

# When inflation is high, investors focus on high pricing power equities

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2022 continues to prove difficult for investors around the globe. The conjunction of heightened geopolitical risks, increasingly hawkish central banks, and runaway inflation has forced many investors to change tack and modify their asset allocation significantly over the last 12 months. Duration has been lowered across asset classes, and a survey we commissioned<sup>1</sup> recently revealed that 77% of European professional investors use equities to hedge against inflation.

## Fighting inflation by wielding Pricing Power

Not all equity investments are equal in the face of inflation. The key differentiator is their 'Pricing Power'. Pricing Power describes the ability of a company to increase its price without impacting demand or losing market share to competitors. In an inflationary environment, margins are under pressure because companies 'import' inflation, whether they want it or not. Overall costs for the companies increase through labour, supply, or energy. The only tool to mitigate the impact of inflation on margin is to increase prices. Companies with Pricing Power will be able to do so the most efficiently. Certain types of companies tend to have higher Pricing Power:

- Companies that deliver essential services tend to wield a lot of Pricing Power as they have somewhat captive clients. This is the case for many companies in the Consumer Staples, Healthcare, Utility, or Energy sectors.
- Companies that deliver high-quality products or services and possess a distinct competitive advantage can also increase prices efficiently.
- Luxury goods companies benefit from their clientele's relatively low price sensitivity.
- Some companies can benefit from favourable supply-demand dynamics at a particular point in time. This is, for example, the case of semiconductors in 2021 or energy companies this year.

## History is the best guide to the future

As is our habit when trying to assess the future, we turn to the past for guidance. The below graph focuses on US-listed stocks since the 1960s. It assesses the average outperformance or underperformance of different groupings of stocks, since the 1960s, when inflation is higher than the last five-year average. We observe that, on average:

- High Quality stocks weathered inflation better than Low Quality stocks

- Value stocks beat Growth stocks
- High Dividend stocks outperformed Low Dividend stocks
- Small Cap and Low Volatility did better than Large Cap or High Volatility companies

Overall, High Quality, High Dividend and cheap stocks appeared to fare better in high inflation environments.

*Source: Kenneth French data library. Data from July 1963 to September 2022. Factors are defined as the value-weighted basket of the 30% stocks with the relevant characteristics. Min Volatility uses lower variance, Quality use operational profitability, Value uses the lowest price to earnings, Small Cap uses the lowest market cap, and High dividend uses the highest dividend yield.*

**Historical performance is not an indication of future performance and any investments may go down in value.**

The same analysis on sectors shows that Value-orientated, High Dividend sectors also tend to do better against inflation. Energy, Healthcare, Consumer Non-Durables (Food, Tobacco, Textiles), and Utilities exhibit the strongest average outperformance during high inflation.

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It is clear here that the quantitative data aligns with our qualitative assessment. The factors and sectors that historically outperformed when inflation was high are those that have the greatest chance to harbour high Pricing Power companies. This should give investors indications on how they could tilt their portfolio to fight inflation.

### **Quality and Dividend Growth to fight inflation**

In light of the unique challenges equity investors face, High Quality companies focusing on Dividend Growth could help strengthen portfolios. High Quality companies exhibit an 'all-weather' behaviour that tends to deliver a balance between building wealth over the long term whilst protecting the portfolio during economic downturns. Dividend-paying, highly profitable companies tend to:

- Exhibit higher pricing power allowing them to defend their margins by passing cost inflation to their customer.
- Exhibit lower implied duration, protecting them in a rate-tightening environment, thanks to a focus on short-term cash flows.
- Provide a defensive tilt and an enhanced capacity to weather uncertainty.

1 Source: CoreData Research, Pan European Professional Investor Study, July-August 2022.

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