Elston

Insights

12th November 2021

Bracing for inflation: the opportunity in value

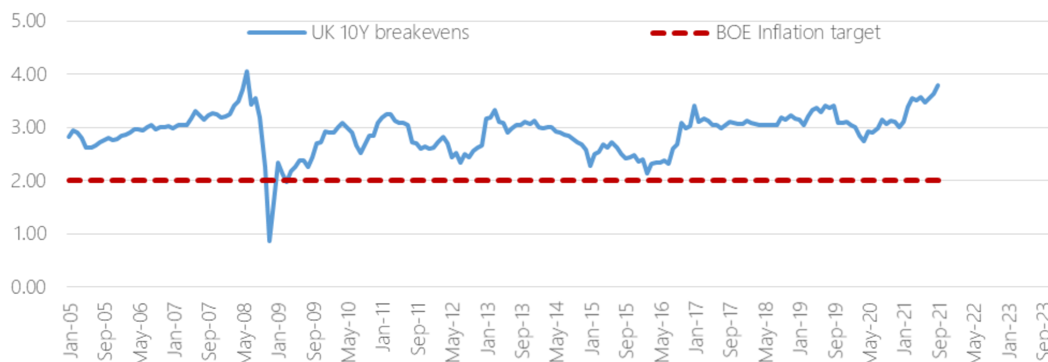
- Inflation: has ‘transitory’ taken on a whole new meaning?
- Value investing in an inflationary environment
- Capturing the opportunity

Just how transitory is transitory?

The extraordinary events that unfolded from the start of the Covid-19 pandemic prompted an unprecedented set of responses from governments and central banks. The normal market drivers and widely-accepted ‘rules’ have been upended, distorting the overall picture presented by global financial markets and making for interesting times when it comes to analysing and predicting market behaviour.

One thing is becoming increasingly certain, however: inflation is on the rise and manifesting in any number of sectors of the economy. Whilst politicians and the Fed have been at pains to cast it as merely transitory, evidence increasingly suggests that it is anything but. A conspiracy theorist might argue that inflation is a stealthy way to erode the value of government debt relative to GDP (which stands at record highs in the developed world) by way of alternative to the blunt and politically unpopular tool of taxation.

Fig.1. UK inflation



Source: Elston research, Bloomberg data, as at end Sep-21

As the world sat on its hands in 2020, bank deposits worldwide rose 11.9% in the course of the year.[1] And as this pent-up spending power is unleashed, prices will rise. The cost of materials, goods and services has already ticked sharply upwards, ostensibly on the back of the damage done by the decoupling of supply and demand during rolling lockdowns. Demand is currently overwhelming, supply in many cases is still lumpy and intermittent. One of the traditional widgets for addressing inflation is interest rates but having sat at historic lows for a number of years, the negative impact of rising rates would put additional pressure on mortgage-holders and borrowers alike.

Value investing as a hedge against inflation

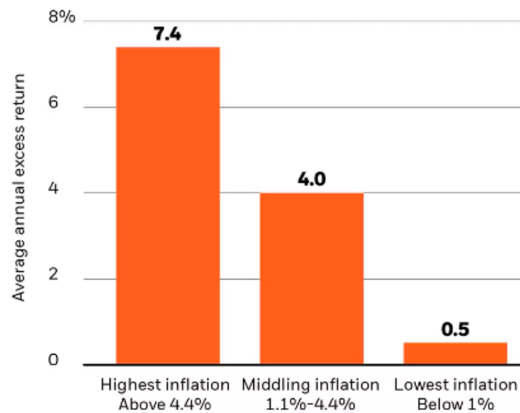
Inflation is painful for investors in a number of ways. It pushes up bond yields thereby depressing prices and it hurts growth stocks by increasing the rate at which long-term prospects have to be discounted. If inflation settles at a higher rate, for example, the earnings yield required to compensate for that means that stocks carrying high Price/Earnings Ratio ("PER") ratios lose some of their relative appeal, as future earnings are worth less when discounted back to today's terms at higher rates.

Value stocks are by definition cheap and traditionally gain popularity at the tail end of a recession and during the subsequent expansion. Albeit that this rule of thumb has been complicated by the liquidity that has flooded the market since the global financial crisis giving value investors a torrid time in the decade preceding the pandemic. But as might be expected, there has been a significant rotation into value stocks since the late 2020/early 2021, and this is visible both in public equity and private equity alike. Buyout groups have paid an average premium of 47% to acquire UK companies in 2021. (The FTSE100 has a P/E ratio that stands at approximately half that of the S&P500).[2]

In a study of the US market[3], BlackRock found that from 1927 to 2020, during inflationary regimes (inflation above 4.4%), Value outperformed Growth by an annualised 7.4%p.a. on average. During periods of middling inflation (1.1% to 4.4%p.a, relative to today's 2% target), Value outperformed Growth by an annualised 4.0%p.a on average. During periods of low inflation (<0.5% pa), Value outperformed Growth by just 0.5%p.a. on average.

