Getting Real About Interest Rates & Inflation

polen capital

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Inflation Redux?

While the global economy and overall health picture have continued to improve since the onset of the pandemic, uncertainty about the duration of inflationary pressures and prospects of higher interest rates have remained two top concerns over the minds of policymakers and investors alike.

Naturally, clients have been asking us what to expect if we enter a more prolonged inflationary environment and, subsequently, if interest rates continue their uptrend. This paper will explore our views on the possible impact these economic forces could have on our investment portfolios and examine the relationship between inflation, interest rates, and equity performance.

Navigating Inflation During an Unprecedented Recovery

Regarding inflation, we have seen the prices of many goods and services increase as the global economic recovery has continued to gain momentum. Unprecedented levels of federal stimulus to businesses and individuals, coupled with broader business reopenings, have helped labor markets make significant gains in many parts of the world while also boosting economic activity. That said, pent-up demand from consumers who were unable to spend during the pandemic, combined with excess savings, resulted in a surge in demand for a variety of products.

This demand has been primarily directed towards goods rather than services, as consumers shifted their spending patterns away from more service-oriented activities such as travel and entertainment. In turn, these distortions are being met by a pandemic-induced shortage of parts and labor across global supply chains, exacerbating the inflationary pressures we are currently experiencing.

In our view, the current imbalances in demand and supply could linger for some time but should gradually wane as the world continues to make progress in the battle against COVID-19. Though it's virtually impossible to accurately predict when conditions will fully readjust given the ever-evolving nature of the virus, we believe that inflation will have to compete in the long term against secular disinflationary forces, including technological innovations, aging demographics, and high levels of debt.

Despite its nearly 33-year track record, it is worth noting that our flagship Polen Focus Growth Composite Portfolio (the "Portfolio") has never been through a genuinely high period of inflation, such as those seen during the late 1970s and early 1980s when inflation levels rose dramatically for well over a decade (see Figure 1). Notably, the economic backdrop was meaningfully different back then: the Fed funds rate reached a high of 20%, while inflation readings hovered in the double digits. As further demonstrated in the chart below, inflation in the U.S. has been relatively stable and trending downward since the 1980s, limiting the data available to examine high inflationary periods.

Personal Consumption Expenditures (PCE) & U.S. Fed Funds Rates

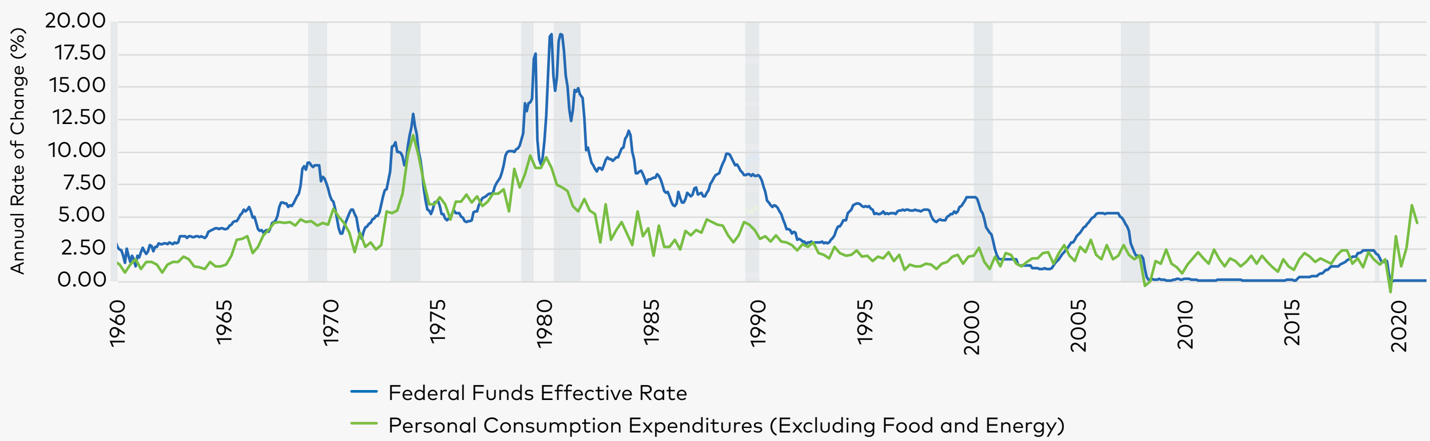


Figure 1: Source: FRED, Federal Reserve Bank of St. Louis. Shaded areas indicate periods of U.S. Recession. As of December 31, 2021.

