Chilton Perspectives: Inflation

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Inflation: Here to Stay or Just Visiting?

Lumber prices have quadrupled from their multi-year average of just under $400 per thousand board feet to more than $1,600 earlier this month. Core Consumer Price Index (CPI) shot up to 3.0% year-over-year, the highest reading since 1996. Oil prices have already exceeded pre-pandemic levels, while office vacancies remain elevated and the summer driving season isn't even upon us yet. Should investors be concerned?

While the market is quick to react to headline news, we believe the next few months will prove concerns of catastrophic inflation levels to be overblown and much of the anecdotal inflation scares to be transitory for several reasons.

- The virus-driven supply and demand imbalance is beginning to self-correct. This should push down prices over the next several months.
- School re-openings coupled with the sunsetting of the $300 a week unemployment bonus will encourage more workers to re-enter the job market and put some downward pressure on wages.
- The end of unprecedented amounts of fiscal stimulus with potential for fiscal tightening (i.e. higher taxes) provides a possible headwind to inflation later in the year.
- CPI readings themselves can be misleading as the year-over-year number typically published is now comparing the inflation number amidst a strong economic recovery fueled by powerful monetary and fiscal stimuli with a prior inflation number amidst the height of the COVID crisis. Once these start and end points begin to normalize, we will get a much clearer economic picture.

Chilton Portfolio Positioning Vis-à-Vis Inflation

When we consider an equity holding for Chilton clients in our internally managed portfolios, we usually start by asking two questions – one: "Is it a great business?" and two: "Does it pass our Quality Ranking Criteria?" These questions are germane to today's inflation scare. One of the attributes we are looking for in a "great" business is pricing power, or said another way: the ability for companies to annually increase pricing for their products or services at a rate equal to or greater than the rate of inflation through any economic cycle. The best businesses, either because of dominant market position, customer loyalty, scarcity value of a service or because of the quality of their product, can increase prices to their customers every year.

Our emphasis on Quality as a stock selection factor means we are looking backwards in time over 15-20 years of company history to see how a business's revenue and margins held up in prior periods of either inflation or recession. We are looking for revenue and profit resiliency which is typically a great clue for ultimately determining if it's a business with pricing power.

Sherwin Williams (SHW), which we own for clients, is a fine example of pricing power. SHW recently announced a 3-4% pricing increase to US and Canadian customers and did not rule out the possibility of another price increase later in the year depending on their material costs for paint. In some businesses, this might risk alienating customers or impact sales volumes. However, we have seen SHW take pricing for years without disturbing its business. SHW can increase prices based on both the quality and more productive nature of their paint product combined with their long history of providing superior customer service to professional contractors for whom paint represents only 10% of the cost of their projects.

Republic Services Group (RSG) is an example of several businesses we own for clients where the company's contract pricing with customers – in this case for hauling waste – is actually linked to CPI or to some other inflation index. In instances such as this, a company like RSG that can control its costs during an inflationary period, is likely to even see a profit margin benefit from inflation.

Our focus on high-quality businesses that consistently generate high returns on invested capital means we are drawn to businesses with inflation protection via pricing power; we do not tend to invest in pure commodity producers (energy, copper/iron ore miners) because these businesses often do not pass our quality criteria and we believe are more prone to boom/bust cycles and poor capital returns. However, we recognize some of these businesses are often viewed as inflation "hedges" and will have their moment in the sun as spot pricing for their products rise alongside the kind of inflation we are seeing now.

External Managers Well-Positioned for Inflationary Environments

Many of our external managers are aligned with Chilton's quality focus and invest in companies with strong pricing power and the ability to withstand various economic environments. That said, there are a number of strategies that are very well positioned to produce consistent returns in a low and rising rate environment. We are highlighting a couple of these from one of our partners below, due to their potential to be broadly applicable.

