Welcome to Money For the Rest of Us Plus. This is the premium podcast episode for Plus members, episode 334. I'm recording this Saturday morning, March 13th, 2021. In today's episode, we're going to take a look at a new inflation protection ETF. We have a question from a member on the role of inverse ETFs, and then we're going to take a look at earnings yields relative to bond yields, including a look at the excess CAPE yield, CAPE being the cyclically-adjusted price-to-earnings ratio.

There has been a lot of talk recently about the potential for inflation, particularly given that the economies are opening around the world, and the U.S. just passed a significant two trillion-dollar stimulus package. Will this lead to capacity constraints as pent-up demand to buy goods and services is released? We don't know, and there are a number of different ways to protect against inflation that we've discussed in numerous episodes on the podcast. There is an investment guide on the Money For the Rest of Us website, a complete guide to understanding and protecting against inflation.

Two Inflation Protection ETFs

Back in Plus episode 319, we discussed the Quadratic Interest Rate Volatility ETF (IVOL); that's now its own investment guide, and that's another ETF solution seeking to protect against inflation. But this week we're going to look at a new ETF that was just launched in January 2021—the Inflation Beneficiaries ETF (INFL). It's managed by Horizon Kinetics LLC; this is a firm that was established back in the mid-'90s. They are a fundamental value contrarian-oriented investment advisor. They have 4.8 billion dollars in assets under management, of which three billion is separately-managed accounts. So this has been primarily an institutional money manager, very experienced, with over 70 employees. Their key founders have over 30 years of investment experience.

I've found it intriguing that they actually started mining cryptocurrencies back in 2015. Their investment approach is to find unique, undiscovered, long-term drivers of value and price appreciation. They do some deep research; they're not focused on what they say is easily-quantifiable short-term attributes. They mention the risk of confirmation and availability biases, where investors tend to put more importance on information that's readily available, easily organized, and consistent with pre-conceived views. One of the ways they try to avoid that is they have their analysts write out detailed theses of their investment case.

Challenges of Using TIPs and Commodities and Inflation Hedges

This particular manager is worried about inflation, but they point out that inflation risk is not a straightforward problem to fix. Treasury inflation protection securities are one way to protect against inflation, but they're tied to consumer price indices, and the manager points out that within the CPI, that reference basket, there can be substitutions. Sometimes substituting lower-cost goods for more expensive goods. This is a topic we've discussed, inflation measured correctly or not. There's always judgments.

This Consumer Price Index is not strictly a measure of rising prices. It is a measure of the cost of living, which is different. If we were just looking at rising prices, we would always compare the same make-up of the reference basket. There would never be any substitutions. But consumers substitute things all the time, and the CPI seeks to capture that. But if we were just measuring price increases with the same goods over time and didn't adjust, let's say, for quality improvements, then inflation would be higher.

The other problem with TIPS is that yields are negative right now. If inflation picks up because the economy is expanding, then that can lead to higher real yields, which makes TIPS fall in price and thus less effective.

The manager points out that commodities have some challenges because most commodities are purchased through commodity futures. And because commodity future ETFs for example have to roll over their contract and purchase contracts that expire a month or two months from now, that can lead to a performance drag. There's an investment guide on the site titled "What is roll yield and how it impacts commodity and VIX ETF returns." Commodity futures have this element of a performance drag, which makes it difficult to be a pure inflation hedge.

Stocks as an Inflation Hedge

Horizon Kinetics' approach is to own stocks of companies that are profitable, well-managed, and don't need inflation to be successful, but that would benefit from inflation. And they list out some reasons we could get inflation. One is that no one's overly-worried about it right now, because we've had a long period of low inflation. Inflation is very much narrative-driven. If households and businesses believe inflation is picking up, they act differently, they hoard, they demand higher wages, and that can feed into a cycle of inflation.

We talk about inflation anchoring. If expectations are for low inflation that can lead to low inflation. And if expectations are for high inflation that can change behavior that actually leads to high inflation.

If we think about stocks and their performance during high inflation periods or low inflation periods—this is data from Ned Davis Research going back to 1947—when the year-to-year change in the Consumer Price Index is less than 1%, that's when the S&P 500 has done the best, up 17% over the next year. And that makes sense, because often when inflation is that low, it's coming out of a recession, and then that recovery boosts stock returns, as the stock market anticipates that.

