Inflation Investing the George Nicholson Way

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OKI Tri-State Chapter of BetterInvesting

Good afternoon, everyone. Thank you again for being here. We think our theme and topic are very appropriate in our times right now and we hope you find this class interesting and educational.

With that, let me introduce Craig Jacobsen, co-writer, and co-presenter of this set of slides we are about to share with you.

Good morning from sunny Arizona. Yes, its still morning here. Going to 98 degrees today. Although I live in Arizona, I am grateful to still be a member of the OKI chapter. I hope YOU find today's presentation interesting and useful.

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This is our disclaimer slide. This presentation is for educational purposes only.

If we mention a stock, it is also for educational purposes and if we mention another company not endorsed by BetterInvesting, it was only for the educational value it may support in our investing endeavors.

With that, I want to turn the mic over to Craig who will start us off this morning.

Craig, take it away.

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From little acorns grow:
Main Street Millionaires

This series of slides was created based on Chapter Six “**Inflationary Lessons**” of the book “Main Street Millionaires” written by Mike Wendland

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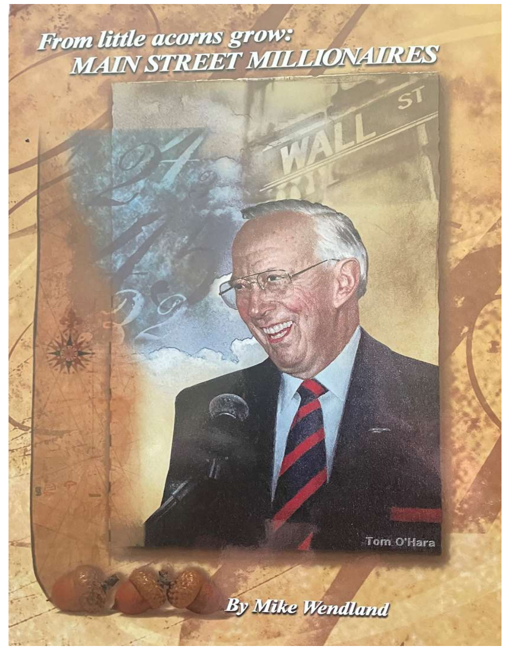
The book was a gift to the attendees of BINC 2022 in Dallas, Texas.

It is available at BetterInvesting for only $4.95 +shipping at [Home/Store/Newsletters & Books]



George Nicholson was the founder of National Association of Investors Corporation (NAIC), forerunner of BetterInvesting. He was the creator of its principles and the Stock Selection Guide. He was a Harvard-educated securities analyst.

George Nicholson developed these lessons years ago. Like many things in investing, they are still valuable today. Investing can be difficult in today’s market due to the uncertain economic picture and geopolitical situations. This presentation is meant to be thought provoking and another tool in your investing toolbox.

Other chapters of this book document the early days of investment clubs and the formation of the National Association of Investors Corporation. We have several copies available for door prizes. If you are not one of the lucky winnrs, you can purchase a copy from BetterInvesting for a very reasonable price. There is a link in the slide deck handout.

As well as containing the lessons we will discuss, the book is an interesting read. As Marty said, it presents an interesting picture of NAIC’s start and the start of the Mutual Investment Club and the stories behind some of the investors in that club. It talks about some of the good times and some of the tough times some of the club members had in being to meet their monthly contribution. Nicholson encouraged them to contribute what they could; even $1; $12 today.

What is 'Inflation"? As defined by Investopedia

- Inflation refers to the general trend of an increase in prices over a certain period of time.
- As inflation occurs, purchasing power decreases, meaning that it costs more to buy the same good or service, or that the same amount of money buys fewer goods and services.
- For investors, it is important that the returns on their investments are at least grow the same rate as inflation.

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In other words, as Jackie put it, inflation is a rise in prices, which results in the decline of purchasing power over time.
What cost $1 yesterday, now costs $1.10, or more.
If your investments are earning less than the rate of inflation, they are losing money, in real terms,—even if gains are shown.
Remember, the inflation numbers we see quoted in the news are usually year over year or quarter over quarter. But those numbers are on top of the inflation from last year. So 8% inflation last year plus 6% inflation this year is really a rate of about 14%!

