



AN INFLATION FOLLOW UP: THE DISPARATE EFFECTS ON COMPANY VALUE

The Search for Inflation Hedges

Inflation is back.. Or not...

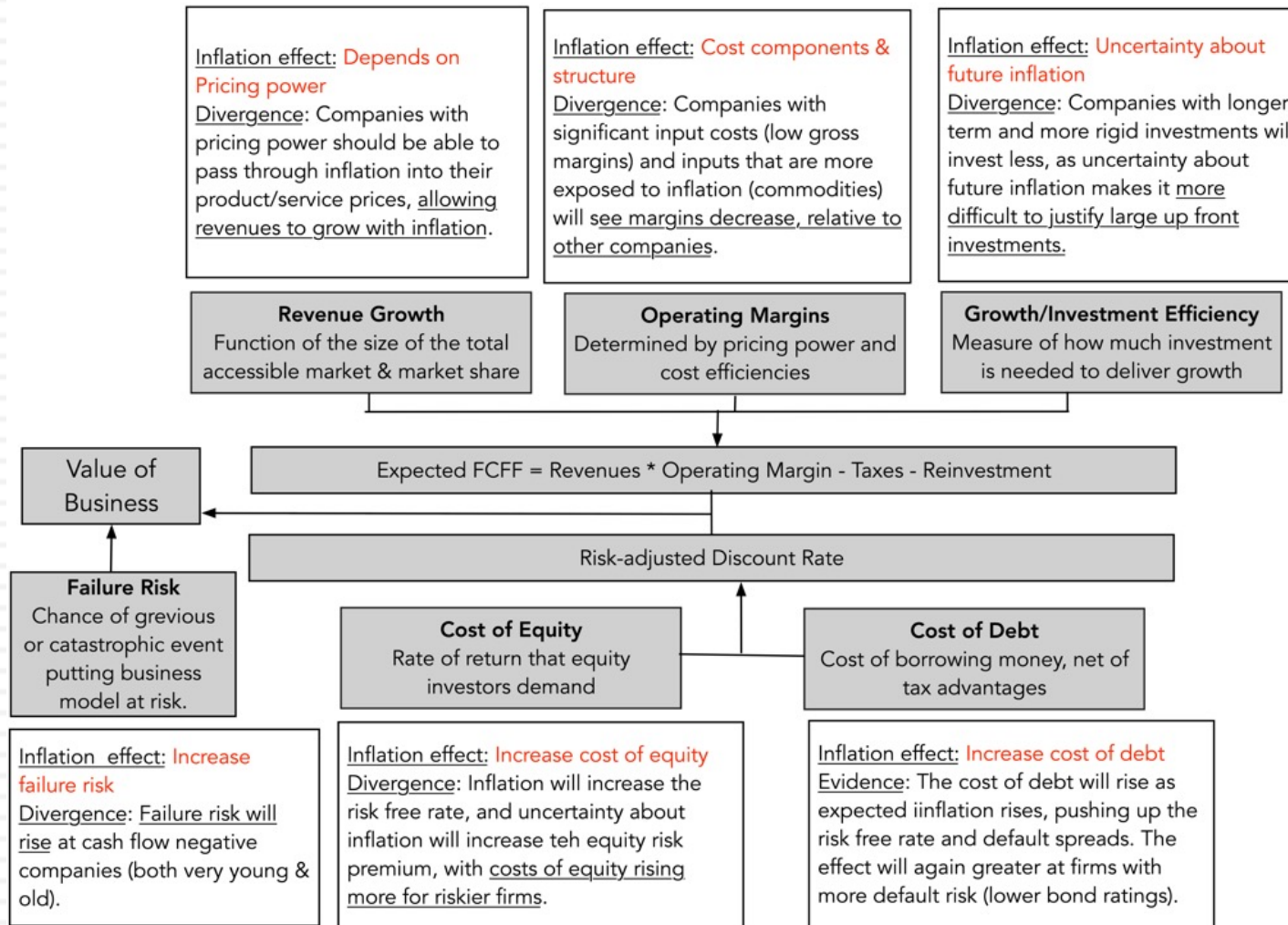
2

- In general, higher and more volatile inflation has negative effects on all financial assets, from stocks to corporate bonds to treasury bonds and neutral to positive effects on gold, collectibles and real assets.
- That said, the impact of inflation on individual company values can vary widely, with a few (perhaps, very few) companies benefiting, some affected only lightly, and other companies being affected more adversely, by higher-than-expected inflation.
 - In an environment where finding inflation hedges has become the first priority for most investors, the search is on for companies that can operate as inflation hedges.
 - The conventional wisdom, based largely on investor experiences from the 1970s, is that commodity companies and firms with pricing power are the best ones to hold, if you fear inflation, but is that true, and even if it is true, why is it so?

