HORIZON KINETICS

Industry Thoughts

ODDITIES OF INDEXATION: INFLATION HEDGES THAT WON'T WORK
(AND SOME THAT WILL)

Problematic Inflation Hedge Vehicles

Fidelity recently launched the Fidelity Stocks for Inflation ETF (FCPI). It has $2.6 million of AUM. If you read the last sentence, you must read this one as well: it has zero exposure to precious metals. There are many possible approaches to inflation protection. Among ETFs, the most popular are bond funds that own inflation-protected debt, such as the iShares TIPS Bond ETF (TIP). The problem with bonds tied to the consumer price index is that one can argue that the Consumer Price Index does not properly measure inflation. In any case, the TIPS Bond ETF is very popular, with $20.6 billion in assets under management.

The Invesco Senior Loan ETF (BKLN) is a reasonably popular alternative, with about $5.7 billion of AUM. The basic idea is that the portfolio is comprised of senior loans with adjustable coupons. If interest rates rise due to inflation, the interest rate charged on the loans will also rise and, hence, the loans will be protected from the convexity/price sensitivity problems that are ordinarily attached to fixed income instruments in rising interest rate environments.

A significant hurdle, though, is that the companies with good balance sheets in a low-interest rate environment can obtain loans without agreeing to adjustable interest rates, so the companies that do (or must) agree to adjustable rates generally have low credit ratings. The Invesco Senior Loan ETF (BKLN) has the following Moody's credit profile.

Table 4: BULN Credit Profile (Moody's)

	Credit Rating
Baa	8.00%
Ba	34.00%
B	56.00%
Caa	1.00%
Ca	0.00%
Not Rated	1.00%

Source: Invesco

The danger is that higher interest rates come during a credit crisis rather than through inflation. In principle, inflation would make it easy for those issuers to repay the debt with inflated dollars, but with low interest rates, it is easy for a rate increase to far exceed the rate of inflation.

Consider that the Invesco Senior Loan ETF has a 30-day SEC yield 4.37%. The Commerce Department declares that the U.S. inflation rate is currently about 2%. If the inflation rate were, rather, 4%, it would mean that prices are rising at 4% per annum instead of 2%. If that were the case, it would not be surprising that the yield of this fund would be adjusted upwards to 6.37% instead of 4.37%. However, the comparison between the two higher rate possibilities leads to bizarre conclusions.

The higher inflation rate simply means that prices would rise by 4% per year instead of 2%. *Yet, if the interest rate on adjustable rate loans were to rise to 6.37% instead of 4.37%, that would mean that the companies in the fund would pay 45.8% more interest expense*: 6.37 (the higher interest rate) divided by 4.37 (the lower interest rate) equals 1.458%, or 45.8% more.

The *inflation rate* is a rate-of-change of price. The *interest rate* is an absolute rate of payment. In the typical leveraged company, the bill for interest payments should rise much faster than revenues and expenses influenced by inflation. The pressures of higher interest payments might place existential pressures upon firms with low credit ratings.

Unfortunately, although the default rate is being suppressed for now, it will eventually rebound. And when it does, it will not be possible for the B-level firms to obtain loans at low interest rates, since it will then become obvious that the current rate of compensation their debt pays is quite inadequate. The B credits will face drastically rising interest rates in a weak economy.

Oddities With Gold ETFs

Gold also presents a logical inconsistency. The two dominant gold ETFs, during the first nine months of 2019, have gathered reasonable inflows: $3.73 billion of additional funds for the iShares Gold Trust (IAU), and $5.25 billion for the SPDR Gold Trust (GLD). This suggests investors are inclined to believe that gold prices will increase.

However, if that were to happen, it is likely that goldmining shares would increase even more, because of the mining companies' operational leverage to gold prices. Nevertheless, the two primary gold mining ETFs experienced fund *outflows* in the same time period: VanEck Vectors Gold Miners ETF (GDX) had $1.117 billion of fund outflow, while the Van Eck Vectors Junior Gold Miners (GDXJ) had $419.9 of fund outflow.

For ETF investors, this is only logical, for they have an oddly different view of risk, one defined by price volatility as opposed to business characteristics or valuation. It may well be that ETF investors cannot or will not accept the 24%-plus standard deviation of a gold miners portfolio. But, a gold ETF might have only a 10% standard deviation. Consequently, there is still capital outflow from gold miners, despite an increase in the gold price.

The major gold mining companies have stopped replacing their reserves as they produce ore. The junior gold miners do not have and cannot raise the capital required to develop new reserves. As a consequence, gold and silver reserves worldwide continue to decline. Various central banks are actually buying gold. Ultimately, the market will correct the imbalance and the price of gold will rise. The rewarding rate of return, however, will be earned by the relatively small number of investors who are willing to accept the higher volatility of gold mining assets.

In any event, the question of ETF oddities is really a question of causation. Do the ETF rules and structures merely reflect the market preferences, such that they merely reflect the valuations as they naturally exist? Or do the ETFs and the flow-of-funds currents they engender actually create valuation phenomena? If one believes that the former assertion is true, one effectively does not believe in the law of supply and demand, since indexation is now by far the dominant investment strategy.

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