Understanding the Impact of Inflation

Still, an analysis of our Focus Growth Portfolio's historical performance dating back to its inception in 1989 showed a very low correlation[1] between inflation rates[2] and our Portfolio's returns. Over this period, the Portfolio's returns fell into a broad range of possibilities at different inflation levels, displaying no statistically significant relationship between them.

Understanding the Impact of Interest Rates

It is also essential to separate inflation prospects from higher interest rates. Despite our sanguine long-term view on inflation, we could still see higher interest rates down the road for several reasons, including a substantial increase in the supply of U.S. Treasuries. Nevertheless, our Portfolio's track record similarly showed a very low historical correlation between different interest rate levels and historical returns, as seen below.

Polen Focus Growth Monthly Returns Since Inception Versus Inflation

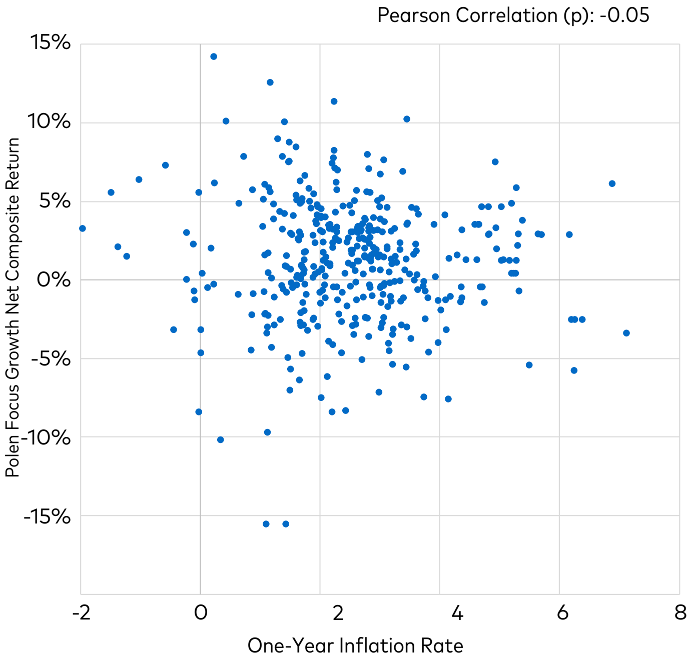


Figure 2: Source: Polen Capital, U.S. Federal Reserve. As of November 2021. Each blue dot represents one month of performance.

Polen Focus Growth Monthly Returns Since Inception Versus Interest Rates

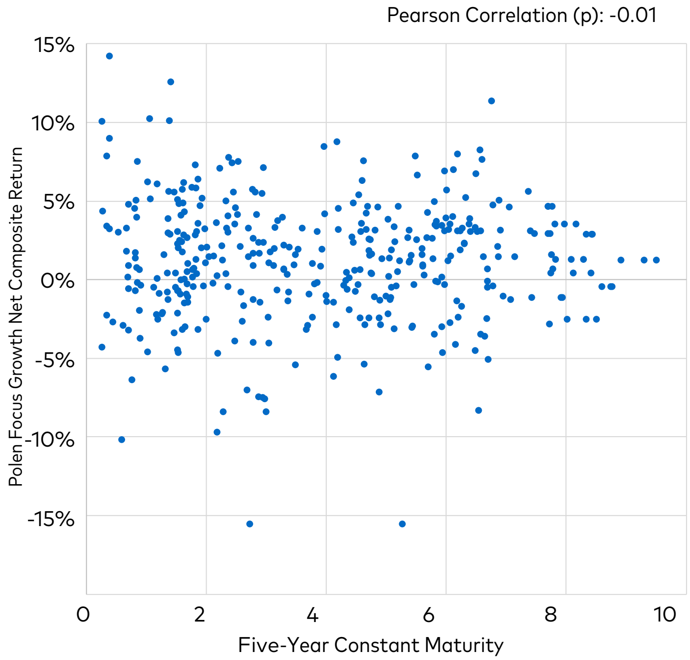


Figure 3: Source: Polen Capital, U.S. Federal Reserve. As of November 2021. Each blue dot represents one month of performance.

1 The Pearson correlation measures the strength of the relationship between two variables. It has a value between -1 to 1, with a value of -1 meaning a total negative linear correlation, 0 being no correlation, and + 1 meaning a total positive correlation.