Inflation and Company Value

3

Inflation and Value: Currents and Cross Currents!



The Factors that determine Inflation Sensitivity

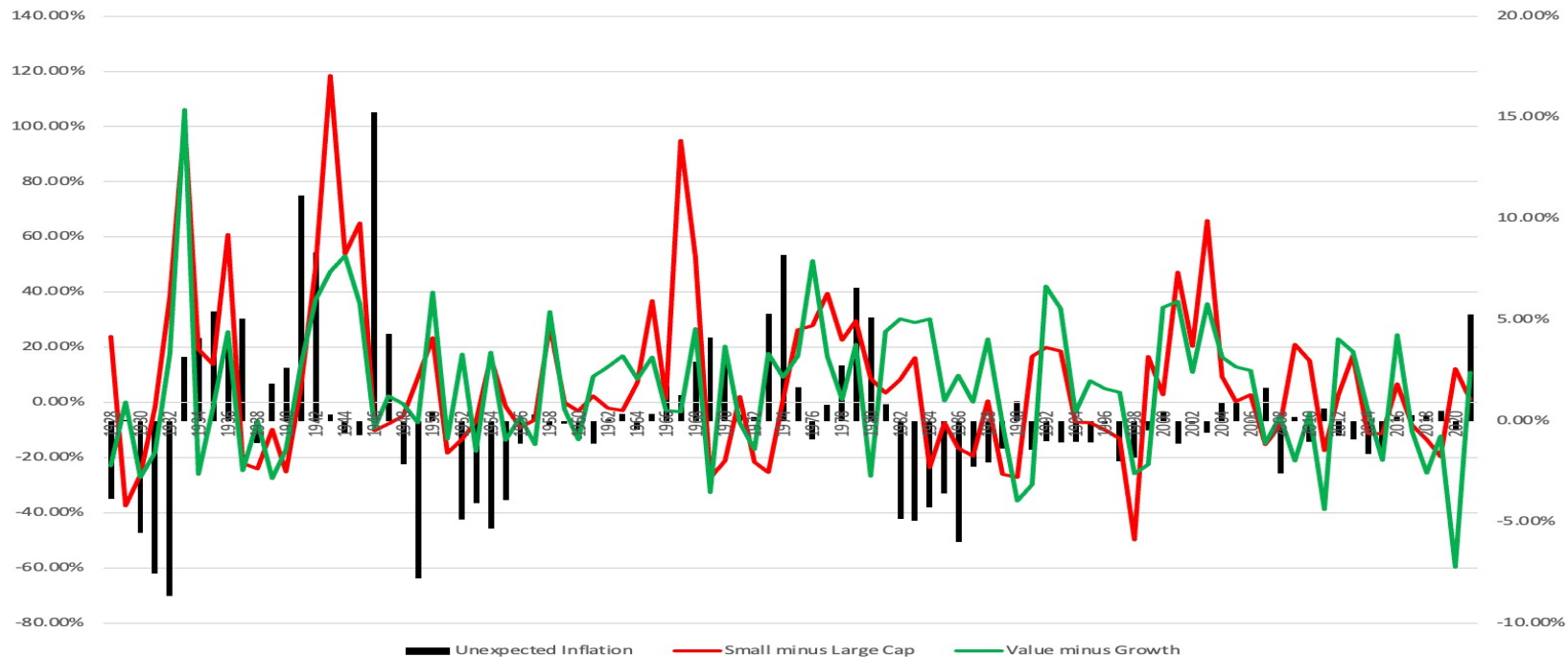
4

<i>Variable</i>	<i>Why it matters</i>	<i>Factors determining variable</i>
Pricing Power	Companies that can pass inflation through to customers are more protected from inflation.	<ol style="list-style-type: none"> 1. <u>Discretionary/Non-discretionary</u>: If the product or service you offer is one that your customers need, and cannot delay purchase, you will have more pricing power. 2. <u>Competition</u>: Companies in competitive businesses will have less pricing power than otherwise similar companies with less competition. 3. <u>Regulation</u>: Companies that face price regulation, from governments or regulatory authorities, will be at the mercy of regulatory pricing decisions.
Cost Structure	Companies that have costs that are substantial and inflation-sensitive will be more negatively exposed to inflation.	<ol style="list-style-type: none"> 1. <u>Cost of Goods Sold</u>: Companies that have higher direct costs of production are more negatively affected by inflation than companies with lower costs of production. 2. <u>Input composition</u>: Companies with inputs that are more exposed to inflation (commodities, skilled labor) will be more negatively affected by inflation.
Investment Efficiency	Companies with longer term & less flexible investment choices will be more negatively affected by inflation.	<ol style="list-style-type: none"> 1. <u>Type of Business</u>: Infrastructure and manufacturing companies generally <u>have to</u> invest larger amounts for longer periods than service or technology companies. 2. <u>Flexibility</u>: Companies that have more flexibility (to withdraw or stagger spending) on their investments are better positioned to weather inflation than companies that don't have that flexibility.
Cost of equity	Riskier companies will be more negatively affected by inflation	<ol style="list-style-type: none"> 1. <u>Sector Risk</u>: Companies in riskier sectors, i.e., sectors more exposed to market/economic up and down turns will see costs of equity go up more than companies in safer sectors. 2. <u>Country Risk</u>: Companies that operate in riskier countries will see bigger surges <u>in equity</u> risk premiums than companies that operate in stable markets.
