



(PRICING) POWER TO THE PEOPLE: EQUITIES AS AN INFLATION HEDGE



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We think certain stocks have the potential to hedge inflation over the long term.

KEY TAKEAWAYS

The **Consumer Price Index** has recently spiked, reflecting the rapid economic rebound the U.S. has experienced so far this year. Here's how we're navigating this inflationary environment in our portfolios.

- We think the factors pushing prices up are transitory, but that doesn't mean we don't take a long-term view when dealing with inflation.
- We believe competitively well-positioned companies can offer attractive inflation protection, but not just any stock will do. We look for companies with **two distinct characteristics**.

1

Companies with pricing power.

2

Companies that avoid "overearning".

IS INFLATION HERE TO STAY?

The most frequent questions we get from clients today are about inflation—is it lasting or transitory, and how are we addressing it? We're seeing higher prices across the economy, so inflation concerns are legitimate.

The chart shows how the **Consumer Price Index (CPI)** has recently spiked, reflecting the rapid economic rebound. That's important because inflation erodes purchasing power and has the potential to harm financial returns across a range of asset classes.

The Federal Reserve argues that the surge in inflation is temporary, and that slack in the labor market will limit upward pressure on wages. For our part, we believe that the resolution of temporary supply disruptions and transportation backlogs as the economy recovers will relieve the short-term pressure on inflation.

Longer term, productivity gains offer the best opportunity to offset the effects of inflation. Examples of these changes include the broad adoption of automation; digital transformation in a range of sectors and industries; and democratization of technology through the internet.

Inflation Over Time

Percent Change
in CPI



The Consumer Price Index is a measure of the average change over time in the prices paid by urban consumers for a representative basket of consumer goods and services. The CPI measures inflation as experienced by consumers in their day-to-day living expenses.

Data from 8/31/1971-8/31/2021. Source: Bureau of Labor Statistics. CPI is seasonally adjusted.

TWO KEYS TO FIND INFLATION WINNERS

1. Finding Companies with Pricing Power

Despite our belief that higher inflation is temporary, we're taking the current price pressures we see seriously. Equities, in general, can be susceptible to high and/or rapidly rising inflation, but the calculus is different for companies with the capacity to raise prices and make them stick.

Therefore, in every conversation we have with corporate management teams, we ask how well the company is positioned for inflation and whether it can defend its profit margins and raise prices if necessary.

Furthermore, we recently reviewed our portfolio holdings to determine which companies we believe would be able to pass through higher input costs (e.g., material, labor costs) while maintaining their profit margins. Our analysis found that approximately 70% or more of holdings across our large-cap growth portfolios would, at a minimum, be able to maintain their profit margins as inflation rises.

2. Avoiding "Overearning" Companies

We invest in companies producing sustainable corporate earnings growth over time powered by enduring competitive advantages and strong management teams. One dimension of quality corporate management is having the foresight to evaluate the lifetime value of the company's customers versus short-term profit. Quality management teams frequently avoid "overearning." Said differently, these companies are "undercharging" for their products. That is, they provide more value than they necessarily charge for in the short term.

We believe that means these companies have room to raise prices if necessary. Consider two prominent examples: Costco's management team has so far resisted the short-term profit temptation when it comes to setting annual membership fees. Similarly, Amazon Prime is another example of a company delivering value in excess of the fee charged for that service.

PLAYING THE LONG GAME

Just as we think it pays to take a long-term view of companies we invest in, **we believe investors benefit from taking a long-term view on inflation.**

Given the uncertainty about inflation, the pandemic and monetary and fiscal policy, we think it's likely markets will be volatile for the foreseeable future. In this environment we believe high-quality companies that can pass along higher costs to their customers should outperform companies in weaker competitive positions that must absorb higher costs.

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