[1] Financial Times, 2021
[2] Bloomberg, 2021
[3] https://www.blackrock.com/us/individual/insights/value-stock-opportunity

Fig.2. Value's relative performance under different inflationary regimes 1927-2020



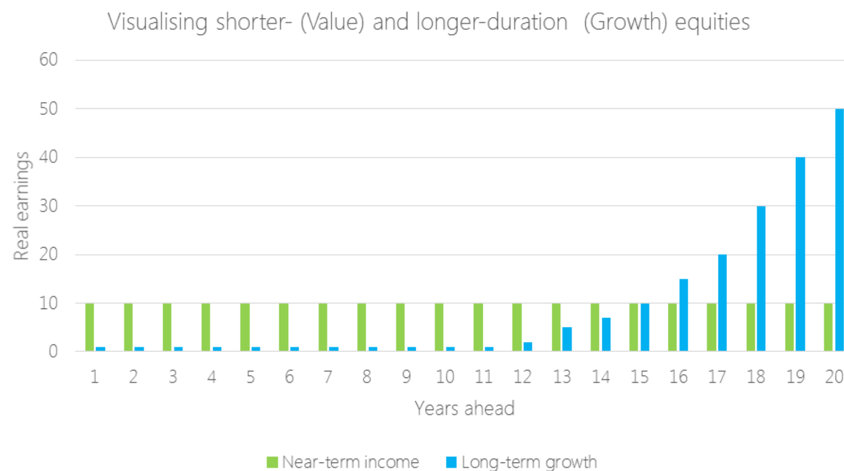
Source: BlackRock, with data from the Kenneth R. French Data Library and from Robert J. Shiller. Fama/French data utilizes the CRSP universe, which includes all companies incorporated in the U.S. and listed on the NYSE, AMEX or NASDAQ exchanges. The level of annual inflation is defined as the year-over-year change in the Consumer Price Index (CPI). "Lowest inflation" represents the bottom 20 years of inflation readings; "highest inflation" represents the top 20 years; and "middling inflation" represents the remainder. The numbers below represent the high-low range in inflation readings for each regime. Value outperformance is annualized and calculated across various inflation regimes using annual data from 1927 to 2020. Value outperformance represents the performance of value stocks minus growth stocks, as defined by the Fama/French HML research factor (i.e., "high valuation minus low valuation" using book to price).

Why duration matters

Equities provide a medium- to long-term inflation hedge, particularly if they have pricing power. A company's value is a function of its future earnings and a discount rate to value those future earnings in today's terms. All other things being equal, as discount rates increase (owing to rising inflation rates), the value of those earnings in today's terms will decrease – unless of course those earnings are <u>also</u> linked to inflation. For companies in traditional industries that are cash-generative and whose earnings in the near-term are said to be "lower duration", those near-term earnings make up a greater part of today's valuation. These companies are typically "Value"-style companies. Companies in innovative industries whose earnings are expected further in the future are said to be "higher duration" companies – distant future earnings make up a greater part of today's valuation. These companies are typically "Growth"-style companies. As the discount rates applied to those future earnings increase to adjust for inflation, longer-duration Growth companies tend to perform less well, than nearer-duration Value companies. For this reason, within equities, we prefer including exposure to cash-generative income-focused value-bias companies.

The contrast in the shape of real earnings projections can be visualised in the chart below.

Fig.3. Illustration of short- and long-term equity duration



Source: Elston research, for illustration only

Capturing the value opportunity

Investors' focus on growth stocks in the past decade has led to a situation whereby – in the past three years - only three of the eleven sectors in the MSCI All Country World index have outperformed the overall index. Suggesting there may be wider opportunities available in the market.

However since inflation fears commenced in September 2020, world equity Value factor has materially outperformed the traditional market-cap weighted world equity exposure, and Momentum factor.

Fig.4. Value style factor has outperformed since inflation fears begain in Sep-20

Source: Bloomberg

If inflation persists, there are a number of ways that UK fund investors can seek to integrate a value-bias into their portfolio depending on implementation and cost preferences:

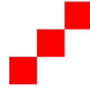
i) Invest in an actively-managed fund that has a value-investing philosophy

ii) Invest in UK equity income fund that has an inherent value bias

iii) Invest in a value-factor specific ETF

Henry Cobbe & Marina Gardiner

Elston Consulting



Find out more

For more insights and information on research, portfolios and indices, visit:

www.elstonsolutions.co.uk or NH ETF<Go>

www.elstonsolutions.co.uk

ABOUT ELSTON

We research, design and build investment solutions with and for asset owners, managers and advisers.

Our Research & CPD focuses on multi-asset strategies, index funds and ETFs.

NOTICES

With reference to the European Union Directive 2014/65/EU on markets in financial instruments ("MiFID II"): this Report does not provide a recommendation for an action, provides information freely available for public consumption and does not therefore constitute "Research" as defined by MiFID II. This is because this report contains purely factual information on one or several financial instruments or issuers and does not explicitly or implicitly recommend or suggest an investment strategy. It does not therefore constitute an investment recommendation as defined within the meaning of Article 3(1)(35) of EU Markets Abuse Regulation ("MAR"), in conjunction with Article 3(1)(34) of MAR. For further information, please refer to ESMA guidance ESMA70-145-111 Version 12.

With reference to the European Union's Market Abuse Regulation (Regulation (EU) 596/2014): we warrant that the information in this report is presented objectively, and the following commercial interests are hereby disclosed: Elston Consulting Limited creates research portfolios and administers indices that may or may not be referenced in this report. If referenced, this is clearly designated and is to raise awareness and provide purely factual information as regards these portfolios and/or indices.

An "Index" is a Regulated Benchmark. An "Index Portfolio" is not a regulated benchmark but a research portfolio of index-tracking investments with a periodic rebalancing scheme.

All company, product and service names and trademarks used in this article are for identification purposes only and are the property of their respective owners, and their usage does not imply endorsement.

This document is not an advertisement or financial promotion. It is provided for informational purposes only and is not intended to be an offer or solicitation, or the basis for any contract to purchase or sell any security or other instrument, or for Elston Consulting Limited to enter into or arrange any type of transaction as a consequence of any information contained herein.

This document is issued by Elston Consulting Limited registered in England & Wales, registration number 07125478, registered office: 1 King William Street, London EC4N 7AF.

© Elston Consulting Limited. All rights reserved No unauthorised reproduction.