Cost of debt	Companies that have more default risk (lower bond ratings) will be hurt more by higher inflation.	<ol style="list-style-type: none"> 1. <u>Stability/Level of Earnings</u>: Companies with higher and more stable earnings will see costs of debt go up less than companies with lower/negative earnings. 2. <u>Debt level</u>: Companies that have borrowed more will see a bigger increase in their costs of debt than otherwise similar companies that have borrowed less.
Failure risk	Companies with a higher risk of failure will be hurt more by inflation.	<ol style="list-style-type: none"> 1. <u>Stage in Life Cycle</u>: Young companies with unformed business models have a greater chance of failure than older companies with more established business models. 2. <u>Debt level</u>: Companies that have borrowed more are more likely to fail than otherwise similar companies that have borrowed less.

Lessons from the past: 1930- 2019

5

Inflation, Market Cap and Price to Book



<i>Decade</i>	<i>Average Inflation</i>	<i>Unexpected Inflation</i>	<i>Small Cap - Large Cap</i>	<i>Low PBV - High PBV</i>
1930-39	-1.92%	0.07%	15.09%	1.77%
1940-49	5.51%	3.08%	25.22%	15.53%
1950-59	2.24%	-1.89%	1.26%	4.14%
1960-69	2.53%	0.84%	16.01%	3.84%
1970-79	7.41%	2.80%	8.09%	13.03%
1980-89	5.14%	-2.33%	-5.51%	11.43%
1990-99	2.94%	-0.90%	-4.23%	-2.42%
2000-09	2.53%	-0.02%	14.65%	11.81%
2010-19	1.76%	-0.38%	-3.97%	-4.82%

Returns in 2022: By Sector

Primary Sector	Market Capitalization on			% Change in Aggregate		
	12/31/21	4/1/22	5/19/22	Qtr 1: 2022	4/1 - 5/19	YTD: 2022
Communication Services	\$ 5,189,965.01	\$ 4,565,242.77	\$ 3,721,480.53	-12.04%	-18.48%	-28.29%
Consumer Discretionary	\$ 6,865,360.90	\$ 6,150,811.42	\$ 4,646,612.25	-10.41%	-24.46%	-32.32%
Consumer Staples	\$ 3,100,713.53	\$ 3,063,281.04	\$ 2,818,857.11	-1.21%	-7.98%	-9.09%
Energy	\$ 1,545,388.21	\$ 2,127,967.47	\$ 2,181,533.44	37.70%	2.52%	41.16%
Financials	\$ 5,991,118.59	\$ 5,839,759.38	\$ 5,063,725.21	-2.53%	-13.29%	-15.48%
Health Care	\$ 6,700,096.78	\$ 6,355,570.42	\$ 5,682,712.56	-5.14%	-10.59%	-15.18%
Industrials	\$ 4,324,760.00	\$ 4,105,364.19	\$ 3,593,844.77	-5.07%	-12.46%	-16.90%
Information Technology	\$ 14,413,867.17	\$ 13,040,351.22	\$ 10,533,339.49	-9.53%	-19.23%	-26.92%
Materials	\$ 1,281,725.71	\$ 1,292,151.66	\$ 1,148,655.35	0.81%	-11.11%	-10.38%
Real Estate	\$ 1,792,603.89	\$ 1,717,921.32	\$ 1,478,137.13	-4.17%	-13.96%	-17.54%
Utilities	\$ 1,209,474.10	\$ 1,262,800.95	\$ 1,193,390.90	4.41%	-5.50%	-1.33%
All US firms	\$ 52,415,086.58	\$ 49,521,253.94	\$ 42,062,305.83	-5.52%	-15.06%	-19.75%

