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

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

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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?

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We believe higher inflation will be temporary. However, if we are wrong, our companies are much better placed relative to their benchmarks. Our reasoning is that, with strong pricing power, companies can pass on rising input prices to customers in the form of higher prices, without materially affecting their value proposition. High quality, structural growth companies should be considered inflation hedges.

Most companies do not have the ability to pass on rising input costs by increasing the prices charged to customers. This is particularly true in an internet- and smart phone-enabled, world where demand growth has been weak post-GFC, and the consumer is very price sensitive and has an abundance of choice. The world has globalised, competition has intensified, and disruption has accelerated as the world has modernised. All things being equal, businesses that are perceived as inflation hedges should be valued relatively higher by investors and should have higher weights in equity portfolios.

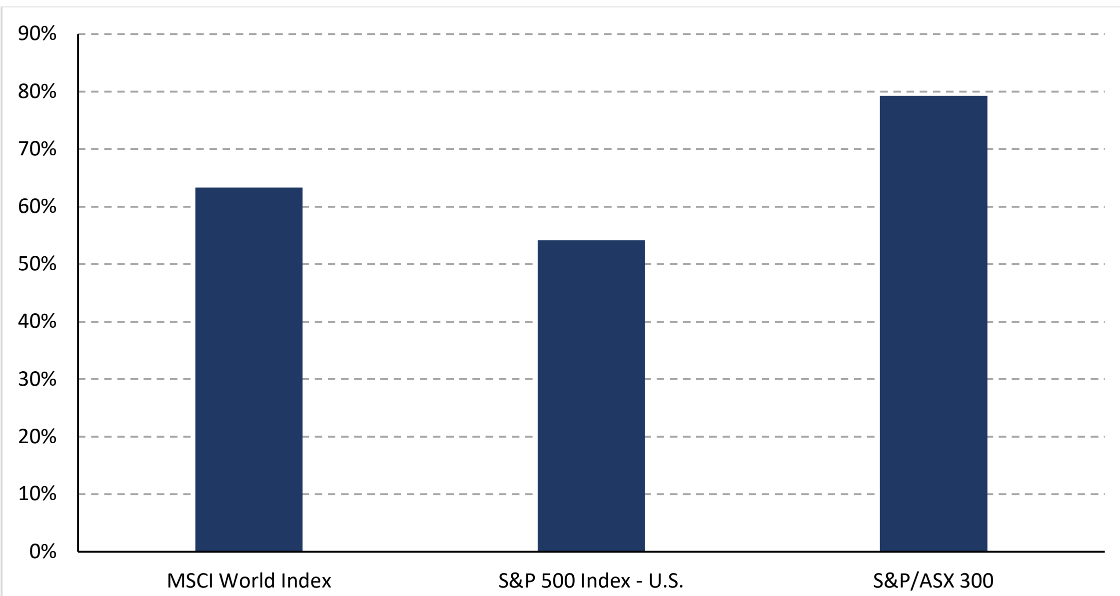
Hyperion has ranked the stocks in our global portfolio by their ability to act as an inflation hedge and believes our global equity strategy has a high degree of pricing power and, thus, defensiveness, in a high inflationary economic environment.

High quality, structural growth companies should perform better in a relative sense than broader equity benchmarks, which are dominated by "old world" businesses, which we define as those that are:

1) no or low growth; and/or
2) being disrupted by a far superior product or service.

Hyperion estimates 79% of the stocks (by index weight) in the Australian S&P/ASX300 Index can be categorised as old world. Outside Australia, 63% of the MSCI World Index and 54% of the U.S. S&P 500 Index have old world characteristics. This means the level of fundamental risk in the main benchmarks globally is high, as they are dominated by low growth businesses that are being disrupted by higher growth, more modern challengers. This disruption is being driven by the stronger value propositions that these modern businesses offer consumers. Over the next decade, we believe there will be significant levels of "creative destruction" as this transition from incumbents to challengers progresses. In this highly competitive environment, it will be difficult for these large, listed businesses to pass on any input cost pressures in the form of higher prices.