The second-best period is when inflation has been between 1% and 4%. In that scenario, the S&P 500, a measure of U.S. large-company stocks, has gained 9.5%. We're worried about if inflation was between 4% and 9%. In that environment, the S&P has only gained 1.2%. So actually, within a short period of time has not outperformed inflation when it pops up and it's above average.

Over the long term, stocks have. It generates a positive real return. But strictly speaking, when inflation jumps to over 4%, stocks have only returned on average 1%. And when inflation has been above 9%, stocks have returned 0.7% over the next year.

Something else interesting in this particular chart is lower levels of inflation have typically corresponded with lower interest rates on long-term government bonds and higher price-to-earnings ratios. We're seeing that now, with low inflation, low-interest rates on bonds; the price-to-earnings ratio in stocks are high.

Royalty Trusts and Exchange Stocks as Inflation Hedges

What this particular ETF is doing then is trying to find areas of the stock market that will benefit from higher inflation. And I've found it interesting, the areas that they went to. They want companies with low capital requirements, but that have exposure to real assets, and that generate cash flow.

Their largest allocation in the ETF is concentrated, only about 33 to 35 holdings. But the biggest concentration is royalty trusts. Their two top holdings—Texas Pacific Land Corporation (it's about an 8% weight), and PrairieSky Royalty Ltd. (6% weight). Both of those companies own land, and they own mineral rights. And they receive income from the production of oil and natural gas. They don't own the wells. Oftentimes they'll provide capital to these oil companies in exchange for a share of the royalties. And then the energy companies use that capital in order to build wells. So it is an asset-light approach; these royalty trust companies is not something that we've spoken much about, but that's a big focus of this particular ETF.

They also own a number of stock exchanges. A stock exchange in Germany. They own an international exchange, they own ACX, the stock exchange in Australia. Their logic is as commodity prices go up, there's more trading potentially, and the stock exchanges benefit from that.

This ETF has a hundred million dollars in assets, brand new, just launched in January. The fee is 0.85%. But it's interesting to see how a manager that is seeing the potential for inflation is seeking to protect that. Royalty trusts is a component, owning stock exchanges, it owns exposure to Cohen & Steers, which is primarily a REIT manager; it actually owns some timber companies. But it is concentrated—35 stocks. So it is another way to potentially protect against inflation.

Inverse ETFs

We had a question from a member on inverse ETFs. He writes "Would you recommend them as non-correlated assets, in place of bonds, REITs, or gold?" Inverse ETFs move inverse to the stock market. It is typically done through a swap agreement. A swap is an agreement between two counterparties to exchange a series of payments. ETFs will enter into a swap with Morgan Stanley, Citibank, and they will receive the inverse of a particular benchmark, be it the S&P 500, Russell 2000. And in exchange, the ETF will payout some cashflow, typically a very short-term rate, let's say LIBOR.

And that's how they work. Except that when anything is shorted, these swaps would have to capture that. If you short a stock, which means you borrow the stock, the stock is sold in the market, the shorter still owes the dividend to whoever owns that stock. If you own the stock, you receive the dividend. If you short a stock, you owe the dividend, and so that ends up being a drag. And because of that, I don't see how owning an inverse ETF is necessarily a great substitute for owning bonds, which actually you receive income, or REITs, where you receive income.

With an inverse ETF, what you're doing is just protecting against the downside of the market. But if the market goes up, you lose money, and you owe the dividends. If we look at the returns of short ETFs—and we're not talking about ultra-short, so two or three times; this is just one-time short. So the ProShares Short S&P 500 ETF (SH) has an expense ratio of 0.9%. The 10-year annualized return is -14.6%. Compared with the iShares Core S&P 500 ETF, which has had a 14% annualized over ten years. So actually, pretty close; almost the exact opposite. For the 5-year, the short ETF, SH, returned -16% annualized, while IVV returned 16.5% annualized.

Things get a little more challenging for Russell 2000 shorts compared to going long the Russell 2000, because that index is more volatile, and these short ETF and the ultra-short ETFs are focusing on replicating the one-day performance, or in this case the inverse of the one-day performance of the Russell 2000. And because the Russell 2000 can be more volatile, the mathematics of return calculations can often lead to a shortfall.