The Small Cap Premium?

<i>Market Cap Decile</i>	Market Capitalization on			% Change in Aggregate		
	12/31/21	4/1/22	5/19/22	Qtr 1: 2022	4/1 - 5/19	YTD: 2022
Bottom decile	\$ 1,381.29	\$ 1,923.86	\$ 1,853.90	39.28%	-3.64%	34.21%
2nd decile	\$ 8,348.79	\$ 8,793.21	\$ 8,607.40	5.32%	-2.11%	3.10%
3rd decile	\$ 27,112.40	\$ 25,613.97	\$ 22,149.18	-5.53%	-13.53%	-18.31%
4th decile	\$ 67,319.10	\$ 62,566.30	\$ 55,319.39	-7.06%	-11.58%	-17.83%
5th decile	\$ 147,104.30	\$ 138,069.70	\$ 124,365.95	-6.14%	-9.93%	-15.46%
6th decile	\$ 276,774.10	\$ 271,189.40	\$ 240,747.00	-2.02%	-11.23%	-13.02%
7th decile	\$ 592,478.40	\$ 547,421.40	\$ 471,925.50	-7.60%	-13.79%	-20.35%
8th decile	\$ 1,415,307.20	\$ 1,317,481.10	\$ 1,118,303.90	-6.91%	-15.12%	-20.99%
9th decile	\$ 3,695,720.00	\$ 3,457,899.60	\$ 2,981,270.10	-6.44%	-13.78%	-19.33%
Top decile	\$ 46,183,541.00	\$ 43,690,295.40	\$ 37,037,763.50	-5.40%	-15.23%	-19.80%
All US firms	\$ 52,415,086.58	\$ 49,521,253.94	\$ 42,062,305.83	-5.52%	-15.06%	-19.75%

The Value Factor

	Market Capitalization on			% Change in Aggregate		
<i>decile(PBV)</i>	<i>12/31/21</i>	<i>4/1/22</i>	<i>5/19/22</i>	<i>Qtr 1: 2022</i>	<i>4/1 - 5/19</i>	<i>YTD: 2022</i>
Bottom decile	\$ 690,455.28	\$ 715,283.34	\$ 652,724.32	3.60%	-8.75%	-5.46%
2nd decile	\$ 1,001,628.92	\$ 1,001,242.73	\$ 883,596.74	-0.04%	-11.75%	-11.78%
3rd decile	\$ 2,422,933.40	\$ 2,557,587.18	\$ 2,336,158.70	5.56%	-8.66%	-3.58%
4th decile	\$ 3,213,577.93	\$ 3,361,894.12	\$ 3,186,192.39	4.62%	-5.23%	-0.85%
5th decile	\$ 2,486,811.66	\$ 2,600,598.64	\$ 2,400,348.91	4.58%	-7.70%	-3.48%
6th decile	\$ 3,418,450.39	\$ 3,306,814.62	\$ 2,919,707.87	-3.27%	-11.71%	-14.59%
7th decile	\$ 3,256,696.86	\$ 3,166,866.17	\$ 2,773,984.84	-2.76%	-12.41%	-14.82%
8th decile	\$ 4,944,739.69	\$ 4,601,578.75	\$ 4,007,752.10	-6.94%	-12.90%	-18.95%
9th decile	\$ 10,181,889.22	\$ 8,998,595.83	\$ 7,627,056.72	-11.62%	-15.24%	-25.09%
Top decile	\$ 18,188,030.72	\$ 16,891,657.44	\$ 13,205,818.39	-7.13%	-21.82%	-27.39%

