COULD INFLATION EAT AWAY AT YOUR INVESTMENTS?

FORAGER

FUNDS MANAGEMENT

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From groceries to energy prices and your standard cup of coffee, inflation can impact all walks of life. But what is the impact of inflation on your investment portfolio? Let's take a look at some of the key signposts of inflation and how it can impact investments.

FIRST, WHAT IS INFLATION AND HOW IS IT MEASURED?

Put simply, inflation is the sustained increase in the prices of goods and services in an economy and it reflects just how far people's money will stretch. On one hand, inflation may indicate cost-of-living pressures, especially if wages aren't increasing in line with rising prices. On the other hand, inflation can also suggest that an economy is thriving. The opposite of inflation, of course, is deflation. At its worst, deflation can suggest a slowing or struggling economy, as well as an oversupply of goods and services.

Inflation is indicated by the Consumer Price Index (CPI), which measures the percentage change in the price of a set "basket" of goods and services that are typically used and consumed by households. As consumer needs change, adjustments may be made to this basket to reflect the changing times. Another indicator – the Producer Price Index (PPI) – is considered an early indicator of price trends which tracks the cost pressures of businesses and measures the prices paid to producers, usually by retailers.

An important driver of inflation is supply and demand. Prices tend to rise if there is increased demand for a good or service or if the supply of that good or service decreases, making it in demand. There are many factors that can affect supply and demand – for example, the cost of materials, the cost of financing (or being able to access a loan), and the cost of exporting goods.

THE KEY SIGNPOSTS OF INFLATION – WHAT TO WATCH FOR

While there are many indicators of inflation, these are top of mind at Forager Funds:

1 Rising interest rates

If an economy is growing too quickly (resulting in demand rising faster than supply is available, thus triggering higher prices and, in turn, inflation) central banks may be pressured to increase interest rates.

This is done to help slow the economy down by making the cost of borrowing money more expensive, thereby making it harder for households and businesses to spend money and continue growing the economy. Over time, higher interest rates not only have a downward effect on the number and size of purchases, but they also impact the repayments on financial products, such as mortgages and business loans – particularly where variable interest rates are applied.

Naturally, as households and businesses struggle with inflationary price increases or, conversely, higher interest rates (and as a result, higher repayments on loans), this may have flow-on effects to business performance and, ultimately, the performance of certain investments.

Take higher-growth businesses, for example. These companies, in order to develop more products and scale their operations, sometimes require investment – whether that's through investors finding the money to invest in them via shares or bonds, or through the business taking out a loan.

"I think the extent to which central banks need to raise interest rates has become kryptonite effectively," says Steve Johnson, Chief Investment Officer at Forager Funds "The days of "putting interest rates up from 5% to 10% to slow the economy down [are gone]. I think you have the same effect these days, putting interest rates up from 1% to 2% because there's so much leverage in the system."

2 Commodity prices such as oil

Commodity prices have a direct effect on the prices of goods and services. If commodity prices rise, then so does what we purchase – resulting in higher inflation. Oil is a key example of this, and one which is very closely aligned with the economy as it's the main source of energy for transportation. For instance, consider the impact of higher oil prices on all of the businesses importing and exporting goods across the world on airplanes, cargo ships and trucks. If oil becomes more expensive, companies begin passing on this cost on to consumers to help retain profits – typically by raising their prices.

CASE STUDY:

One company that this has impacted is UK-listed fast-fashion online retailer Boohoo, in which Forager Funds was previously invested. In its first half to August

2021, Boohoo discussed the proportion of its costs that were determined as COVID-related and short term in nature. Most of this was due to increases in outbound freight costs. The impact was almost 3% of margin, which is quite large considering in the first half of the last financial year, Boohoo's margin was around 11%. Boohoo noted that freight rates per ocean containers and air freight were up 400% and 300% respectively.

