Written by Tye Bousada

The $1.49 Beefy Crunch Burrito

Two stories caught my attention last week due to their emphasis on inflation. The first was about a Taco Bell customer in San Antonio, Texas who fired an air gun at employees after discovering that the beefy crunch burrito that he used to be able to buy for $0.99 suddenly costs $1.49. The second story, albeit much less dramatic, was about comments made by the Chief Executive Officer of the biggest retailer in the world. Specifically, Walmart CEO, Bill Simon, was quoted by USA Today as saying that he is “seeing cost increases starting to come through at a pretty rapid rate” and that he believes near-term inflationary pressures are “going to be serious”.

Inflation is dangerous. In fact, there are few things as dangerous as inflation when it comes to the financial health of a household. Here’s some basic math to back this up. The average annual inflation rate in the U.S. since 1913, the first year it was tracked, has been 3.4% (source: inflationdata.com). Assuming that inflation for the next decade approximates the long-term average, your living expenses will cost 40% more in 2021 than it does today. Conversely, if you hold all of your wealth in cash for the next decade, you will be 40% poorer in 2021.

The big assumption in this scenario is that inflation will match the long-term average. This might be wishful thinking given the inflation rates we’re seeing around the world. More specifically, below is a list of the 2010 price increases for a number of commodities, many of which are used on a daily basis in most households.

2010 Price Increases by Commodity

Commodity	Price increase (%)
Palladium	99.5%
Cotton	61.3%
Nickel	47.9%
Copper	45.4%
Silver	37.3%
Platinum	33.7%
Coal	32.4%
Coffee	30.7%
Zink	29.4%
Aluminum	29.0%

Commodity	Price Increase (%)
Lean hogs	28.8%
Heating oil	28.5%
Lead	24.6%
Sugar	23.9%
Corn	14.6%
Live cattle	13.2%
Wheat	10.0%
Natural gas	5.3%
Cocoa	5.1%
Soybeans	4.3%

And as if the 2010 numbers were not bad enough, since the beginning of the year, cocoa has risen another 43%, cotton another 42%, heating oil another 23%, silver another 21%, and lean hogs another 11%. This is in just three months.

With these types of increases, the assumption that inflation over the next decade will only match the long-term average is a stretch. During the last nine decades, since inflation rates have been recorded in the U.S., there have been three decades where the inflation rate was above 5%. If we were to assume an annual inflation rate of 5% rather than the 3.4% used above, then your living costs would end up costing you 63% more a decade from now rather than 40% more. High inflation can destroy wealth for those who are not prepared for it.

What can you do to help insulate yourself from ravages of inflation? You must first understand what types of investments do poorly in a high inflationary environment. Cash is a terrible insulator against inflation, as well as are most types of bonds, especially long-term bonds with fixed interest rates, because as inflation and interest rates rise, bond prices decline. In general, stocks don't perform well either. The value of a business is determined in large part by its future expected profit, and inflation reduces this. As an illustration, let's say you own a business which is expected to produce $100,000 in profits next year. If inflation over the next year is 2%, that $100,000 is equivalent to $98,039 today. However, if inflation is 10%, then $100,000 is worth only $90,909 today. As such, the higher the inflation rate is expected to be, the less I am willing to pay for a $1 worth of future profits. This results in lower stock prices.

There are businesses, however, that can better weather the effects of inflation. These are businesses that have the ability to grow in an inflationary environment and/or have pricing power. We have talked about the importance of growth in many of our past commentaries. Growth is critical for a business to be able to compound its value over time. We have not, however, written about the importance of pricing power. This is the ability of a business to protect its profit margins by increasing prices in line with inflation. If a business has pricing power, its profits will grow at the same rate as inflation, which is additive to the underlying growth of the business.

Let's say, for example, that inflation is 10% and a business increases its prices by 10%. All else being equal, its profits will also increase by 10%. Higher future profit not only protects against inflation but also protects the share price. Finding a business that not only has pricing power but whose future growth is not reflected in the current stock price creates a very attractive investment opportunity.

Businesses with pricing power are difficult to find. Try to think of some businesses that can raise prices by 10% and not see a corresponding drop in business. Shoppers will likely look for a substitute product, use a lower quality or less expensive item or simply stop consuming the product altogether.

Tim Horton's, which represents approximately 5% of the portfolio, is an example of a business that we believe has pricing power. If you are a coffee drinker, ask yourself whether you would stop drinking your morning Tim's if the price of a large coffee increased by $0.16 to $1.74. History has shown that in the face of increasing prices, few customers have cut back their consumption. In fact, with past increases, Tim Horton's same store volume has actually increased. Perhaps they are attracting disenchanted Starbucks customers who don't like paying more for a coffee that already costs a small fortune. Regardless, Tim's has pricing power, and as an owner of this business, you benefit from this.

Before any price increases, we believe Tim Horton's has the ability to grow its same store revenue by 3% to 4% per year. Furthermore, we think it can grow its store base by 3% per year. This presents approximately 6% to 7% growth before any price increases. At the time of writing, Tim Horton's trades at approximately 18 times earnings. Stated another way, if you were to buy the entire business, you would receive a 5.5% (or 1/18) annual return on your investment before any assumption of growth. Including the growth potential of 6% to 7%, this represents a potential 11.5% - 12.5% annual return.

We believe this is pleasing relative to other opportunities, especially when Tim Horton's' pricing power is taken into account.

In summary, we believe inflation is a significant threat. If history is a guide, the best way to combat this threat is to buy companies whose future growth is not reflected in its stock price. Or better yet, find companies that also have pricing power. We have attempted to populate your portfolio with companies like Tim Horton's that we believe have this blend of growth and pricing power.

As always, we approach investing in these turbulent markets with a sense of measured confidence. We thank you for your confidence and look forward to having the opportunity to build wealth for you over the long term.

Sincerely,

Tye

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