Equity Risk

<i>Beta Decile</i>	Market Capitalization on			% Change in Aggregate		
	12/31/21	4/1/22	5/19/22	Qtr 1: 2022	4/1 - 5/19	YTD: 2022
Bottom decile	\$ 92,703.36	\$ 83,006.50	\$ 63,864.79	-10.46%	-23.06%	-31.11%
2nd decile	\$ 532,267.87	\$ 579,577.09	\$ 544,264.24	8.89%	-6.09%	2.25%
3rd decile	\$ 5,506,843.40	\$ 5,625,314.66	\$ 5,387,083.65	2.15%	-4.23%	-2.17%
4th decile	\$ 6,197,457.48	\$ 6,193,464.92	\$ 5,696,283.28	-0.06%	-8.03%	-8.09%
5th decile	\$ 6,820,007.30	\$ 6,583,259.41	\$ 5,847,111.50	-3.47%	-11.18%	-14.27%
6th decile	\$ 11,598,445.98	\$ 11,120,867.75	\$ 9,447,420.00	-4.12%	-15.05%	-18.55%
7th decile	\$ 11,146,405.08	\$ 10,342,205.55	\$ 8,387,032.89	-7.21%	-18.90%	-24.76%
8th decile	\$ 4,762,628.17	\$ 3,958,822.57	\$ 3,163,297.41	-16.88%	-20.09%	-33.58%
9th decile	\$ 4,297,062.59	\$ 3,913,153.73	\$ 2,728,680.86	-8.93%	-30.27%	-36.50%
Top decile	\$ 723,125.59	\$ 565,184.97	\$ 352,084.56	-21.84%	-37.70%	-51.31%

Bond Ratings

S&P Entity Credit Ra	Market Capitalization on			% Change in Aggregate		
	12/31/21	4/1/22	5/19/22	Qtr 1: 2022	4/1 - 5/19	YTD: 2022
A	\$ 3,498,441.80	\$ 3,237,358.00	\$ 2,749,893.30	-7.46%	-15.06%	-21.40%
A+	\$ 3,995,895.50	\$ 3,843,577.30	\$ 3,551,435.90	-3.81%	-7.60%	-11.12%
A-	\$ 4,921,494.30	\$ 4,704,447.70	\$ 4,156,345.70	-4.41%	-11.65%	-15.55%
AA	\$ 2,761,477.10	\$ 2,856,858.10	\$ 2,104,011.30	3.45%	-26.35%	-23.81%
AA+	\$ 4,835,138.50	\$ 4,700,819.90	\$ 3,756,056.50	-2.78%	-20.10%	-22.32%
AA-	\$ 2,507,288.50	\$ 2,535,140.70	\$ 2,355,052.80	1.11%	-7.10%	-6.07%
AAA	\$ 2,975,442.40	\$ 2,788,251.60	\$ 2,362,083.70	-6.29%	-15.28%	-20.61%
B	\$ 348,125.60	\$ 339,253.40	\$ 257,053.30	-2.55%	-24.23%	-26.16%
B+	\$ 395,987.00	\$ 394,325.60	\$ 333,237.20	-0.42%	-15.49%	-15.85%
B-	\$ 87,601.10	\$ 93,144.80	\$ 76,636.70	6.33%	-17.72%	-12.52%
BB	\$ 1,052,878.60	\$ 945,218.50	\$ 783,844.60	-10.23%	-17.07%	-25.55%
BB+	\$ 2,862,480.00	\$ 2,875,147.00	\$ 2,231,663.80	0.44%	-22.38%	-22.04%
BB-	\$ 475,030.10	\$ 430,398.00	\$ 379,028.20	-9.40%	-11.94%	-20.21%
BBB	\$ 4,508,193.00	\$ 4,253,101.70	\$ 3,816,169.60	-5.66%	-10.27%	-15.35%
BBB+	\$ 5,856,518.30	\$ 5,660,570.40	\$ 5,078,665.70	-3.35%	-10.28%	-13.28%
BBB-	\$ 2,111,172.80	\$ 2,053,390.00	\$ 1,873,634.90	-2.74%	-8.75%	-11.25%
CCC & Below	\$ 58,542.90	\$ 46,127.10	\$ 27,024.43	-21.21%	-41.41%	-53.84%

