CLIFFORD SWAN
THE Investment Counselor
MAY 2022
WISDOM *for* GENERATIONS

STOP THE INFLATION SWINDLE

By Daniel J. Mintz

As a key tenet of our mission at Clifford Swan is to preserve and grow our clients' wealth, inflation protection is always on our minds. Recently, however, the topic has made national headlines, with the Consumer Price Index (CPI) for the year ended March 2022 rising 8.5% versus the previous year—the highest jump since 1981. A closer look at the data shows why the topic has captured so much attention. Several of the components inflating the most involve everyday purchases like "food at home," up 22% year-over-year in February, or gasoline, up 47%.

In last quarter's newsletter, my colleague Randy Zaharia covered some potential causes of inflation and ways to position portfolios accordingly. In this article, we focus on equities. Though stocks don't offer guaranteed inflation protection, company analysis and disciplined stock selection can give the investor an opportunity to maintain or grow purchasing power in a variety of inflationary environments.

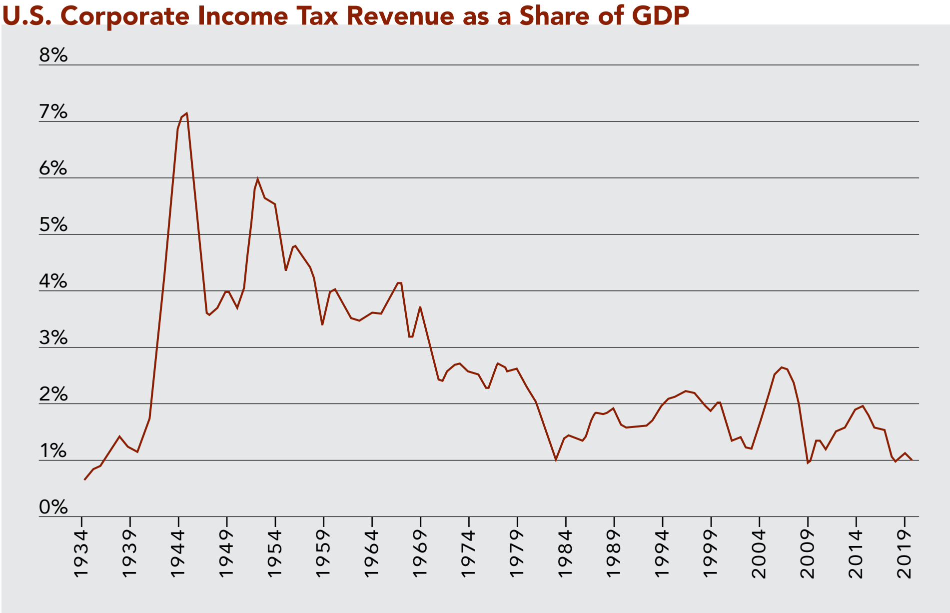
In a 1977 *Fortune* article titled "How Inflation Swindles the Equity Investor," Warren Buffett challenged the conventional wisdom that stocks are always a hedge against inflation. He looked at years of data across various inflationary and non-inflationary periods and found that, on average, return on equity (ROE)—the income generated relative to equity capital invested—was relatively stable for the market at around 12%, regardless of the inflationary backdrop. In other words, typically when sales see a boost from inflation, expenses and reinvestment requirements balloon as well, making it very difficult to benefit on the revenue line without taking a corresponding hit to the bottom line. Granted, ROE is not a perfect proxy for what an equity investor should earn over the long run. But since 12% is a fixed number, Buffett noted that stocks can look a lot like fixed income investments unless this "equity coupon" can grow. Moreover, for most investors, the "equity coupon" is pre-tax. Depending on how high tax rates and inflation are, real returns can be much lower.

> "…company analysis and disciplined stock selection can give the investor an opportunity to maintain or grow purchasing power in a variety of inflationary environments."

