

Advisory Blog

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[Equities](#) | [Inflation](#)

EV Forward: High Quality Businesses May Benefit from Higher Inflation

By: EV Forward | April 29, 2022

Atlanta - When asked who benefits from higher inflation, investors typically mention commodity-exposed stocks. We believe that high quality¹ businesses may offer a better hedge against inflation.

It's true that commodities can benefit from inflation, but only in the short term. Over the long term, inflation also impacts a large proportion of their costs. And commodities tend to require a large amount of capital investment each year, so their earnings and free cash flow can be pressured even as their revenues rise.

Here are three reasons why we think high quality stocks could weather inflation better over the long term:

Intangible assets and pricing power

High quality companies often derive their value from unique intangible assets such as patents, well-known brands, proprietary databases, software and so on. These assets are in place and produce value after much of the investment behind them has already occurred.

Inflation increases the value of these assets with no associated increase in cash costs, and their proprietary nature gives the companies who own them pricing power. This means that high quality businesses may have the ability to maintain and increase margins — even during periods of high inflation.

Low capital intensity

High quality companies tend to have very low capital expenditures as a percentage of sales and cash flow. In other words, they can avoid redeploying as much capital into their businesses each year as value or unprofitable growth companies. This is an obvious benefit when costs are rising, often leading to higher free cash flow that can be used to make acquisitions or return cash to shareholders.

High margins

High quality companies generally have higher margins than their low quality peers. Mathematically speaking, it can be easier for a high margin business to maintain and increase dollar profitability during inflation.

As a hypothetical example, at 7% cost inflation, a company with 70% gross margins only has to increase the selling price by 2.1% to maintain gross profit dollars. A company with 20% gross margins has to raise prices by 5.6% to maintain gross profit dollars.

During periods of inflation, high quality businesses with pricing power can actually increase their dollar profits if they are able to raise prices in line with inflation.

Market bubbles then and now

Market bubbles seem so obvious in hindsight — even for those who got caught in them. An easy rule of thumb is that excess liquidity can create bubbles, and monetary tightening usually brings the party to an end.

- In the 1980s, Japanese real estate values soared in response to overly stimulative Japanese monetary policy. When that accommodation was removed, the period that followed became known as the *Lost Decades*.
- The U.S. real estate bubble that preceded the financial crisis was born from easy monetary policy and exceptionally loose lending standards.
- The dot.com bubble of the 1990s was fueled by accommodative monetary policy and excessive hopes for a tech renaissance.

Both U.S. bubble episodes ended after monetary tightening resulted in significant losses for investors who were caught unaware.

We are all too familiar with the potential risks in the current environment: The same expansive monetary conditions that inflated valuations in more speculative parts of the equity market now appear to be driving higher inflation in real assets. The Fed has clearly been caught off-guard by this rapid rise in inflation and is now being forced to withdraw stimulus and raise rates much more rapidly than they expected.

Bottom line: As we begin to see the liquidity punch bowl pulled away from the market, we remain constructive on attractively valued high quality equities. Their ability to weather the effects of higher interest rates, inflation or slower economic growth should prove valuable in uncertain times.

1. Higher quality companies typically have consistent earnings, strong balance sheets, significant free cash flow generation, growing revenues and meaningful competitive advantages, whereas the opposite is true for their lower-quality counterparts. Historically, high quality equities have outperformed over full market cycles.

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EV Forward

> Rising inflation, less accommodative central bank policies and heightened geopolitical risks have created significant market volatility in 2022. In this series, our investment teams offer their views on the opportunities and risks present for their strategies. As always, our goal is to seek fundamental value that helps build client wealth over the course of many business cycles.

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