Operating Cash Flows and Dividends

Returns on Stocks, based upon EBITDA/EV in 2022

decile(EBITDA/EV)	Market Capitalization on			% Change in Aggregate		
	12/31/21	4/1/22	5/19/22	Qtr 1: 2022	4/1 - 5/19	YTD: 2022
Bottom decile	\$ 68,299.24	\$ 57,650.54	\$ 41,031.72	-15.59%	-28.83%	-39.92%
2nd decile	\$ 190,673.55	\$ 156,882.67	\$ 109,609.93	-17.72%	-30.13%	-42.51%
3rd decile	\$ 462,796.74	\$ 392,506.07	\$ 290,103.44	-15.19%	-26.09%	-37.32%
4th decile	\$ 1,568,935.45	\$ 1,221,809.43	\$ 809,668.77	-22.12%	-33.73%	-48.39%
5th decile	\$ 7,267,478.41	\$ 6,313,968.10	\$ 4,439,655.28	-13.12%	-29.69%	-38.91%
6th decile	\$ 15,511,603.72	\$ 14,661,868.07	\$ 12,063,064.01	-5.48%	-17.72%	-22.23%
7th decile	\$ 10,074,171.12	\$ 9,187,900.69	\$ 8,095,908.79	-8.80%	-11.89%	-19.64%
8th decile	\$ 6,336,143.30	\$ 6,384,857.65	\$ 5,893,734.90	0.77%	-7.69%	-6.98%
9th decile	\$ 3,946,542.54	\$ 3,983,686.69	\$ 3,759,802.62	0.94%	-5.62%	-4.73%
Top decile	\$ 3,336,215.13	\$ 3,756,485.12	\$ 3,556,042.37	12.60%	-5.34%	6.59%

Returns on Stocks, based upon Dividend Yield in 2022

Dividend Yield	Market Capitalization on			% Change in Aggregate		
	12/31/21	4/1/22	5/19/22	Qtr 1: 2022	4/1 - 5/19	YTD: 2022
Non-Dividend Payers	\$17,614,331.92	\$15,802,268.14	\$12,140,148.07	-10.29%	-23.17%	-31.08%
Bottom quintile	\$11,833,321.83	\$11,056,233.48	\$ 9,059,690.05	-6.57%	-18.06%	-23.44%
2nd quintile	\$ 6,863,745.19	\$ 6,511,143.06	\$ 5,781,328.03	-5.14%	-11.21%	-15.77%
3rd quintile	\$ 7,960,574.88	\$ 7,649,659.49	\$ 6,928,831.04	-3.91%	-9.42%	-12.96%
4th quintile	\$ 4,938,213.88	\$ 4,936,696.67	\$ 4,651,766.14	-0.03%	-5.77%	-5.80%
Top quintile	\$ 3,204,898.88	\$ 3,565,253.10	\$ 3,500,542.50	11.24%	-1.82%	9.22%

Value Investing vindicated?

- Companies that generate more cash flows from their operations and return more of that cash flow in dividends to stockholders have clearly held their value better than companies with low or negative cash flows that pay no dividends.
- Looking at these results, value investors will undoubtedly find vindication for their beliefs that this is a correction long over due, i.e., a return to normalcy where safe stocks in boring sectors that pay high dividends deliver excess returns.
- I do think that given how consistently growth stocks have been beating value stocks for the last decade, a correction was in order, but I don't believe that this is the start of return of old-fashioned value investing.

Bottom Line

- This has been a painful year for investors in US equities, but the pain has not been evenly spread across investors.
- The question of whether these trends will continue to apply for the rest of the year cannot be answered without taking a stand on inflation, and the effects that fighting it will create for the economy.
 - If you believe that there is more surprises to come on the inflation front, and that a recession is not only imminent, but likely to be steep, the returns in the first five months of 2022 will be a precursor to more of the same, for the rest of the year.
 - If you believe that markets have mostly or fully adjusted to higher inflation, betting on a continuation of the small cap and value outperformance to continue is dangerous.
 - To the extent that there may be other countries where inflation is not the clear and present danger that it is in the United States, investing in equities in those countries will offer better risk and return tradeoffs.