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Inflation repellent review

You could say that the signs of inflation are everywhere except on a Bloomberg terminal. Since the close of 2020, the price of gold has fallen by 4.5% while the U.S. Dollar Index has rallied by 6.5%. At this very moment, the average junk bond is priced to deliver a real yield of negative 2.4%.

Now in progress is a look back at the inflation-sensitive securities that have featured in these pages since before the CPI took flight in 2021. A pair of interest-rate hedges and an inflation-themed ETF top the agenda. As we remain concerned about the incredible shrinking dollar, so we remain committed to our picks to protect against it.

The now-notorious CPI reading for December—up 7% from the year earlier, the highest leap in 39 years—may, in fact, flatter the true price picture, given the computational approach of the Bureau of Labor Statistics. The heavily weighted cost of shelter, as every school child used to know when class was in session, is derived from "rent of primary residence" (a 7.3% index weighting) and "owners' equivalent rent" (a 23.5% weighting). In December, the BLS reported, the duo rose by a weighted average of 3.7% from a year earlier. Compare and contrast the 2022 new year's edition of the Apartment List National Rent Report, which calculates a 17.8% jump in the median cost of renting an apartment in calendar 2021.

Thus, the question before the house: How to protect your portfolio from inflation when Mr. Market, or at least the fixed-income and monetary portion of that gentleman's brain, is almost prepared to deny its existence?

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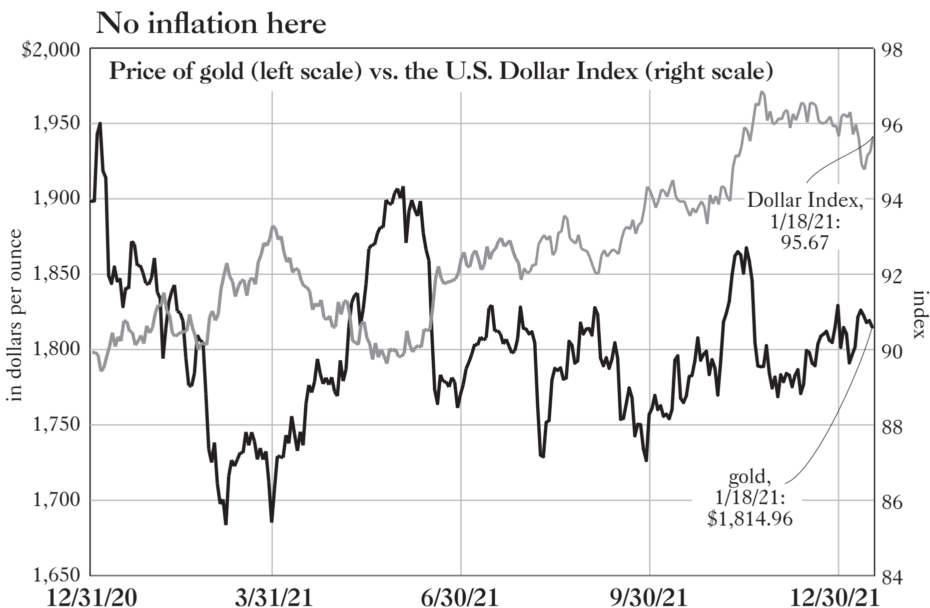
Since its Jan. 12, 2021 debut, the Horizon Kinetics Inflation Beneficiaries ETF (INFL on the NYSE Arca) has generated a 22.8% return, including reinvested dividends. Nothing wrong with that, except for the dispiriting fact that it just about matches the S&P 500.

Hard-asset, capital-lite, high-margin, pricing-power-endowed businesses are the kind that the Horizon Kinetics portfolio managers aim to buy (*Grant's*, Sept. 17, 2021). "We think this portfolio, even if we don't get a meaningful increase in inflation, will do fine over a normal business cycle," managing director Andrew Parker tells colleague Evan Lorenz. "Our view is this is more than a hedge against inflation. This will do well in an inflationary environment and a non-inflationary environment. This isn't going to hurt you if we don't get inflation."

Energy, real estate and agriculture have delivered INFL's signal successes. Energy royalty companies including Permian Basin Royalty Trust, Freehold Royalties Ltd. and Viper Energy Partners, L.P. have rallied between 80% and 281% since the INFL launch. "The energy exposure benefited twofold," adds Parker's colleague, James Davolos. "One, rising



source: The Bloomberg

oil and gas prices, but, also, the level of inexpensiveness was profound: You were buying some of these companies, even using far lower energy prices, at forward yields of 12%–15%."

Real estate broker CBRE Group, Inc. and food processor and commodities trader Archer-Daniels-Midland Co., likewise fit the fund's favored capital-lite specifications. ADM, says Davolos, is "effectively the toll booth on procuring, milling or crushing the grains of the world and seed oils into finished starches, sweeteners and olefins. In a rising tide, they will generally earn a fixed spread if not a higher spread on a higher price level of food."