Twelve Guiding Principals

- George, "*being a student of economics and inflationary forces decided that he needed to spell out inflationary lessons as both an encouragement to investors going through the dark days of the seventies but also as a guide to **ALL** investors.*
- *Thus, he prepared these "twelve guiding lessons," that during inflationary times, would stand the test of time"*

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We will discuss all 12 of George's lessons starting with the next slide.

Lesson #1 Don't Let Your Money be Idle

- ***"While the climate may appear bad for stocks, do not let your money be idle. Search out and hold the strongest companies."***

- Don't be complacent
- Don't let your cash lie inactive
- Keep on investing in common stocks

How do you win the battle of investing during inflation? As General Douglas MacArthur said when asked about the fine points of strategy in fighting a battle, "you fight like the dickens until the battle is won." Something tells me Mac Arthur used a little different language, however.

Don't be complacent and don't let your cash lie inactive.

Keep on investing, cautiously, in common stocks until the battle is won.

In other words, "keep on keeping on."

There is always light, perhaps a bright one, at the end of the tunnel.

Lesson # 2 Survivability

- *"Survivability is an important factor during inflation. Pick companies with strong survivability characteristics."*
- A good company with good management demonstrates an ability to responsibly handle its finances, has stable, effective business principles, and a high probability of surviving

Nicholson says the absolute key to inflation investing is survival of the investment.
Avoid companies with a low probability of surviving. Hold the strongest companies. To have a high probability of surviving, a company must have strong management, demonstrate responsibility in handling its finances and have stable, effective business principles. To help find a company strong on management, see the "Evaluate Management" section of the Stock Selection Guide.

% Pre-Tax Profit on Sales
% Return on Equity
% Debt to Capital

And don't forget the "compare peer's" button to focus on the company's record verses the industry and peer companies.
If you have access to a company's performance in the last period of high inflation, so much the better.
I would also add that a company's ability to raise prices is also a big plus for survivability. Think Proctor & Gamble. The company has raised prices notably—and those increases seem to be sticking.

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Lesson # 3 Types of Inflation

- ***"Recognize the type of inflation that is occurring and choose companies capable of meeting it problems."***

- Among those types of inflation George wanted investors to understand were.
  - Printing Press inflation
  - Cost-push inflation
  - Government generated inflation

Here you can see the 3 types of inflation George wanted investors to understand.
It can be difficult to identify the type of inflation if you are not an economist. And even then, economists often disagree.
I, for one, am surely not an economist!

Lesson #3 – Types of Inflation, cont.

- **Printing Press Inflation**
  - When the government prints money, it devalues its worth.
- **Cost-push Inflation**
  - Excessive price increases
    - Such as in oil or high demand products or commodities.
- **Government generated inflation**
  - Continuous government effort to control the economy with deficit spending and money supply stimulation.

George says being able to identify the type and cause of inflation is critical, and identifying the type of inflation can be difficult.

Printing press inflation. The government floods the system with money. Sound familiar?

Cost-push inflation. Remember when OPEC quadrupled the price of oil?? It caused many different products to increase in price.

Government generated inflation. Continuous government effort to control the economy with deficit spending and money supply stimulation
Does government-generated inflation sound familiar? How about printing press inflation?
Can we safely state the current inflation is both a Printing Press and Government Generated inflation?

Lesson #4 Management is Important

- ***"Management, as always, is vitally important. Make sure management passes all of the tests in the Stock Selection Guide with top grades."***
  - Chief executive officers should have near fortune-telling abilities.
  - They must be good managers in ordinary times but have the skills and imagination to bring the corporation through the extreme turbulence of inflation .
    - Tight control of inventories and receivables is extremely important.
    - Companies operating with a 'business as usual' attitude will not survive.
    - Expansion is not a good process in extreme inflation.