To combat such a mediocre real return scenario, Buffett describes actions company management can take to grow ROE. These include taking on more debt or cheaper debt, paying lower income taxes, increasing turnover (the ratio of sales to assets), or expanding profit margins. At the time of writing, Buffett argued that these actions were easier said than done. From our perspective, he's as right today as he was in 1977. Taking on more debt will be too burdensome for many companies in the current

INFLATION | Continued on page 2

U.S. Corporate Income Tax Revenue as a Share of GDP



Source: Office of Management and Budget

environment, as inflation generally leads to higher interest rates and borrowing costs. Further, lower tax rates seem unlikely. Corporate income tax as a percent of GDP is near multi-decade lows [see the chart on the previous page], making it unwise to bet on tax rates falling from here. Next, corporate profit margins, which have tended to mean-revert over long periods, are near multi-decade highs [see the chart to the right]. And finally, to create a higher ROE for shareholders via higher turnover, sales growth must outpace asset growth. Unfortunately, inflation of a company's capital requirements makes it challenging to widen the ratio of sales to assets arising from an increase in revenue.

> "A major advantage the 'equity coupon' has over a bond coupon is that the equity coupon can be retained and reinvested by management instead of being paid to the investor in cash. Diligence into how company leadership allocates these funds is critical."

For the market as a whole, the current inflationary environment seems formidable when considering the likelihood of attractive real investment returns. However, looking on a firm-by-firm basis, it is possible to uncover businesses capable of mitigating the effects of inflation. Our stock selection process seeks out these types of companies in several ways. Through active management, equity portfolios can be positioned accordingly.

First, we keep a close eye on balance sheets. For the most stable companies with recurring revenues, sometimes more debt may be added to prudently boost ROE. For most companies, we don't like to rely on more leverage to drive returns. We favor businesses with economics that are so attractive that management doesn't need to borrow to fund operations or growth. If inflation leads to higher borrowing costs, it shouldn't matter too much to our companies under coverage.

We don't find it to be a good use of time to forecast U.S. tax policy. However, some companies benefited from the Tax Cut and Jobs Act of 2017 more than others. For the ones that benefited the most, we are particularly cautious about assuming "lower for longer" tax rates. All else being equal, we prefer that the intrinsic value of our companies does not rely on generationally loose tax policy.

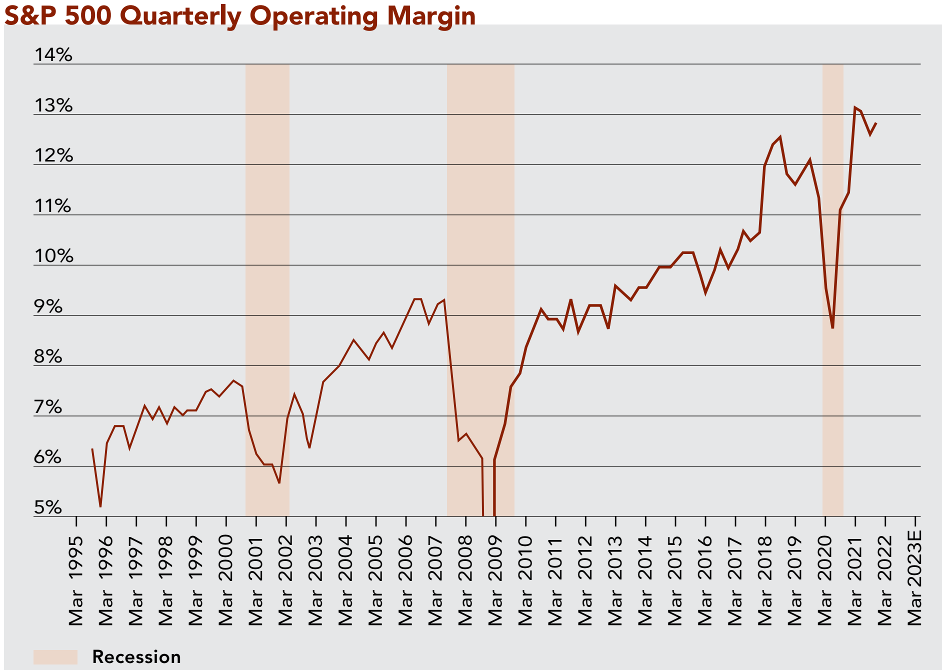
We spend significant time analyzing the final two sources of ROE growth—turnover and profit margins.

