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***Revisiting a low growth, low interest rate, low inflation world through COVID-19***

# Part 4 - Why high-quality businesses can handle high inflation better than most other investments

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In this white paper series, we examine whether inflation is likely to stay at low levels over the next decade. We also examine how future inflation and overall economic growth rates will impact the attractiveness of the returns Hyperion's global equity strategy is likely to produce in the long run. The main topics covered in this series are addressed in five interrelated papers:

Part 1 - Why the recent increase in inflation and growth is temporary;

Part 2 - Why the rotation to lower quality value stocks will not be sustained;

Part 3 - The relationship between growth, inflation, interest rates and valuations;

Part 4 - Why high-quality businesses can handle high inflation better than most other investments; and

Part 5 - What if our views on inflation turn out to be wrong?

## Part 4 - Why high-quality businesses can handle high inflation better than most other investments

Stocks that have sustainable business models tend to have longer durations compared to lower quality, less sustainable stocks. That is, they sell on higher short-term price-earnings ratios and, therefore, more of their expected future free cash flows are further out in the future, compared with lower quality, less sustainable businesses. All other things being equal, longer duration assets, including stocks, tend to be more sensitive to changes in long-term bond yields and discount rates.

However, the duration of a stock, as a measure of its share price sensitivity to changes in interest rates, is only valid if the nominal growth rates in the future free cash flows do not change by a similar degree and match the change in long-term bond yields.

If the long-term expectation regarding nominal GDP growth increases by 1% (assuming this increase in economic growth is reflected in a 1% increase in long-term government bond yields) and the expectation for growth in future free cash flows also increases by 1%, then the present value of the stock should remain unchanged. Whereas, if the nominal future free cash flows do not increase or increase by a lower percentage relative to the bond yield increase, then the present value of the stock would decline.

Lower quality businesses tend to have shorter durations, because the market has lower levels of confidence that the business will have predictable free cash flows in the long term. That is, the market treats these businesses as being less robust and less sustainable. This is because lower short-term price-earnings ratios mean the potential future free cash flows are closer in time, and therefore the duration of these stocks is lower than a more sustainable, higher quality business. These lower quality companies tend to sell on lower short-term price-earnings ratios, and thus their market valuations are relatively less impacted by increases in discount rates relating to inflation and economic growth rates.

Again, this statement is only true if the business cannot match the increase in interest rates with increased free cash flows.

Some resource and materials stocks have high levels of sensitivity to changes in nominal GDP growth rates. If the prices and/or volumes of the commodities they sell increase at rates above the rise in the relevant discount rate, then the present value of these stocks can increase even in the face of higher discount rates. Therefore, some lower quality stocks would have the ability to benefit from higher inflation. This situation would reduce the relative growth advantage that high quality, structural growth stocks would otherwise enjoy compared to resource and materials stocks.

As stated above, **the duration of a stock only becomes important in assessing the sensitivity of its valuation to changes in bond yields if it cannot change its future growth rates to match those changes in bond yields.**

A stock that cannot pass on its inflation-related costs to its customers will not be able to increase the growth rate of its future free cash flows sufficiently to fully offset increases in bond yields and discount rates. Therefore, its present value will decline in the face of higher bond yields and discount rates. The longer the duration of such a stock, the more sensitive it will be to changes in bond yields and discount rates. Thus, **long duration businesses without pricing power will be more sensitive to any one-off changes in discount rates,** because they are generally valued based on cash flows that stretch out further into the future.

Businesses that have strong pricing power normally can offset any increase in long-term bond yields, because they can adjust their future free cash flows to compensate for the higher discount rate resulting from increased inflation or higher expected real economic growth rates.

The *relative* attractiveness of higher quality, structural growth companies compared with that of lower quality companies declines if expectations regarding future nominal GDP growth rates increase.

At the extreme, if the world could produce sustained high levels of economic growth, and associated profit growth was also strong and widely distributed, then the valuation gap (dispersion) between high quality, structural growth businesses and lower quality businesses would narrow. However, this high growth world has not existed since the GFC and is unlikely to exist in the future. Therefore, in a low growth world, high quality, structural growth businesses are significantly more valuable and therefore will be more highly rated and have longer durations compared with lower quality, low growth businesses.

This expectation of higher levels of overall nominal GDP growth can be driven by higher real economic growth rates and/or higher inflation. Higher rates of real economic growth are more beneficial than expectations of higher rates of inflation for stocks in general.

High quality, structural growth stocks tend to be less reliant on the overall rate of economic growth, compared with lower quality stocks. This is because high quality, structural growth stocks generally can grow their sales and profits through taking market share. Lower quality stocks generally do not have the ability to take market share. Therefore, higher levels of nominal economic growth reduce the growth premium that high quality stocks enjoy when economic growth expectations are more subdued. In other words, a lower gap between the sustainable growth rates of high quality and low quality stocks means that the market valuation differential between them declines. In high growth economic environments, growth becomes abundant (and subsequently less valuable), whereas in low growth economic environments growth becomes scarce (and subsequently more valuable).

All other things being equal, the higher the underlying structural growth of a business, the better its ability to recover from the negative impact of a one-off increase in the discount rate over time. High quality, structural growth businesses can compound their future free cash flows at higher rates that enable them to recoup any adverse change in government bond rates with more certainty.

In addition, high quality businesses tend to have strong value propositions that enable them to pass on higher inflation in their cost base more easily to their customers and thus maintain expected future free cash flows in real (inflation-adjusted) terms. This ability results in a situation where the nominal future free cash flows increase by the same amount as the bond yield, the discount rate, and the inflation rate.

On the other hand, many listed stocks would not have the ability to pass on high levels of inflationary costs onto their customers, so their real future cash flows would decline in the face of higher inflation levels.

***Hyperion global equity strategy***

Bonds do not have the ability to pass on increases in inflation and maintain the inflation-adjusted value of their future cash flows. We believe our global equity strategy does have this ability. Theoretically, the interest rate sensitivity of the strategy should be higher than a 10-year zero coupon bond, as its duration would be longer than ten years.

We estimate that a 10-year zero coupon bond would be expected to decline in value by approximately 9% if 10-year government bond yields increased by 100bps because of an increase in inflation.

**However, this longer duration is not relevant if the underlying free cash flows of the portfolio can be maintained in inflation-adjusted terms and fully match any increase in the relevant discount rate.** Therefore, an increase in long-term government bond yields based on higher inflation should have no material impact on the intrinsic value of the strategy.

It should also be noted that the earnings-per-share growth for the portfolio is estimated to be approximately 20% per annum over the next fifteen years. Therefore, even if we assumed that the portfolio's underlying free cash flows were not able to fully offset a future increase in the long-term bond yield, the rising intrinsic value of the portfolio would be capable of recouping any one-off negative valuation impact from a future increase in the bond yield over time.

The stocks in the strategy should be able to retain their expected future free cash flows in real (after inflation) terms even if inflation levels increased. Therefore, higher levels of inflation, as reflected in higher long-term government bond yields and higher discount rates, would be fully or mostly offset by higher future levels of cash flows. Thus, the present value of the portfolio should remain unchanged from an increase in the discount rate that results from higher expected inflation levels.

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