Dear fellow shareholder,

An Inflation Solution

Although I grew up during the seventies, I recall little of the great price rises that characterised that low decade. I do remember some of the political consequences, especially the strikes that marred the premierships of Heath and Callahan. There were power cuts and we sat at home and read, talked and ate in the candlelight – surely the first time that had happened in London for a century.

The industrial disputes arose out of diverging prices, those of labour and goods. If your wages went up by 5% but the cost of food rose by 10% you would be forced to eat less, live off debt or economise elsewhere. In an era where industrial disputes were common, and there was full employment, withdrawing your labour was the most direct way to negotiate a pay increase. Could it happen again? I guess we are about to find out.

Inflation this time round started with the post Covid jam in logistics. Shipping, Chinese manufacturing and semiconductor assembly could not keep pace with the stop-start of the pandemic shutdowns. And now added to this are the energy price shocks resulting from Russian sanctions. Energy is a kind of raw material input of all goods, as well as of transport, so we can expect price increases in food, industrial and household goods. And, per the transmission mechanism mentioned above, in wages.

Another likely result of renewed inflation will be a rise in interest rates. This is the yield on the ten year gilt since 1962:

Source: Macrotrends

The yield today is 2% but, even ignoring the 15% peak, the long-term average over the past sixty years is about 6%. It so happens that this is by how much grocery bills rose in the past year. What would a rise in yields from 2% to 6%, together with nominal inflation of 6%, mean for investment? The most obvious victims would be bondholders. Every fixed rate bond of

reasonable maturity, including gilts, would be slaughtered. For example, a ten-year zero-coupon bond would lose a third of its value in this scenario. Pensions and insurance-related investments, which are still heavily reliant on bonds, would likewise suffer. *Any* income stream without inflation adjustments would be worth less.

An interesting intermediate case is property. This asset class has ridden the ski slope of the above graph down and to the right for forty years. Incomes have gone up which has benefitted rents but the biggest impact on values has been the fall in interest rates. If you are a buy-to-let landlord you have seen rental yields fall in recent years by a half or more and this on its own has doubled house prices. Moreover, you are stuffed to the brim with cheap debt, so you are still enjoying a positive carry (your cash rents are higher than all of your overheads, including interest payments). If interest rates spike it will reverse each of these effects and there will likely be a huge fallout for property investors, particularly if they are leveraged. On the positive side there might be rent increases and the net effect will depend on the balance of each landlord’s portfolio, especially its leverage.

All financial assets have been marched upwards by the ski slope effect and this is true for equities as well. Squeezed yields have propelled cash into dividend stocks and REITS, and, lord knows, the exciting end of the stock market – promotions, meme stocks, “growth stocks” with no earnings, SPACs and beyond into the cryptosphere. An interest rise of size would bring a lot of the froth down to earth. Public spending and borrowing, huge since WWII and compounded by the unprecedented programme of quantitative easing, has also set the stage for a return to interest rate hikes. There are likely secondary consequences for private equity and leveraged buy-outs.

Is there a way to avoid this outcome and even benefit from inflation? Here are some ideas:

1. Companies sitting on large cash balances have seen no benefit in terms of interest income since the 1990s. At Derby Street we have a file of possible investees sitting on outsized cash resources. To take one example, Wise plc, a low-cost foreign exchange dealer, has £5.3 billion in cash and similar instruments and £100m in debt. It has a net interest outflow of £5m per year. If interest rates were 6% that would become a net interest inflow of over £300m per year. (Not yet invested on valuation grounds.)

   An important precaution: we for some years owned a company called Appreciate Group. Its interest earnings were minimal, even though its cash balances were high, and certainly not enough to overcome the poor results from its operating business. So, if you are to invest in businesses with high net cash, make sure the businesses are sound and managers are good capital allocators.