Management skill plays a key role in the growth or decline of these two factors. A major advantage the "equity coupon" has over a bond coupon is that the equity coupon can be retained and reinvested by management instead of being paid to the investor in cash. Diligence into how company leadership allocates these funds is critical. Investments in projects involving a new product or a new market might generate both higher turnover and wider margins. In contrast, missteps may lead to declining fundamentals, or worse. Management track records, incentives, and strategies for the future can be analyzed. We form views on which teams are most likely to succeed in a variety of macroeconomic conditions, inflation notwithstanding.

Each company and industry has its own nuances. Addressable markets might be large, creating opportunities for higher turnover but also inviting more competition. Or, markets may be more niche, limiting potential turnover growth, but also keeping new entrants at bay and providing the opportunity for wider margins for incumbents. Some companies can raise prices faster than underlying expenses, and some cannot. Certain businesses can grow sales volumes without many corresponding fixed costs. Others cannot. We believe that analyzing fundamentals to determine potential sources of ROE improvement is time well spent.

Although recent headlines may raise eyebrows and invoke memories of 1970s-style inflation, there are ways to "stop the inflation swindle." We believe that, over the long run, an investor can maintain and grow purchasing power through disciplined stock selection. ◆

S&P 500 Quarterly Operating Margin



Source: Deutsche Bank Research, Bloomberg Finance LP

SOCIAL SECURITY AS AN INFLATION HEDGE

By Erica S. White
CFA, CIC

Inflation is top of mind in the investment community. As my colleague Dan Mintz discusses in his corresponding article, inflation is historically high. At Clifford Swan, we have strategies to preserve and grow our clients' wealth in an inflationary environment. Our approach to disciplined stock picking, as described by Dan, is one of them. In addition, outside of our clients' investment portfolios themselves, there are other tools we can employ to combat rising prices. For our senior clients in particular, Social Security benefits—which make up about one-third of income of all retirees—can be an extremely compelling hedge against inflation.

> "…outside of our clients' investment portfolios themselves, there are other tools we can employ to combat rising prices."

For all of us, inflation impacts our daily lives. It makes the goods and services we demand more expensive, and for seniors in or nearing retirement, this can be particularly worrisome. For one, rising prices mean we need to spend more on the things we need. As we plan for retirement, it's important to project into the future how much we may need to spend. To the extent that rising inflation makes those predictions more difficult to make, and higher, inflation can undermine our confidence and our potential ability to sustain ourselves into a long retirement. Secondarily, inflation itself or fears about it could even disrupt investment markets, leading to lower investment returns.

> "…when inflation increases, so do Social Security benefits, and even better, if inflation decreases, benefits remain even."

To combat the impacts of rising inflation for seniors, Social Security is an extremely valuable tool. Social Security is an inflation hedge, with payments 100% positively correlated to inflation. This means that when inflation increases, so do Social Security benefits, and even better, if inflation decreases, benefits remain even. Benefits adjust annually for the impact of increases in consumer prices.

There are several types of Social Security benefits, including benefits paid for individual retirement, disability, to a spouse/dependent children, and to surviving family members. Social Security decisions ought to consider an individual or family's particular circumstances, including health status, life expectancy, and other financial factors as well. For the purposes of this article, we will focus upon benefits paid to individuals, based on their own work records, and we recommend that clients consult with their investment counselors when considering when and how to craft their own claiming strategy.

> "…you have a choice in when to start collecting Social Security payments, and that timeline also impacts the amount of your benefit."

For individual workers, the calculation behind each of our Social Security benefits can be complicated and confusing. In general, your individual benefit is based upon your highest 35 years of wages, and you must work for 10 years to qualify for worker benefits. Furthermore, you have a choice in when to start collecting Social Security payments, and that timeline also impacts the amount of your benefit. In most scenarios, you can start collecting Social Security as early as age 62. However, collecting before your

> "…in an economic environment where inflation is top of mind, growing your individual benefit for a long as possible means having a larger base for Social Security's annual COLAs (cost of living adjustments) going forward."