CCan you name some CEOs that fit this description? How about Warren Buffett, J.P. Morgan CEO Jamie Dimon, Microsoft CEO Satya Nadella?? Boeing CEO?? Not so much. Remember, these companies are not recommendations. They are examples.
Tight control of inventories and receivables is especially important in retail companies. Actually, all the time; not just in inflationary times.
Some other favorable characteristics:
  Debt control
  Ability to avoid dilution by not having to sell stock or sell a division for the company to survive.
  Expansion is never advised in extreme inflation. It might be OK if the buying company has lots of cash and strong cash flows and deploys those fund judicially.
Don't buy stock in companies operating under "business as usual" rules. Revenue and earnings must grow at least at the rate of inflation in their industry.

Lesson #5 Honest Accounting

- ***"Honest accounting is very important in inflationary periods. Be sure profits are coming from the operation of the business, not from price or inventory inflation."***

- Compare prior earnings reports.

Slide 11 Lesson #5 Honest Accounting

Be sure profits are coming from the operation of the business, not from product price or inventory inflation.

Are sales and earnings growing faster than inflation in the respective economic sector?

Take Kroger, for example. We all know food inflation was and is high and it affects all of us. When Kroger reports quarterly results, I always wonder how much growth comes from inflation. I do not follow Kroger. To the owners of Kroger stock in our audience today, there is a lesson for you here.

Nicholson really gets into deep stuff in this lesson about the over-statement of earnings against the under-statement of asset values.

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Lesson #6 Strong Companies Grow

- ***"During inflation strong companies survive and grow even faster by acquiring weak, poorly managed companies."***
- Companies that survived did so by reason of tangible assets, valuable trademarks, or high proprietary 'know-how' in manufacturing and distribution.
- And by creating a strategy for raising money.

Nicholson concluded inflation and expansion are much alike. Both need plenty of money to avoid insolvency.

The problem was how to survive without diluting stockholder's equity.

The financially and competitively strong companies survived best.

As inflation rages and abates, surviving companies "inherit" business from companies that fail or flounder.

Investors should take advantage of this "inheritance factor" in inflation investing.

Don't invest in companies that lack survival characteristics or which dilute stockholders' equity substantially.
Invest in companies with <u>strong management characteristics</u>.

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Lesson #7 Government's "Stop-Go" Movement

- ***"Where government is conducting an inflation control "stop-go" movement, recognize this as a time not of fear but a time for bargain hunting. Be sure you don't sell just as the shift to "go" is being made."***

  - Inflation fighting by the government is like slowing down an automobile on icy pavement.
    - Put on the brakes – Take off the brakes before skidding badly.
    - Repeat until inflation is under control.

Don't believe that stocks are a poor inflation hedge because stock prices are lower when inflation is highest.

The "stop" phase of inflation is a time for bargain hunting among companies with good survival characteristics.

Lesson #8 Utility Investing

- ***"Utilities are subject to "regulatory lag". Regulators often are late adjusting rates to inflation. This tends to make utilities excellent buys late in the inflation cycle."***

- Think Electricity for example.

Utilities are subject to regulatory lag, which is defined as the "**delay between the time of filing for a rate increase by a utility company and the time of granting a rate increase by the utility commission**".

Nicholson saw advantages in utility stocks. Electricity is essential and many power companies are high in quality and offer strong and high dividends. He went on to say "investing in regulatory lag" had the advantage of high quality and income with good probabilities of appreciation.

This lag varies by state; some are good with keeping up on increases; others are not.

Lesson #9 Inflation Lag

- *"Inflation lag also takes place in stock prices. Put this lag to work for you in finding bargains."*

- Cousin to "regulatory lag"
  - Fear
  - Confusion
  - Doubt or self-doubt
  - Don't miss the "go phase" of inflation.

Whereas utility regulators are prodded by necessity to make inflation adjustments, in a similar vein, other stocks are subject to "inflation lag." Inflation lag refers to the catch-up stock prices are subject to after an inflationary period.

Some or even many investors lack training in inflation investing. They are scared and confused and are hesitant to act to take advantage of 'inflation lag' in stock prices.

Often opportunities are **greatest** when investors are in doubt about depreciating money and investments. The investor may be influenced by bits of trivia, better known as noise, and not by the big picture.

When the 'go' phase of 'stop-go' inflation fighting gets underway, it is easier to see the big picture and investors come back into the market.

Don't miss these catch-up phases in stock prices.

However, these catch-up phases may have lag in them.

