

>: 5 Ways to Check Your Portfolio For Financial "Cancer"

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WARREN BUFFETT WAS RIGHT WHEN HE SAID THAT INFLATION WAS LIKE CANCER -- IT MAY GO INTO REMISSION SOMETIMES, BUT IT NEVER TRULY GOES AWAY.

Those words have taken on much greater meaning this past year as inflation has started to seep through much of our economy.

As consumers, it's been easy to see how devastating inflation can be to our own wallets. From the gas pump to the airport to the grocery store, all of us know that our dollars don't get us what they used to. Gas prices are an easy example of how much our dollar has declined in value: two years ago \$1 bought us 1/2 gallon of gas -- we're lucky now if it buys us a quarter gallon.

But how exactly does inflation impact corporate America? And what does that mean for the stock market? The bond market? Or our individual portfolios?

Today I'd like to examine that question, because it occurred to me recently that many investors have never really had to plan for inflation in their lives before.

Sure, we've heard of inflation before. And intellectually the concept isn't too hard to understand.

But unless you were old enough to be an active investor in the 1970's you probably haven't seen this type of financial destruction up close and personal quite yet.

Indeed, to those of us who have "come of age" as investors during the last 20 years, the inflation monster we've seen lately is a relatively new phenomenon.

Paul Volker's crusade against inflation was largely over by the late 80's, and in both the 1990's and the 2000's inflation was in remission due to incredible increases in both computerized productivity (90's) and cheap overseas labor (00's).

In short, I think it's fair to say that when the history books are written, the low inflation growth that marked the period from 1985 to 2005 will be looked back upon as a great time for the American investor.

The bad news is it's likely to change. The good news is that there's plenty you can do to both protect yourself (and dare I say) profit from it -- as long as you know where to look.

Below is a quick primer on how to quickly identify whether the financial equivalent of cancer is lurking in your portfolio, so both you (and/or your under-40 financial adviser) will know where to start.

Why is this so important for us as investors?

Because when producers have to pay more to make the stuff they sell us, they pass that price increase onto consumers -- and that could lead to inflation.

And as I mentioned before, ask any investor who lived through the 1970's and they will tell you inflation is one of the biggest destroyers of wealth!

Let me explain, using Hershey Foods (SYM: HSY) as an example.

Let's say that last year you bought a Hershey Bar for \$1.

But now, in 2008, the price of the same bar has risen to \$1.05.

That's an increase of 5 percent.

Now that wouldn't be so bad if your salary increased by 5 percent as well.

But wages generally increase at 2.5 percent per year.

So what does that mean to you?

It means that you are actually LOSING 2.5 cents per year for every \$1 you have.

That's a net loss of 2.5 percent.

before) aren't the only examples.

Another good one is a company like Comcast Corp. (NNM: CMCSK). Comcast is the largest cable company in the country.

And Comcast, as anyone who gets a bill from them every year is well aware, increases your prices each and every year no matter what! To make matters worse (or better if you own the stock) they increase your prices more than the inflation rate.

But that's only half the reason Comcast is a good example. The other half leads me right into rule #2:

Rule #2: Avoid companies that have to spend a lot of money in plants and equipment to manufacture their products.

Let me offer an example. Most companies, like chip maker Intel Corp., introduce newer and faster chips to consumers seemingly every year. To introduce these chips, Intel is constantly building new plants to manufacture them.

In an inflationary environment, the amount that it costs to build new plants will rise each year. In other words, if Intel spends \$1 billion on a plant in 2008, it may cost \$1.05 billion in 2009.

That's a HUGE drag on the value of the existing plants Intel has, and makes the future plants it's going to build much more expensive.

What if Intel couldn't pass that increase in cost to its customers? The short answer is that while Intel's expenses rose, its profits would decline rapidly, sending the stock lower.

Before you know it Intel would start to look more like the "Big" 3 than a rapid-fire technology company.

In contrast, Comcast is in a very rare position indeed. It already upgraded its cable networks so, unlike Intel, it doesn't need to build new plants each year.

The Bottom Line: Own companies whose heavy expenses for plant and equipment are already low or are actually declining, and who are able to pass higher prices along to customers!

Rule #3: Own companies with strong consumer brand names.

When consumers are wading through a rough economy with limited funds, brand names -- especially ones selling inexpensive products like Hershey -- are the first places they look.

Rule #4: Own companies with high profit margins.

High profit margins (and conversely, a low cost structure) are so important, because it proves (beyond a reasonable doubt) that management understands the optimal cost structure of the business and doesn't spend one penny more than they need to.

But a deeper examination reveals something much, much more important: how a cost structure affects the bottom line during a rough economic environment.

Let's say Company A has the highest profit margins of its industry group, at 15%. They also have no debt.

In comparison, Company B has profit margins of 6% and debt that equals 40 percent of their capital structure.

Now, looking at a worst-case scenario, let's assume that the U.S. economy hits a terrible recession and both companies have a lot of trouble selling candles.

But Company A, which has profit margins of 15%, decides to lower prices to match the demands of the marketplace. At these new lower prices Company A is still profitable, but its margins have shrunk to 5 percent.

In response, Company B decides that it must lower prices also so that it doesn't lose market share to Company A. But Company B has a little problem. If it lowers prices to match Company A, it will be losing money each time it sells its product.

That's when companies like Company A gain major market share while companies like Company B announce major restructurings.

The above example leads to Rule #4:

Rule # 5: Own companies with little or no debt.

To explain, let me continue with the Company A/ Company B example from above.

Remember, we're in a recession, and Company A has lowered prices so that it can sell more candles. Company B has followed suit, but because of

its already low profit margins, it now finds itself losing money on every candle it sells.

As Company B keeps losing money, it takes on a variety of ?restructuring? charges. Sooner or later, given its weak capital structure, Company B will have to borrow more money just to stay even with Company A.

If borrowing money during bad economic times isn't bad enough, what's worse is that Company B will be borrowing money to sell candles for less money than it costs to make them.

My goal in sharing these rules with you is to make sure you check your portfolio and make sure that you avoid one of the worst positions to be in when investing in a market like this: the dreaded position of owning a company which has a lot of debt (above 25 percent of its capital structure), no pricing power, and low profit margins.

Because if you do find yourself in that situation, you can bet your last dollar (and you probably will) that its stock will decline much more than companies without those characteristics.



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