In this case, the iShares Russell 2000 ETF (IWM) has returned 12.9% annualized over the past ten years, but the ProShares Short Russell 2000 ETF (RWM) has returned -16.1%. It's done worse than the inverse of the S&P, and I believe that's because of just the mathematics of calculation. If you lose a lot of money, it takes a higher return to recover that, and it can lead to a performance drag.

I'm trying to think of when one would want to use an inverse ETF. I guess if they had a short-term bearish view of the stock market. Perhaps there's a holding, a long-term ETF holding that they have, that has a large, embedded gain that they don't want to sell, they have to pay the capital gains tax—purchasing an inverse ETF would be a way to neutralize some of that exposure. But by and large, I think investors should choose their asset allocation that fits their risk profile, and not have to worry about purchasing an inverse ETF.

Now, we've talked in other episodes about using options to protect and hedge portfolio losses. This is really another way to do that, although in this case, it's not as nuanced, because it's strictly just the inverse of whatever particular index it's seeking to do the inverse of. So it's not like an options strategy where you can protect against losses greater than 10% or 20%. This is just simply the inverse of the particular index.

Excess CAPE Yield

Finally, there's been some discussion on the Money For the Rest of Us Plus forums about a new paper that Robert Shiller, Laurence Black, and Farouk Jivraj published as part of a Barclays QIS Insights. It was titled "CAPE and the COVID-19 pandemic effect." They were looking at the cyclically adjusted price-to-earnings ratio, CAPE, and looking at the level back then for different countries, and they've found the U.K. was one of the cheapest relative to its long-term average, as was Japan. The U.S. not so much. But then they got into a discussion of the excess CAPE yield, which is the inverse of the cyclically adjusted price-to-earnings ratio. So one divided by the CAPE.

Just like we can look at the price-to-earnings ratio over the previous one year, or we can look at the earnings yield, which is the inverse of that, and that's what we do on the monthly investment conditions report. We have earnings yields for the previous 12 months, as well as the forward earnings yield based on expected earnings growth. That same analysis could be done with CAPE. And then they back out the real interest rate on 10-year bonds.

What they concluded is the excess CAPE yield, CAPE earnings yield minus interest rates—that spread is at a historical high for many countries. What does that mean? It means that stocks are more attractive relative to bonds. And that stocks will more than likely outperform bonds over the next 5-10 years. Something that I have mentioned in the investment conditions report.

I think it's useful to compare earnings yields to bond yields. It's something that I occasionally share in the investment conditions report. I don't share it every month, because one of the frustrations has been getting the data for that for different regions, and to put it into context. If we look at the median earnings yield, so the median stock in the All-Country World Index, relative to the median government bond yield, the earnings yield is 4.3%, the government bond yield is 1.4%. That spread is 2.9%. And it is at a historical high. But that spread has been positive since 2002, whereas from 1980 to 2002 bond yields were higher than earnings yields. And that was a bull market for stocks, from 1980 to 2002, even though bonds were more attractive relative to stocks, if we just look at the yield

data. From 2010 to 2019 we had the earnings yield above the bond yields, and we were also in a bull market.

My conclusion is it's helpful to look at this data and recognize that if bond yields are low and stocks are yielding more than bonds, then stocks will probably do better than bonds over longer-term periods. Not necessarily year by year, but over longer-term periods that's important to recognize.

If bond yields are higher than the earnings yield on stocks, then bonds could potentially outperform stocks over a 5–10-year period. Bonds did very well during the 1980s as interest rates fell. So what matters is the starting conditions—looking at bond yield to maturities, looking at earnings yields on stocks, looking at dividend yields on stocks, and using those as inputs to estimate returns over a 5–10-year period.

This then, this excess earnings yield is just another tool, another metric to be aware of as we go about building our portfolios and projecting returns. We'll be releasing new 10-year expected returns at the beginning of April, based on the most recent valuation data that we have. Again, we'll be using our building blocks approach, which starts with the yield—be it yield to maturity on bonds, the dividend yield on stocks and income strategies, and then we'll have expectations for the growth of that income or earnings, and any adjustments due to valuations. We do that every six months.

I'll link to the Shiller paper; you can take a look at some of the valuations. The bottom-line conclusion is that stocks will probably do better than bonds going forward, which is intuitive, because interest rate yields are so low, and in many cases the dividend yields for stocks, just the dividend yields are higher than bond yields.

That then is Plus episode 334.