Figure 1: Proportion of benchmarks that are "old world"



Source: *FactSet, Hyperion. Hyperion has assigned companies with no or low expected EPS growth and/or with risk of permanent business model disruption as "old world".*

The largest companies by revenue globally are predominately businesses in traditional industries. The top ten businesses have nearly $US4 trillion of forecast aggregate revenue, with Amazon and Apple arguably the only modern businesses in this list. The top 20 businesses by forecast revenue ($US6.6 trillion of aggregate revenue) are dominated by traditional fossil fuel-based energy and automotive companies.

These old-world businesses are highly sensitive to economic activity levels. As the COVID-19 crisis impacted aggregate demand levels, transportation related services and oil and gas producers suffered declines in revenues, and this impacted their rankings in the 2020 year. Other old world companies, including the large auto OEMs, also suffered declines in revenues during the early part of the COVID-19 crisis.

Longer term, we think traditional fossil fuel-based energy and auto businesses will be disrupted by electric vehicles and renewable energy generation, storage and distribution. This disruption will result in these old world businesses permanently disappearing from the top of global revenue ranking lists. One of the largest beneficiaries of this shift should be Tesla. Overall, we believe trillions of dollars of revenue will be transferred from traditional legacy businesses to new market leaders over the next decade.

Table 1: Largest global companies by estimated FY2022 Revenue

Rank	Firm	Forecast Revenue (USD billion) *	Industry	MSCI World Index Weight Rank^	MSCI World Index Weight^	"Old World"	Fossil fuel based
1	Amazon	$581	Retail, Information Technology	3	2.54%	No	No
2	Walmart	$567	Retail	32	0.38%	Yes	No
3	State Grid	$390	Electricity	N/A	N/A	Yes	Yes
4	Saudi Aramco	$369	Oil and gas	N/A	N/A	Yes	Yes
5	Apple	$368	Electronics	1	3.97%	No	No
6	China National Petroleum	$366	Oil and gas	N/A	N/A	Yes	Yes
7	PetroChina	$358	Oil and gas	N/A	N/A	Yes	Yes
8	Royal Dutch Shell	$316	Oil and gas	134	0.14%	Yes	Yes
9	Volkswagen Group	$314	Automotive	261	0.08%	Yes	Yes
10	China State Construction Engineering	$309	Construction	N/A	N/A	Yes	Yes
11	UnitedHealth Group	$305	Healthcare	13	0.66%	Yes	No
12	Toyota Motor	$295	Automotive	48	0.32%	Yes	Yes
13	CVS Health	$294	Healthcare	98	0.19%	Yes	No
14	Berkshire Hathaway	$289	Financials	12	0.66%	Yes	No
15	Alphabet	$275	Information Technology	5	1.28%	No	No
16	ExxonMobil	$271	Oil and gas	23	0.46%	Yes	Yes
17	Samsung Electronics	$263	Electronics	297	0.07%	Yes	No
18	McKesson	$259	Healthcare	428	0.05%	Yes	No

19	BP	$244	Oil and gas	120	0.15%	Yes	Yes
20	Glencore International	$231	Commodities	297	0.07%	Yes	Yes

***Source:** *FactSet, Fortune, Forbes, Hyperion. Forecasts are FY22 FactSet consensus figures converted to USD billions from local currency. Note: State Grid forecast uses Statista 2020 revenue figure converted to USD; China National Petroleum forecast uses 2019 FactSet data. Largest companies sourced from 2021 Fortune 1000 and 2021 Forbes 2000 Global company rankings.*
^ MSCI World Index Rank by constituent weight. Data as at 30 June 2021. Hyperion has assigned companies with no or low expected EPS growth and/or with risk of permanent business model disruption as "old world". Volkswagen Group and Toyota Motor are classified as fossil fuel based due to low proportions of vehicles sold being electric vehicles.

Conversely, we define "new world" businesses as those that are:

1) disrupting incumbent businesses through innovation and by creating products that are significantly better and/or cheaper than existing legacy products; and

2) likely to be able to produce high sustained relative growth rates in the long run by expanding into large addressable markets and sustaining their innovative cultures.

Listed equity markets are typically dominated by large, incumbent, mature businesses. Furthermore, these businesses (and the corresponding investments in their listed security) were often developed through effectively understanding and targeting the growing baby boomer cohort. Over time, consumer behaviour and corresponding investment decisions will be driven by a younger generation that are digital natives and are better educated and globally aware. We believe changes in behaviour and patterns of consumption will be fundamentally driven and structural.