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Lesson #10 Investing Temptations

- *"During periods of high inflation there is a temptation to move into bonds paying ten percent or more. The most important task is always to protect principal. This means being at least seventy percent in stock."*
- Do bonds look good or even better than stocks right now?
- Stick to your knitting. Own <u>well-managed</u> growth companies.

Stick with Stocks, Nicholson said. His experience over the years that owning stocks of well-managed growing companies was always likely to beat the ten percent offered on bonds and preferred stocks.

Playing interest rate roulette with the Federal Reserve was seldom profitable. Everyone, please take note of the "blue text italicized quotes" from Mr. Nicholson himself. I am going to read it for emphasis.

Well, maybe not ten percent, but five percent feels quite good right now. This is not to say invest 100% in stocks. Some bonds belong in a well-balanced portfolio.
Bonds may look good in times of high inflation, but one must keep an eye on the longer term, when inflation abates.
If more than a balancing portion of investments is transferred into bonds, when will one identify a good time to get back into stocks?
Owning stocks of well managed growth companies will likely outperform bonds in the intermediate and long terms.

Lesson #11 Comparison as a Selection Tool

- ***"Comparison is a stock selection method that always works. In inflation times stick with basic comparisons and don't venture into the unknown."***

- Use Stock Selection Guide tools.
  - Stock Comparison Guide
  - "Compare Peers" button on the Stock Selection Guide
- In the book, there are many types of comparisons mentioned.
  - Industries, stocks and bonds, sales and/or earnings growth, pre-tax profit margins, earnings on invested capital and on and on.
  - Remember Kavula Rule #1 ???

For valid comparison, the investor must have objective facts, not hunches, theories or opinions. The SSG tools of the Stock Comparison Guide and "Compare Peers" button give us that objective comparison.
The book goes into more possible comparison than just those of the Stock Selection Guide
Do your homework!!
Kavula Rule?? Does anyone know what that is? "Don't study a stock in isolation."

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Lesson #12 The Prudent Man Rule

"Remember the investment rule stated by Justice Putnam in 1830. "*Do what you will, the capital is at risk. Observe how men of prudence, discretion and intelligence manage their own affairs in regard to the permanent disposition of their funds, considering the possible income as well as the probable safety of capital to be invested."*

- Look ahead to future purchasing power.
- Avoid speculation.
- Nicholson wrote: *"Don't fail to use prudence, discretion and intelligence during inflation, always with the longer term in mind."*

Who is Justice Putnam?? '

I found Justice Samuel Putnam, 1768-1853 was the Massachusetts Supreme Court Justice. He authored the Prudent Man Rule stated on this slide.

Look ahead to future purchasing power as inflation abates. Look to stocks of well-managed growth companies over bonds.

Avoid short-term speculation. Use especially good judgment. Always, look to the future.