Gold is INFL's problem child, as it is ours, with royalty-streaming companies Franco-Nevada Corp., Wheaton Precious Metals Corp. and Osisko Gold Royalties Ltd. detracting heavily from performance. "If you look at what's happening from physical owners, whether that is central banks, or individuals in non-OECD countries, I think there is a growing and strong demand for precious metals," says Davolos. "If the dollar continues trending the way it is this year, I think that could be a huge catalyst to see precious metals finally come to fruition."

Gold, with millennia of monetary service under its belt, seems not to share the impatience of its performance-minded 21st-century fans, but whose fault is that?

The biggest risk to the Beneficiaries ETF, as far as we can see, is the limited number of businesses that meet the management's exacting standards. Overall, the portfolio commands a trailing price-earnings ratio of 21.4 times, not everyone's idea of a bargain, even if it does represent a discount to the S&P 500's 25.1 times.

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It's a different performance story in the fixed-income department of our inflation-protection picks. The Quadratic Interest Rate Volatility and Inflation Hedge ETF (IVOL; see the issue of *Grant's* dated Feb. 19, 2021) has posted a 3.1% loss since year-end 2020, including reinvested dividends, while the Simplify Interest Rate Hedge ETF (PFIX; it, like IVOL, trades on the NYSE Arca) has generated a 18.1% loss since its May 11, 2021 launch (*Grant's*, May 14, 2021).

While the duo pursue very different strategies, each has been dragged down by the tiny yields that still attach to longer-dated Treasurys, inflation or no. The Quadratic fund owns a mix of Treasury Inflation-Protected Securities (TIPS; 85% of the portfolio) and over-the-counter options that stand to profit from wider-term premia—the greater the spread between short yields and long, the better for the investors.

Unfortunately, the difference between 10-year and 2-year Treasurys has narrowed to 0.8% from the 1.6% quoted on March 31, 2021. The fund's OTC options track the general movement in cash bonds and, as Nancy Davis, IVOL's portfolio manager and founder, observes, stand to catch a bid when and if the bond market jumps on the inflation-expectations bandwagon. For now, in bondland, "transitory" is still the rallying cry.

PFIX, in contrast, holds a mix of Treasury securities maturing on April 30, 2026 and 6-year-forward, 20-year payer swaptions with strike prices between 4% and 4.25%. The polysyllabic "payer swaption" is essentially a put on the 20-year Treasury with strikes between 4% and 4.25%. Since the ETF launched last spring, the 20-year yield has remained stuck at 2.2%. When PFIX completed its listing, the fund allocated half its assets to 5-year Treasurys and half to options. Owing to the drop in the value of the options portfolio, the Treasury position now sums to 60.6% of the $40.02 NAV per share.

While the bond market, either in its foresight or fat complacency (time will tell which), has deflated both ETFs, the two present dramatically different payout profiles. As noted, TIPS compose 85% of the Quadratic fund's assets, and, as the inflation-linked securities are in hot demand, the yield on the 10-year TIPS stands, or rather slumps, at negative 0.6%—thus, TIPS alone are destined slightly to underperform the rise in reported inflation.

Longer-term bonds typically offer a higher yield than short-term notes because investors usually price more uncertainty into more-distant cash flows. Thus, advises Davis in her fourth-quarter missive to shareholders, the ETF "captures inflation expectations.... Our options portfolio has the potential to generate asymmetrically positive returns if/when the curve steepens."

Despite a disappointing 2021, IVOL has generated a 5.2% annualized return since its May 14, 2019 launch, outpacing the 3.6% annualized rise in the CPI over the same period. One may think of the ETF as a cash-management tool, although, to be sure, a cash management tool not under the protection of the Federal Deposit Insurance Corp. Then, again, the FDIC provides no armor against the depredations of other branches of the U.S. government. According to BankRate.com, the average bank savings account yields just 0.06%.

The Simplify fund is a straight-up bet on, or, better, hedge against, higher rates. Think of it as fire insurance, Harley Bassman, progenitor of PFIX, counsels. Would you, the policy holder, really be unhappy if your house didn't go up in smoke?

If, come 2028, the 20-year Treasury yields more than 4.25%, the fund's options would be in the money. If the yield were less than 4%, the options would expire worthless, leaving shareholders with the value of the maturing Treasury securities, i.e., $24.27.

As to how to size one's exposure, Bassman offered this advice at the latest *Grant's* conference (see the issue dated Oct. 29, 2021): "If you've got a million dollars of interest rate risk, you buy $50,000 of this product—not shares, the product."

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To view standardized returns for INFL click here. Click here to view holdings.

Investments involve risk including the possible loss of Principal. The Fund is actively-managed and relies on the Adviser to implement investment strategies for the Fund to meet its investment objective. The Adviser's evaluations and assumptions regarding investments may be subject to the risks associated with changes in interest rates, inflation, and market conditions. These factors could have a negative impact on the Fund and it could decline in value.

(Price-to-earnings ratio is a measure of a company's share price to the company's earnings per share. The ratio is used for valuing companies and to find out whether they are overvalued or undervalued.)