In terms of U.S. retail spend, Gen X and older is 68% of this spend, with Millennials at 27% and the next generation, Gen Z, at 5%. However, by 2030 this is forecast to shift to Gen X and older at 52%, Millennials at 31% and Gen Z at 17%[1]. Currently, Millennial and Gen Z represent only 31% of total spend and 37% of retail spend despite being 50% of the work force[2].

The sustainable nominal growth rates of most listed businesses over the next ten years are likely to be weak relative to the past five decades, particularly when compared with the high growth period before the GFC. In a high inflation environment with low rates of real economic growth, the earnings streams (in real terms) of these average quality businesses will be even more challenged.

[1] Forecasts based on the University of Michigan Panel Study of Income Dynamic 2005-2017, Bureau of Labor Statistics CE Generation Tables, Census Bureau Population projections for United States.
[2] Australian Bureau of Statistics Labour Force Survey, May 2020; Australian Bureau of Statistics Census 2016. HILDA Wave 18 Note: Definition of generations in this report: Gen Z includes individuals born after 1996, Millennials includes individuals born between 1981 - 1996, Gen X are individuals born between 1965 - 1980, Older generation are individuals born before 1965. Retail spend includes clothing and footwear, home repairs, renovation and maintenance, medicines, prescriptions and pharmaceuticals.

Businesses that can sustain high real growth rates typically have the following attributes:

1) strong and sustainable value propositions;

2) innovative cultures that actively improve the features and quality of the existing products and create new products over time;

3) yet to fully monetise the value of their existing product offering; and

4) revenues that are small relative to the size of their total addressable market ("TAM").

However, most businesses operate in a competitive industry structure and do not have the value proposition to sustainably increase (relative) prices to consumers. Consumers have been increasingly exposed to more frequent and larger discounting, including specific promotional periods. When product differentiation is low and choice is plentiful, the ability to increase relative prices is poor. We believe this is the typical operating environment most businesses face. It is only the few exceptional businesses that have strong pricing power.

Companies with strong pricing power typically have:

1) a perceived scarcity factor through strong branding and heritage;
2) controllable or limited product supply;
3) an exceptionally strong value proposition relative to competitors; and/or
4) limited competition in terms of alternative products (which typically denotes a technological or regulatory advantage).

Hyperion attempts to identify exceptional companies with a compelling value proposition and competitive advantage that offers strong pricing power. These companies are rare, as they tend to have natural monopolistic characteristics such as a network effects or a perceived scarcity factor, such as some global ultra-luxury brand names. For example, we estimate the price of Hermes' flagship Birkin handbag has compounded at double-digit rates over the past 30 years in the second-hand market. Some rare disorders that are life threatening can cost hundreds of thousands of dollars to treat, including some immunoglobulin products supplied by CSL. We estimate REA Group as the owner of realestate.com.au has increased its prices by high single-digit rates over the past ten years (with revenue growth significantly higher due to the migration of customers onto premium products).

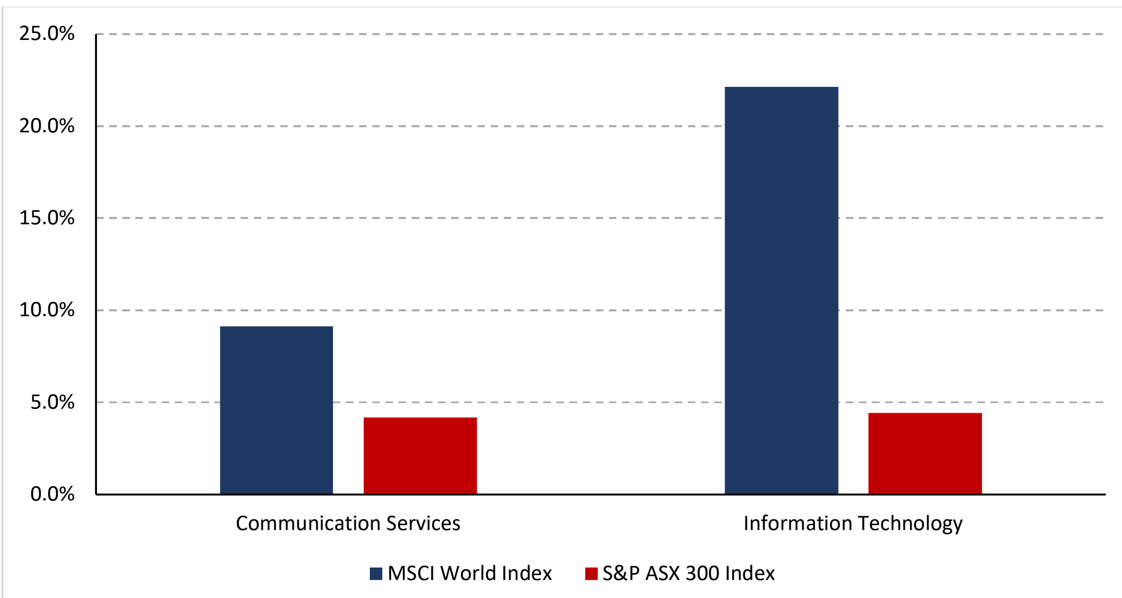
Companies with strong pricing power can offset increases in input costs with higher prices for their services or products without affecting their value proposition. This means real earnings are preserved. Companies with commoditised products may not be able to pass through any meaningful amount of their higher input costs, resulting in declines in their real earnings.