3 Supply chain issues

Major weather events, global pandemics, labor strikes, and wars are just some examples of how supply chains can be both disrupted and disruptive to the operations and bottom-lines of companies. In Australia, the 2009 flooding in Queensland caused supply disruptions to bananas which temporarily increased costs by 400%. Globally during the pandemic, the auto sector was impacted by a lack of microchips which caused manufacturers to halt production on new cars.

CASE STUDY:

One example of a business that has been impacted by supply chain issues is US insulation installer Installed Building Products.

Instead of buying insulation materials directly from overseas manufacturers, the company has been forced, due to supply shortages, to purchase from regular consumer stores like local home centres and distributors, which are generally more expensive. This impacted its margins in 2022. Under such circumstances, some companies manage cost increases by trying to make their money back – resulting in mark-ups on their products and services which are passed on to consumers.

4 Cost of labour

The cost of paying workers for their labor is one of the largest costs to businesses. It's also believed to be a key indicator of inflationary conditions.

Profits as a percentage of Gross Domestic Product (or GDP, the final value of goods and services produced by an economy over a given timeframe) have been going up around the world for the past two decades. The cost of labor for companies during that time has remained low, however, thanks to many companies offshoring workers and managing efficient supply chains. But that's begun to change over the past few years for certain countries and sectors.

CASE STUDY:
Staff costs might not be the first thing that comes to mind when we think of the technology sector, but it's a huge issue that could become more permanent in future. For instance, during a time of lockdowns and supply chain shortages, industry competition and a demand for first-class programmers and developers have contributed to inflationary pressures. After all, there are only so many people to go around in this sector who know how to code and build the companies everyone is trying to build. To retain the best, companies need to pay the most.

"During our research stage for investment ideas, we'll get excited about some tech businesses. They'll have really cash-generative businesses, and the free cash flow yield looks amazing," says Forager's Senior Analyst Chloe Stokes about the cost to businesses of staff compensation. "But a lot of reports that you read don't actually include share-based compensation in their models. So, once we go through and add in the cost of share-based compensation and deduct it out of a company's cash flow, the value of its cash flow is virtually erased."

The costs of hiring and retaining suitable employees can therefore have a flow-on effect to the costs of acquiring customers, as well as the prices customers pay for a company's goods and services. A big question for investors, then, is what this change in regime might mean for equity valuations over the long term.

WHAT ARE THE IMPACTS OF INFLATION ON INVESTMENT PORTFOLIOS?

In order to deliver positive results and value to investors, an investment needs to return more than the rate of inflation.

For example, with fixed income investments such as bonds, the income remains consistent throughout the bond's lifetime until maturity. But if inflation increases, an investor's purchasing power with that stable income eventually diminishes.

In comparison, asset classes like shares (which typically generate higher returns than bonds) have typically been good investments over the long term, relative to inflation, as quality businesses can increase their prices when inflation prompts broader price increases.

Another sector of the market that may perform well during periods of higher inflation is commodities. Reflecting on the oil example previously, while the cost of a commodity increases prices for everyday consumers, this may mean higher returns for an oil company. That is likely to be reflected in its share price and the returns it generates for investors.

Overall, however, having a diversified portfolio with various assets is something to consider as a way to help offset inflation risk and manage the effects of market fluctuations over time.

NOT JUST ANY FUND MANAGER

Forager is not just our name, but it's also what we do and who we are. We find opportunities in unlikely places – in Australia and across the world.

And while macro factors – like inflation – impact all investments in some way, we look through the noise of market trends to focus on finding good businesses we believe are significantly undervalued and where we expect that value to be realised within five years. Forager takes a bottom-up investment approach to selecting companies to invest in.

We don’t just talk about our investments either – our team invests right alongside our investors. With serious skin in the game, we understand the importance of getting our hands dirty, working to our strengths, and arming ourselves with the expertise necessary to help investors achieve their goals.

Led by our Chief Investment Officer Steve Johnson, you can catch the Forager team in the media where we share market-leading insights and other helpful resources on investing. You can also find us on social media – follow us for the latest updates and chat with us directly.

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