2 As measured by the seasonally adjusted U.S. Total Consumer Price Index (CPI).

Taking a step further, we conducted an analysis that grouped returns from previous years into periods of either falling or rising rates. Once again, as seen in Figure 4, the results failed to demonstrate a meaningful change in expected returns solely based on interest rate trends or fluctuations alone. Composite returns for the Portfolio were relatively similar in rising and declining rate environments.

Range of Polen Focus Growth Returns Under Falling and Rising Interest Rates

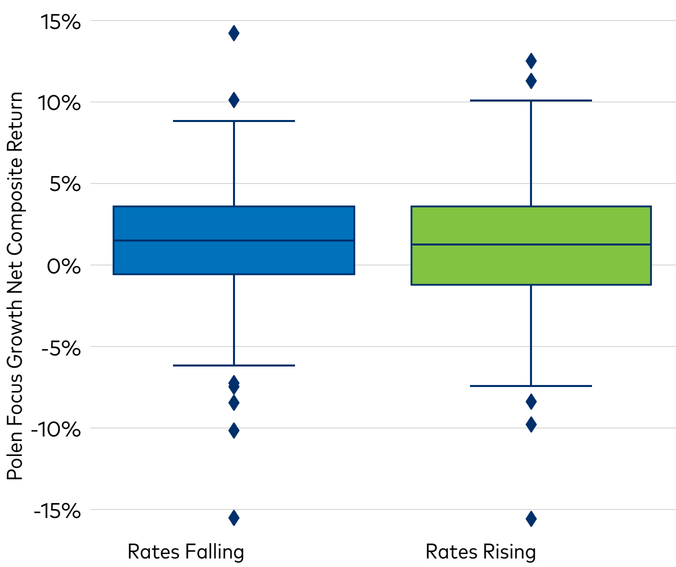


Figure 4: Source: Polen Capital, U.S. Federal Reserve. As of November 2021.

Polen Capital's Approach to Investing in the Current Landscape

While prospects of higher inflation and interest rates may have a negative connotation to some members of the investment community, it is essential to consider that these forces—when in check—aren't inherently good or bad for equity markets. In reality, the fact that the Fed and other central banks are thinking about lifting rates from current levels may be interpreted as a sign that the current economic expansion continues to gain traction.

In turn, an expanding economy tends to be fertile ground for growth stocks, enabling them to grow sales and earnings at solid rates. Therefore, we believe that sustained earnings growth may help offset any possible valuation compressions stemming from higher interest rates, as illustrated by **The Polen Heat Map**.

However, we also think that not all companies could be impacted equally. In our view, high-quality companies that possess durable economic moats tend to be better positioned to thrive even in the face of macroeconomic headwinds.

Not surprisingly, our adherence to our investment philosophy and five time-tested guardrails often leads us to resilient companies that our research has shown are capable of adapting to different environments and successfully generating sustainable, above-average earnings.

At Polen Capital, we're not just going after the fastest-growth companies. We also seek to own companies that we think have safety-like qualities.

Polen Capital's Guardrails:

1. Real organic revenue growth
2. Stable to improving profit margin
3. High and/or expanding returns (ROE & ROIC)
4. Abundant free cash flow to reinvest in the business
5. Strong balance sheets

Constructing Resilient Portfolios

Though higher inflation and the anticipation for rate hikes could spark volatility in the near term, we believe that long-term earnings growth—and not macroeconomic forces—will eventually determine the success or failure of a company. This focus illustrates that, in our view, the best way to hedge against inflation is by investing in competitively advantaged companies that can contribute continuous and robust earnings growth to the Portfolio under any economic environment.

With that being said, we also believe that low-quality growth companies (including those with high debt levels or unprofitable business models) could face more challenging outcomes. This includes firms that cannot self-fund their growth and generally depend on debt or equity markets to meet their capital needs.

In our opinion, **Microsoft** is a clear example of a business with durable competitive advantages, combining its intellectual property, high switching costs, and economies of scale to create a wide economic moat. In our view, one of the best defenses a company has against inflation is pricing power. In Microsoft's case, its subscription-based models and mission-critical solutions—notably, its Office Suite of products—enable it with the flexibility to raise prices and pass on higher costs to customers without experiencing a significant reduction in demand. In addition, high-quality businesses like Microsoft are generally less impacted by higher interest rates because they have strong balance sheets with no or low interest-bearing debt levels.

Looking at emerging markets, **MercadoLibre** has prospered even through multiple inflationary environments—annual inflation in Brazil averaged 8% between 2014 and 2016[3]—thanks in part to its scale, high customer engagement, and superior network effects. The most popular e-commerce provider in Latin America[4] has positioned itself as a regional leader and strengthened its platform by integrating fintech and logistics capabilities. Looking forward, we believe that MercadoLibre's strong cash flow generation will allow the business to advance its growth aspirations independent of the economic landscape.