Historically, some commodities and non-fiat currencies such as gold have been considered good inflation hedges. However, we believe **software companies will be identified as more effective, modern inflation hedges** going forward. These companies typically have software that is absorbed in the workflow of an organisation, which means there are high switching costs. Often the software is under-monetised relative to its value, as the focus has been growing its user base and capturing the addressable market opportunity rather than optimising pricing. Companies that have strong market positions and a loyal user base paying relatively low monthly subscription fees could substantially increase their prices. Globally, examples include flagship products from both Salesforce and Atlassian, who charge relatively low monthly subscriptions for access to their software. Domestically, examples include core products from both WiseTech Global ("WiseTech") and Xero. For example, we understand WiseTech through its CargoWise One platform only charges a small amount at the point of value transfer (time of invoice) for each transaction. Based on the complex problems WiseTech helps solve for its customers and the limited cloud based available alternatives, we believe these fees could be increased substantially while retaining its customer base.

Software has moved from the edges of society and business to the core over the past decade. This trend has accelerated through COVID-19. However, software, as largely represented by the classification of Information Technology and to a lesser extent Communication Services, is still a relatively small percentage of the major equity benchmarks. This contrasts with Hyperion's portfolios, where most of the stocks are innovative and modern businesses that use technology well.

We estimate software represents less than 30% of developed global equities and less than 8% of the Australian listed market. The Information Technology and Communication Services sectors currently have weights of 22% and 9%, respectively, in the MSCI World Index. Furthermore, Information Technology and Communication Services is 4.4% and 4.2%, respectively, of the S&P/ASX300 Index[3]. We believe software is a good segment of the market to discover companies with strong pricing power.

Figure 2: MSCI World Index and S&P/ASX 300 Index sector weightings



Source: *FactSet. Data as at 30 June 2021.*

Higher quality businesses have more pricing power and are in a better position to pass on any inflation-based increases in their cost base by lifting the prices they charge their customers. Thus, they are in a good position to retain the "real" (inflation-adjusted) value of their future free cash flows. In this situation, the long duration nature of higher quality stocks is not relevant to their present value. That is, if these businesses can increase the nominal rate of growth in their future free cash flows sufficiently to offset any increase in the discount rate resulting from an increase in inflationary expectations, then the present value remains unchanged.

In addition, extremely high structural growth stocks are in a better position to handle high levels of inflation compared with stocks with a more modest growth rate. Even if we assume these high-quality

[3] GICS Sector weightings as at 30 June 2021. Source: FactSet.

stocks are not in a position to increase the nominal value of their future free cash flows and thus retain the real value of those free cash flows, the relative impact on the cash flow is lower.

In a relative sense, the higher the nominal structural growth rate for a company, the less the real growth rate declines for any given increase in inflation. A business with a 40% structural growth rate with 10% inflation suffers a 25% decline in real structural growth (compared to a zero-inflation situation). Contrast that with a 20% nominal growth rate company that would suffer a 50% decline in real growth from a move in inflation from 0% to 10%.

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July 2021

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