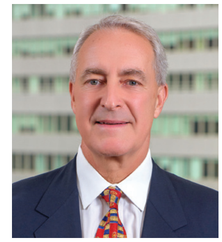
Thoughts for Investors



Albert C. Boris, III
Managing Director, Investments
215.854.1527 or 800.443.7500
New York/Philadelphia/Naples
al.boris@alexbrown.com
alexbrown.com/boriskaplanputrich

The Inflation Fire Extinguisher

Winter Client Letter 2022

"We didn't start the fire. It was always burning since the world's been turning. We didn't start the fire. No, we didn't light it, but we tried to fight it.

We didn't start the fire. But when we are gone, it will still burn on, and on, and on, and on, and on, and on, and on, and on."

– Billy Joel

When I started working in this industry in 1984, a major topic of conversation was inflation. Forty years after seemingly being extinguished, inflation has reignited. Interest rates will be pushed up by inflation and pulled up by the Federal Reserve. Millennial and Generation Z investors should pay particular attention because beyond education costs, they've not experienced inflation's widespread effects and aren't likely to learn if they only get their financial education from social media and/or only "trade" the "meme" stocks.

But before I shower baby boomers with investment laurels, how did they act during the last inflationary period? While inflation was mostly controlled by 1984, many investors thought its return imminent. In my office is a copy of a 1982 municipal bond underwriting for a major Philadelphia medical college. I keep it as a reminder. The 30-year bonds yielded 14%. If you were a Pennsylvania resident and owned this bond you received 14% free of federal, state and local taxes for 30 years! As you can imagine, investors tripped over themselves for these bonds. NOT!

Why? Back then few wanted to "lock-up" their money for 30 years. The mantra for consumers was "buy it today because inflation will make it more expensive tomorrow." But the mantra for consumers changed since then. "Don't buy it today; it will be cheaper and better tomorrow" is the new mantra, even though healthcare and education tried to convince consumers "better costs more." Many goods and services did become cheaper and better, even in healthcare and education. How? Thanks goes to the computer, Steve Jobs' "bicycle for the mind" and software, the language of computers, and the internet, a communication network. Together, these have fostered the widespread availability and free-flow of information, a "democratization of information." Information is no longer controlled by either producer or consumer. Theoretically, everyone can use it in making smarter decisions.

"Inflation is always and everywhere a monetary phenomenon."

– Milton Friedman, U.S. economist

I agree. Inflation is a monetary phenomenon. As long as there is fiat money (paper money made legal by a government decree), the potential for inflation exists. In Argentina, inflation averaged 50% in 2021. Working Argentinians spend all their paycheck immediately, storing up on staples that get more expensive by the day. What does that leave Argentinians for investing in the future?

But this client letter is not a discussion of cause or blame. Rather it is about what investments are best suited to protect the "purchasing power" of both producers and consumers. In a word, stocks, but not every stock. I don't include "meme" stocks in the helpful category.

In inflationary times, producers must work extra hard to hold the line or reduce costs. That means improve efficiency. At the same time, they are also expected to deliver increasing value to consumers to grow revenue. That means improve effectiveness. Failing one or both means losing customers to competitors. Succeeding on both means you earn the third "e," essential.

What "tools" are available to improve efficiency and effectiveness? Some include: 5G, Wi-Fi, artificial intelligence, machine learning, cloud computing, edge computing, autonomy, robotics, internet-of-things, industrial internet-of things, cybersecurity, gene sequencing, robotic surgery, quantum computing, data centers, data storage, cell towers, drones, online learning, advertising or commerce, collaboration software, software-defined-networks, content-delivery-networks, digital conferencing, digital publishing, telemedicine and virtual care, streaming and podcasts, logistics, and natural language processing. These tools continue to disrupt, transform and most of all advance the economy.

"A platform is when the economic value of everybody that uses it exceeds the value of the company that creates it."

– Bill Gates

Tools that can be used widely across many industries are often called "platforms." Microsoft (Office), Apple (iPhone), Google (search technology), Amazon (AWS cloud computing) and Nvidia and Intel (semiconductor chips) are examples of platform companies. Platforms can expand the list of creators. Just as General Motors and Ford helped create wealth for Mr. Charles Goodyear and his investors, the above companies helped create wealth for investors in other creators such as Qualcomm, Netflix and Shopify, to name a few.