We also believe that asset-light businesses, such as **Etsy**, are similarly well-positioned to navigate periods of rising costs as they benefit from lower capital needs. Etsy, a peer-to-peer marketplace that connects millions of global buyers and sellers of unique and creative goods, neither creates, owns, stores, nor ships the underlying products sold on its platform. This means that as Etsy has grown and continues to scale its business, it isn't burdened with the same capital-intensive investments that we see in areas like manufacturing.

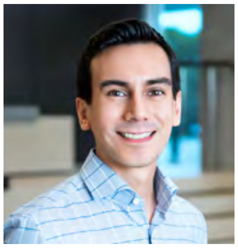
In the case of high-quality and innovative businesses such as Microsoft, MercadoLibre, and Etsy, we believe that developing disruptive technologies and opening new markets are some examples of factors that we view as more critical in determining the future long-term success of a business. This is why, at Polen Capital, we prefer aligning our clients with businesses that we believe have favorable long-term earnings power rather than attempting to predict the timing of macroeconomic movements or short-term trades.

> **Warren Buffett—widely considered one of the greatest investors of the 20th century—illustrated this concept in a 1977 article for Fortune magazine by stating that "if you feel you can dance in and out of securities in a way that defeats the inflation tax, I would like to be your broker—but not your partner."**

3 The World Bank data.

4 In terms of users.

Authors



Ernesto Angles
Investment Content Manager

Mr. Angles joined Polen Capital in 2021. Prior to joining Polen Capital, Mr. Angles was the Director and Head of Investment Communications at First Republic Private Wealth Management in San Francisco, California. At First Republic, Mr. Angles was responsible for performing investment research and producing thought capital focusing on macroeconomics and investment strategy across various asset classes. Mr. Angles received a B.B.A. in Finance from Florida International University.

Stephen Atkins, CFA
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Mr. Atkins joined Polen Capital in 2012. Prior to joining Polen Capital, Mr. Atkins spent 12 years as a portfolio manager at Northern Trust Investments, including eight years as a mutual fund co-manager. Before joining Northern Trust, Mr. Atkins spent two years as a portfolio manager at Carl Domino Associates, LP. Mr. Atkins received his B.S. in Business Administration from Georgetown University and a General Course degree from the London School of Economics. Mr. Atkins is a CFA® charterholder and a member of the CFA Institute and the CFA Society of South Florida.

Going Beyond with Polen Capital

Polen Capital is a team of experienced investment industry professionals who share an unwavering commitment to our clients, investors, community, and each other. We have been dedicated to serving investors by providing concentrated portfolios of the highest-quality companies for more than three decades. At Polen Capital, we have built a culture of results, and in this, an inherent belief in going beyond what's expected for the people and communities we serve.

We believe that an important part of growing our clients' assets also includes preserving it. To ensure this, we adhere to a time-tested process of researching and analyzing the highest-quality companies around the globe—selecting only the best to build highly concentrated portfolios. Then, we invest for the long haul and with a business owner's mindset—giving these companies time to grow.

Connect with Us

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Past performance is not indicative of future results. There can be no assurances that any portfolio characteristics depicted herein shall be replicated in the future.

Past performance does not guarantee future results, and profitable results cannot be guaranteed. There can be no assurances that any portfolio characteristics depicted herein shall be replicated in the future. Returns are presented net of management fees and have been calculated after the deduction of all transaction costs and commissions and include the reinvestment of all income. Net of fee performance was calculated using actual management fees. Please reference the following GIPS report: Focus Growth.

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Chart Methodologies

Fig 2: Using the Polen Focus Growth Net Composite returns from 3/31/1989 to12/31/2021 and comparing it against the Seasonally Adjusted Consumer Price Index (CPI) from the U.S. Federal Reserve, we are not able to find a statistically significant relationship either to the positive or the negative between the two.

Fig 3: Using the Polen Focus Growth Net Composite returns from 3/31/1989 to 12/31/2021 and comparing it against the five-year constant maturity U.S. Treasury bill (with the five years representing an approximate holding period for the strategy), we find a Pearson correlation of almost exactly zero, and similarly, no statistically significant relationship.

Fig 4: Similarly, using the Polen Focus Growth Net Composite returns, we created a Box Plot to visually represent the historical range of outcomes of the Focus Growth Portfolio from 3/31/1989 to 12/31/2021.