WESTBOURNE
INVESTMENT ADVISORS

INVESTMENT PERSPECTIVE — THIRD QUARTER 2021

"As sure as the spring will follow the winter, prosperity and economic growth will follow recession."
– Robert Foster Bennett

The positive effects of vaccines and herd immunity continued in Q2, as Covid-19 infection and death rates dropped dramatically, lockdowns were lifted, and the great reopening continued in earnest. The market's expectations for robust growth took hold as demand boomed and parts of the market reached new highs. This welcome economic surge comes amidst a backdrop of low interest rates, monetary expansion, and massive Federal spending. However, the pandemic's lingering economic effects are significant supply-chain and labor market disruptions.

The rapid growth in demand for goods, services, and construction puts significant pressure on pricing, causing worries about inflation's effects on the economy and market returns. A key question for policy-makers and investors: Is the current level of inflation transitory (temporary) or will it be with us for the long-term (structurally)?

It is likely there are elements of both, but we will not know the complete answer until the passage of time. We do know that a low level of inflation is a normal outgrowth of any expanding economy. The Federal Reserve's goal of a 2% average inflation rate is certainly better than the inverse – deflation - where asset prices fall due to lack of demand. In any case, the challenge of inflation is normal in a growing economy, but currently the U.S. economy is experiencing a higher rate of inflation than desired.

"Invest in Inflation. It's the only thing going up" – Will Rogers

We have discussed in the past how inflation presents a long-term risk to savers and investors in the form of *purchasing power risk*, which is the risk that the *value* of wealth is eroded by inflation. Inflation was relatively tame in the pre-pandemic economy but is currently exploding as the rapid reopening growth surge strains against the pandemic's economic dislocations – supply-chain disruptions, coupled with government intervention and labor/ material shortages– with growing demand pushing wages and commodity prices upward. The current annualized inflation rate is around 5%, but even in relatively low inflation environments, without proper management inflation slowly but surely dissolves wealth's purchasing power.

The average annual inflation rate over the last 10 decades has been around 3.22%[1]. That doesn't sound too bad until one realizes, at that rate of inflation, that prices double roughly every 20 years: **today's dollar will be worth the equivalent of around $0.50 cents in twenty years**. In a mere five years, $1.00 will diminish to ~ $0.83 cents of today's purchasing power.

This erosion of purchasing power over time destroys wealth if wealth does not grow along with inflation, therefore it is important for investors to have adequate investment in assets that grow faster than inflation. *Historically over the long-term, equities outperform fixed income instruments like bonds, bank deposits, and money markets, and grow faster than inflation.*

In early June, the year-over-year inflation rate was reported *at 5% -- the highest in 13 years!* We do not know whether this level of inflation is transitory or permanent, and believe it is some of both. Regardless, some inflation is normal and expected, and we need to position our portfolios to address the risk of long-term inflation. Inflation cannot be controlled but the risks associated with it may be managed. We have made the case that investors need ample

[1] Source: Inflationdata.com

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exposure to equities to preserve purchasing power. *Equities represent ownership in the assets of companies* and in a period of rising asset prices, in general, equities rise along with inflation. However, some equities are better at keeping up with inflation than others - inflation hurts some companies, helps some companies, and leaves some companies largely unaffected. Valuation matters. Business models matter. Companies generating cash (as opposed to those consuming cash) tend to do better in every economy, particularly in an inflationary economy, and our bias is towards cash producers with resilient business models. Company valuations relying mostly on earnings predictions far out in the future will likely be hurt in a prolonged inflationary period, since rising interest rates hurt their growth prospects, borrowing capacity, and valuations.

"There are two main drivers of asset class returns - inflation and growth." ~ Ray Dalio

Inflation generally means higher prices across the entire economy. We seek to own companies with *pricing power* - the ability to raise prices of the company's products without hurting demand or suffering a decline in profitability. Companies with strong brands, monopolies/duopolies, and products that are a small and/or necessary portion of consumer budgets typically have pricing power. Companies that can pass price increases to their customers while preserving their profits can thrive during inflation - companies such as Apple, Microsoft, Google, Paypal, and Facebook have pricing power since their products are embedded in our daily lives. These are largely "pass through" platform companies that are not reliant on picking winners and losers in the economy and benefit from overall economic activity. These platform companies pass on higher prices and can handle much larger volumes of activity that come with economic growth without taking on substantial costs. On the other hand, companies that fare poorly in inflationary times are companies that rely heavily on variable pricing from suppliers without the ability pass price increases on to consumers – e.g., construction, manufacturing, and some services.

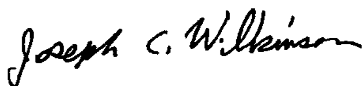
In contrast with stocks, bonds are debt instruments, not asset ownership. Fixed rate bondholders have no pricing power as they cannot raise rates. In inflationary times when interest rates are rising, bonds fare poorly – especially long-dated bonds which are 10+ years in duration.

What about defensive inflation strategies like Gold? Commodities? Currencies?

We make investments in companies participating in the long-term growth of the U.S. and global economy – buying stocks in companies that are well-positioned, well-valued, and well-managed with inflation-fighting advantages discussed above. We believe this is the best way to grow wealth and protect purchasing power and believe the management teams of these companies will, over time, navigate through inflation, taxes, regulations, currency swings, etc. in ways most appropriate for their specific companies. As portfolio managers, we do not participate in short-term hedging strategies using commodities (e.g., oil, copper, gold) or currency hedges, as these strategies are best suited to traders and speculators whose businesses rely on these strategies to mitigate their near-term exposure risk to the price swings of commodities and currencies.

As always, we thank you for your trust and we welcome your questions and comments. Call us if you would like to discuss inflation, or any other financial matters.

All the Best,



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