies that are asset-light. Asset-light companies have fewer capital expenditures and depreciation, which are the worst forms of expense since money is spent first, then the item is expensed via depreciation over its useful life and then the item is replaced at a substantially higher cost.

CONCLUSION:

History teaches us that politicians, economists, policymakers, or business leaders can guarantee the world will maintain low and stable rates of inflation and inflation can arrive with little warning. Using the definition of too much money chasing too few things.....there is ample evidence that inflation may increase. But there are several ways to protect against higher inflation.