The "creators" of these tools are helping make things cheaper and better, stretching our purchasing power and creating wealth for their shareowners. We believe the reigniting of inflation will further accelerate the need and use of tools. In fact, some argue that decreases in data storage and computing costs can act as deflationary counterbalances. Both producers and consumers, which pretty much encompasses everyone, benefit.

"It is not the profit margin of the past but those of the future that are basically important to the investor."

– Philip Fisher, Famed growth stock investor

Stocks of "users" of the tools can also make worthy investments if the company is forward-thinking and the tools improve a company's efficiency and effectiveness. Caution: every company claims they want to be innovative. That can be costly, takes time, doesn't always bear fruit and often hurts profit margins in the short run. If management thinks short term, this can make investing in those "users" unsuccessful. Opt for long–term, forward–thinking managements even if it means delayed profits in the short term. Yes, inflation makes $1/share in expected earnings worth less if received three years from now instead of today. "A bird in the hand is worth two in the bush" as they say. That is the overarching concern with "growth" stocks during inflationary times. But if in three years, managements with imagination get you $2 instead of the expected $1, well I think you know what that can do to the share price. For example, according to Value Line, in 2012 Amazon earned $0.29/share and Ford earned $1.42/share. For 2022, Value Line's estimate for Ford is $1.90/share and $70.00/share for Amazon (both with steady share counts).

What about investing in commodities and related stocks? How might they fare with inflation? In the past, they were often a good hedge but that may no longer be the case. We believe commodity prices should always be in decline. Technology can drive down commodity prices such as happened to oil as fracking technology improved. Or it can help find/create a substitute such as less need for office space with work-from-home and widespread availability of Wi-Fi.

Fixed income investments generally fare poorly with inflation, declining in value as inflation rises. Who wants fixed income at today or tomorrow's rates when the prospect of 14% is out there again. Inflation can also stress credit ratings. Investors, hungry for yield as inflation reduces their purchasing power often "chase yield" by accepting lower quality investments. Beware of investments using leverage to increase yield, a hidden trap.

"An optimist sees an opportunity in every calamity; a pessimist sees a calamity in every opportunity.

As for me, I am an optimist. It does not seem too much use being anything else."

– Sir Winston Churchill

In summary, we didn't start the fire of inflation. It's always been smoldering and after 40 years has reignited. Regardless of origin, the loss of your "purchasing power" is happening faster now as companies raise prices. We believe to successfully extinguish inflationary pressures companies must accelerate the use of the latest technology "tools" to increase their "efficiency" and "effectiveness." We believe investing in stocks, of both the "creators" and "users" of these tools, will be the best creators of wealth and inflation hedge. Their "future earnings" may even be understated. Nevertheless, investing takes time. Time for companies to recognize the need for the tools, time to choose and implement the tools and time for readjustment if necessary. That means being a patient investor when there is a step back after a few steps forward. Markets are bound to be volatile in this new "era" as they assess the likely winners and losers, who will thrive, survive or dive.

What if inflation is "transitory"? Well it never hurts to have a fire extinguisher handy anyway. Besides, what's wrong with innovation leading to lower cost and increasing value?

"Man's mind, stretched to a new idea, never goes back, to its original dimension."

– Oliver Wendell Holmes

AUDI PARTEM ALTERAM

"HEAR THE OTHER SIDE"

The Boris Kaplan Putrich Group // 1735 Market Street, Suite 1400 // Philadelphia, PA 19103 // T 215.563.2300
320 Park Ave., 14th Floor // New York, NY 10022 // T 212.430.2385
www.alexbrown.com/boriskaplanputrich

To subscribe, unsubscribe or to request back issues mentioned in this client letter simply send an email to al.boris@alexbrown.com.

The Boris Kaplan Putrich Group manages over $1.3 billion in assets on behalf of private families, foundations and institutions. We create custom portfolios consisting of 35 positions. We are long only, all cap, opportunistic investors. If you would like to discuss the topic of this client letter, or our team's approach to investing please contact us.

Thoughts for Investors is a quarterly client letter written for clients since 1997 by this author. The purpose is two-fold. First, it is meant to help explain the investment philosophy that guides the author's approach to portfolio management. Second, it is meant to remind readers of important behavioral skills that the author believes are necessary to help them become successful investors. The author welcomes comments and criticisms, especially if they can be shared for the betterment of all investors. Quotation is permitted with full attribution.