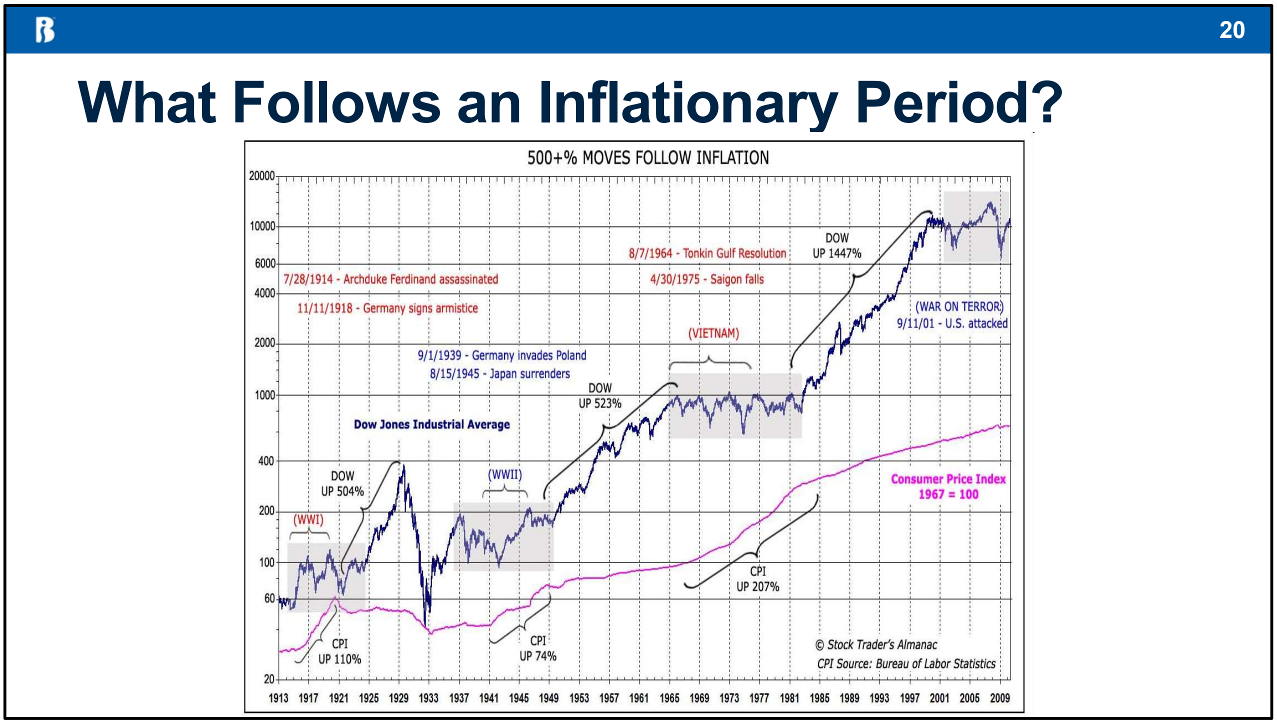
What Phase Are We in Now?

- The “stop” phase?
- The “go” phase?
- What well managed growth companies do you have in mind?
- Additional information on today’s subject can be found on page 42 in the May 2023 issue of BetterInvesting magazine.
- *“Safety First. Your Portfolio Needs Protection in Tough Times”* by Jordan Chussler.

Here are a couple questions for you to ponder.
What phase are we now in? Stop? Go? Or somewhere in between?
How long do you think high inflation will last?
Have you a company or companies in mind that would be a great company to own now?Stay in your seats. The next session will be Ken and Mark’s famous category with a twist: “Let’s Talk “Inflation” Stocks.”

Also, as noted at the bottom of the slide, page 42 of the May 2023 BetterInvesting magazine is a source of additional information on today’s subject.

That is a very good article. Although not specifically addressing inflation it makes some of the points we have presented here today.



In closing, Mark Robertson shared this slide that I thought was a great finishing touch on today's theme. As inflation abates, stock prices are likely to start increasing. Thank You, Mark

Notice the grey areas and how the Dow price bars act when inflation ended.

After the troubling times in the early 19th century, the Dow increased 504% starting in 1921. How many remember that? 😌 I did not see any hands go up. 😌

Following the second period, mostly the WWII era, the Dow increased 523%. Probably a few of us were around at that time but probably were not investing in stocks: maybe it was school or even girl friends.

After 1961 through the mid-eighties, the Dow soared 1447%. I think most of us have some recollection of this era.

So, what can we expect next as we hopefully are reaching a period of stableness? God only knows. But let's invest wisely and follow the good advice that Mr. Nicholson left with us.

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StockUp: What's Inflation Got to Do with Stock Investing? May 11th 8:30 – 9:45 PM

- Stock Markets move based on business conditions, both present and expected.
- For the first time in many years, higher inflation has entered the picture.
- Join Cy Lynch as we discuss the ways that current inflation rates and inflationary expectations impact stock prices.
- Then against this foundation, we'll consider whether we should adjust our Stock Selection Guide judgments and portfolio management tactics to consider inflation and , if so, how.

In ending, I'd be remiss if I did not mention the next StockUp webinar featuring Cy Lynch which will continue with Inflation as the theme.

Don't miss this.

Question and Comments

Inflation Investing the George Nicholson Way

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OKI Tri-State Chapter

Marty, Thank you everyone for your attention. I want to mention that a paper is being passed around for you to sign if you wish a copy of this slide deck. It will include the notes. Mark and Ken, are you willing to share your decks with me so I can include them to.

Time for Questions and comments.