SOCIAL SECURITY AS AN INFLATION HEDGE | Continued on page 4

SOCIAL SECURITY AS AN INFLATION HEDGE | Continued from page 3

full retirement age ("FRA"), which is currently 66 or up depending on your birth year, will reduce the benefit you receive. If you wait beyond FRA, your benefit grows at a rate of 8% per year, until you reach age 70. Even in a low inflation environment, we generally recommend that, in the absence of a shorter life expectancy or other unique circumstances, clients wait to collect Social Security until age 70. The 8% per year growth is guaranteed as long as Social Security remains solvent, and that is extremely compelling. Furthermore, in an economic environment where inflation is top of mind, growing your individual benefit for a long as possible means having a larger base for Social Security's annual COLAs (cost of living adjustments) going forward. Over time, that is even more beneficial when inflation is high or increasing. Additionally, because Social Security is only taxed on 0-85% of the benefit you receive, depending on the particulars of your finances, the inflation-indexed growth achieved by waiting to collect is even more powerful.

Unfortunately, the way Social Security measures inflation may not match seniors and their spending habits well. Each fall, certain months of the Consumer Price Index for Urban Wage

> "Unfortunately, the way Social Security measures inflation may not match seniors and their spending habits well."

Earners and Clerical Workers (CPI-W) are averaged together to produce Social Security's annual COLA. In October 2021, it was determined that the COLA for 2022 benefits would be 5.9%. Importantly, annual COLAs are applied to all benefits for individuals aged 62 and older. In other words, even if you delay collecting Social Security, you are still getting the benefit of inflation-based cost of living adjustments. However, basing the COLA for retirees upon the CPI-W really reflects the impact of inflation upon a working household, not a retiree's. For most senior households, spending might be more focused on items like healthcare, for example, and historically healthcare costs have risen by more than overall inflation itself.

However, despite this, we still recommend that clients consider their Social Security benefits as a powerful tool to protect against inflation and act accordingly. Your investment counselor

> "For those who might have already filed for Social Security and want to change course, it may not be too late."

can help you navigate your particular situation, but to maximize this inflation hedge, seniors should strongly consider waiting until age 70, but not beyond 70, to start collecting benefits. For those who might have already filed for Social Security and want to change course, it may not be too late. If you are younger than 70, but over your FRA, you may be able to suspend collecting your benefit for a period to time, to allow it to grow until you resume collecting benefits again at 70.

To summarize, we recommend that clients consider delaying collecting their Social Security benefits and consult their investment advisor for guidance. For healthy individuals, waiting until age 70 to collect has always been a compelling value proposition if you can afford to do so, and the longer you live, the more impactful waiting and growing your benefits will have been. However, in the current investment environment where inflation is especially concerning to seniors, waiting to collect Social Security and maximizing the amount of your income that is therefore inflation-indexed is especially appealing. Waiting until age 70 to collect benefits is one of the most effective inflation hedges out there for retirees. ◆

CLIFFORD SWAN
INVESTMENT COUNSELORS

PROFESSIONALS

Peter J. Boyle, CFA, CIC
James R. Brown
Kevin J. Cavanaugh
Kenneth H. Dike, Esq., CPA, CLPF
Roger L. Gewecke, Jr., CFA
Kathleen Gilmore, CFP®
George E. Hasbun, CFP®
Anil Kapoor, CFA
Gretchen E. Lee
David Y. Lin, CFA
Jennifer I. Maqueda
Daniel J. Mintz
Murcy Huang, CFA
Maxwell R. Pray, CFA
Erica S. White, CFA, CIC
Carlota B. Venegas, CFP®, CDFA®
Lloyd K. Wong, CFA
Randall L. Zaharia, CFA, CAIA®

OFFICES

Pasadena
177 E. Colorado Blvd., Suite 550
Pasadena, CA 91105
626.792.2228 | 626.792.2670 FAX

Evergreen
P.O. Box 2945, Evergreen, CO 80437
720.746.1244 | 720.294.9896 FAX

cliffordswan.com

Both this and past editions of *The Investment Counselor* are available on our website.