   The largest positions in our UK fund have substantial cash and investment holdings:

Name	Percentage of market cap in net cash and investments
Premier Miton	23
Robert Walters	21
Naked Wines	14
Jet2	10

We like investees with cash principally because it reduces our risk and increases the ability of managers to make good investment decisions when opportunities arise. But, in an inflation, the cash could itself become an important asset.

2. High class businesses act as "pass through" securities. What does this mean? Remember the poor workers in the seventies with costs racing ahead of their wages. A well-positioned company can more than compensate for an increase in the price of its inputs i.e. the cost of raw materials, distribution or labour. It may do this by increasing its prices, managing its costs or simply by benefitting from volume efficiencies. Crucially, that is what it will already have been doing. Businesses with advantages over their competitors, offering goods and services of value to their customers are usually well placed with regards to their employees and suppliers. A counter example is football clubs. Although they have reaped the rewards of soaring television and merchandising revenues, they are weak compared to their main "suppliers", the football players. The net income of even leading clubs has struggled but players are doing fine.

   At Derby Street we typically invest in companies that are strong in each of these areas, with pricing power compared to their customers, employees and suppliers. So, cost increases are passed through or mitigated by efficiencies. For example, Indel B, the largest holding in our European fund, manufactures small and mobile fridges. It is clearly vulnerable to inflation but by dint of its size and determination, as well as the growing demand for its products, it can pass on price increases through its distribution channels and continue to benefit from scale economies.

   Indel's return on capital (ROC) is over 15% and we estimate that it could soon reach 20%. Buffett focussed on this metric in his classic article, "How Inflation Swindles the Equity Investor", published in *Fortune* magazine in 1977. He estimated that the average American corporation had an ROC of 12%, which he regarded as a fixed number, unlikely to rise even in inflationary conditions. ROC compares earnings to the amount of investment required to run a business. If you employ £100 million in factories, stock and so on, and make a net profit of £12 million, your ROC is 12%.

   Buffett, writing in the middle of the oil-shock inflation of the 1970s, saw that the average business would be punished by inflation. It would need to build more factories and invest in more stock at higher and higher prices, but its quasi-fixed ROC meant it would be earning only just enough to make these investments and no more – its free cash flow would dry up.

   The twin corollaries to this are that low ROC businesses (start-ups, hotels, below average performers) will have negative cash flow in times of high inflation, as they do not produce sufficient cash from earnings to reinvest; and that high ROC businesses ought to be more able to produce cash, as they commit a lower percentage of earnings to reinvestment.

   However, I don't want you to conclude from all this that inflation is going to be a bed of roses. Cost of living increases will depress demand, perhaps temporarily, perhaps for longer. Not all businesses, even the high ROC ones, will be able to pass through the costs. In other words, owning high ROC businesses is a defensive move against inflation, not a sufficient one. The crucial strength is pricing power. Companies with this ability are the most likely to overcome inflation.

3. There may be an additional category of companies that positively thrive in an inflationary environment. One of our UK fund’s top positions is Robert Walters and one of our European fund’s top positions is Synergie. Both are geographically diversified, long-established, cash-rich recruitment consultancy firms. Here is what Mr Walters said last month, “The jobs market is strong, wage inflation is increasing everywhere…” and he meant this as a positive. The revenue of recruitment consultants is made up of commissions on wages; if wages are inflationary so will be their revenues. Industries like these (one could also consider lettings agents or shipping brokers) can effectively tax inflation. So long as they are effectively operated, they also will have good operating margins and ROC, so the increases in turnover translate into disproportionately larger increases in profit and cash. These two companies hold large cash balances so they will also benefit from the interest rate rise effect.

We are not macro forecasters at Derby Street. We don’t know when the war against Ukraine will end (soon, we hope) or when oil and other prices will fall. I don’t imagine we shall be working by candlelight any time soon, but our funds are prepared for all manner of outcomes.

Thank you for supporting Derby Street. We look forward to speaking to you all soon,

Richard Simmons
Portfolio Manager
Derby Street Investments

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