The Blackstone Private Credit Fund, a privately traded BDC, is a strong example of this.[1] The portfolio is comprised of senior secured floating rate loans to high quality middle market companies in the U.S. The floating rate dynamic of the fund is important, as a rising rate environment enables them to simply pass through any rate increases. Thematically, the composition of loans favors logistics, healthcare, and home improvement industries, all of which have very strong growth characteristics in today's environment.

Another effective addition to portfolios for diversification and a hedge against rising rates is the Blackstone Real Estate Investment Trust ("BREIT"). Income-generating real estate serves as an effective inflation hedge, and BREIT properties have historically proven to produce strong income characteristics and appreciation for investors. We believe the areas in which BREIT has pronounced exposure – multifamily housing, warehouses and triple net lease properties – all stand to benefit from higher rents, improvements in property values and very strong cash flows, serving investors yield and solid total returns in a low and rising rate environment.

Near-Term Outlook

Overall, we view the current inflation environment as largely reflationary with some transitory elements as our economy reverts to some semblance of normalcy. In the meantime, we remain confident in our active investment approach with a focus on buying quality businesses with pricing power, complemented with external managers who share this philosophy. For clients who are especially concerned about the potential for longer-term inflation we offer flexible solutions that should continue to perform well amidst a multitude of inflationary outcomes.

[1]Note that the Blackstone Private Credit Fund and the Blackstone Real Estate Investment Trust are private investment funds and as such, are subject to specific state and federal security rules and regulations. Potential investors must meet specific eligibility and suitability requirements as detailed in the underlying manager's offering documents. This should not be viewed as a solicitation to buy or sell interests in any of the investments noted herein, and any investment decision should be made after a thorough review of the associated marketing materials. Please see the disclaimers at the end for more information.

LOUISA M. IVES is a Managing Director & Head of Manager Research. Ms. Ives is responsible for external manager selection and due diligence for Chilton clients and is also a member of the Executive and Investment Committees at Chilton Trust. Prior to joining Chilton, Ms. Ives was a Managing Director at Chilton Investment Company, where she was a research analyst covering the financial services sector. She also served on the company's Board of Directors. Prior to joining Chilton, she worked at Coopers & Lybrand Consulting Group, reporting directly to the CEO, and began her career at Chemical Bank in their Middle Market Lending Group. Ms. Ives graduated cum laude from St. Lawrence University with a B.A. in English Literature and earned an M.B.A from Harvard Business School.

Ms. Ives serves on the boards of The First National Bank of Long Island, The Project Y Theatre Company, and on the Investment Committee of Vinalhaven, ME Land Trust.

NICK FRELINGHUYSEN is a Managing Director & Portfolio Manager – Equities Nick is responsible for investments on clients' equity portfolios, with more than 27 years of experience in equity research and portfolio management. Most recently, he was a partner at the boutique investment firm, Eagle Ridge Investment Management, LLC where he served as a portfolio manager and Co-Head of Research for an organization with $950m in assets focused on high net worth individuals and institutions. Prior to his role at Eagle Ridge, Nick worked at Oppenheimer Capital (Allianz Global Partners) as Co-Portfolio Manager on a $2B Mid Cap value mutual fund and served as Cohead of Mid-Cap and All-Cap investments for the $25B firm. He began his career on the sell side at Donaldson, Lufkin & Jenrette. Nick attended Princeton University as an undergraduate and holds an MBA from The Wharton School at the University of Pennsylvania.

LARRY MCKAY, CFA is a Senior Vice President– Head of Portfolio Construction. Larry was, most recently, a Co-Founder of Empactful LLC which is an SEC Registered Investment Advisor focusing on unique opportunities for High Net Worth clients. Prior to that, he spent over 10 years with Bank of America/US Trust as a Senior Investment Strategist within the Chief Investment Office and 5 years at Capgemini Ernst & Young as a Senior Consultant in their Vienna, VA office. Larry is a Chartered Financial Analyst and holds an MBA from MIT and an undergraduate degree from Virginia Tech.

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