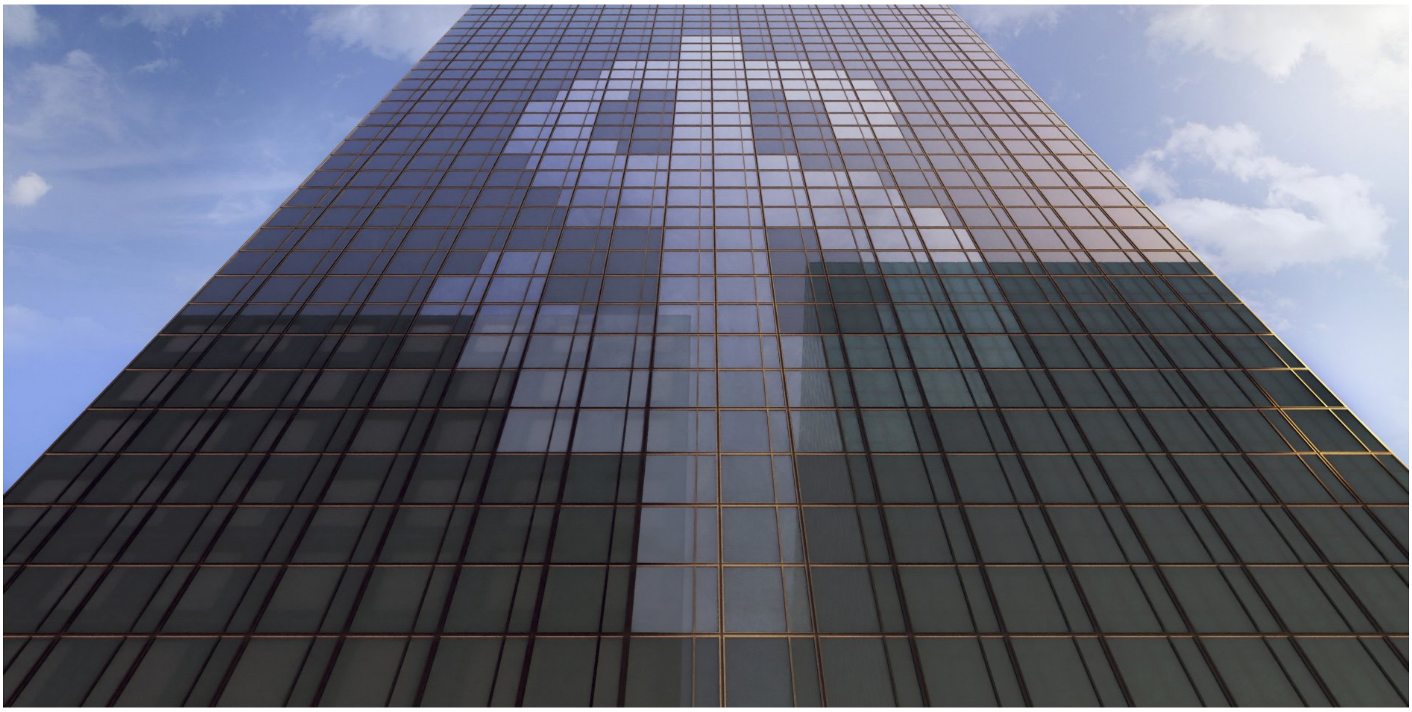

Pricing Flexibility in an Inflationary Environment

May 6, 2021

Inflationary pressures are rising, driving up input costs in the form of materials, components, and labor. With U.S. equities at high absolute valuations, there is little room for companies reporting "in-line" quarters, let alone earnings disappointments. Higher input costs become a key risk to stock performance for the *average* company that is unable to react in a timely manner. Our investment approach focuses on superior quality companies that can have more differentiated products or services that offer more flexibility to react and potentially avoid financial disappointments.

With what our Global Equity Team colleagues call the "Mother of All Recoveries" well underway, some economists and investors expect inflation to rise. Although the rate of increase in inflation, and the ultimate level and duration, are yet to be determined, there is general agreement that something has to give. This expectation is grounded in the unprecedented U.S. monetary and fiscal stimulus that has occurred to date, as well future plans articulated by the Biden administration, Congress, and the Federal Reserve.

At the same time, equity valuations are at historical highs, suggesting two immediate risks to equity owners.

The first is valuation multiple risk, which occurs as interest rates rise (particularly for longer-duration, higher-growth earners). This occurs because as interest rates change, so does the discount rate. Investors must discount earnings streams back at a higher rate.

The second is earnings risk. If inflation and interest rates rise, input costs could also rise, and earnings could be vulnerable.

Valuation Discipline Addresses Rising Rates

As money managers, we have no control over the perception, let alone the reality, of future interest rates.

But our U.S. Growth & Core Equity Team seeks to have a valuation discipline, incorporated across our investment philosophy and process, that focuses our attention on the most attractive risk/reward opportunities as we discount that projected earnings stream back.

Our valuation discipline seeks to limit our exposure to valuation multiple risk relative to our investment universe.

Quality Focus Addresses Earnings Risk

One thing we do have control over is our investment philosophy and process, which allows us to address earnings risk by helping us identify companies that we believe have a strong likelihood of reporting better-than-expected earnings over time.

So, how do we think about earnings risk in a more inflationary environment? With first-quarter reporting well underway, we've learned that material costs and wage inflation are, in many instances, rising meaningfully relative to the past decade.

In recent years, U.S. inflation concerns have been limited to specific commodities or components; these concerns have not been broad-based or long-lasting. Wage inflation was a popular topic pre-pandemic as unemployment levels reached historic lows, but productivity largely kept wages in check (mainly due to technological innovation).

That's changing for many reasons.

First, pent-up consumer demand is rising at an unprecedented rate as retail doors re-open and service companies re-emerge for business amid broad U.S vaccine distribution.

Second, supply-chain disruptions are exacerbating manufacturers' ability to produce goods and retailers' ability to keep goods on the shelf.

Third, fiscal stimulus may encourage some individuals to remain out of the workforce longer. This is limiting manufacturing and services at a time when their offerings are needed most.

The combination of these factors is creating inflationary pressure. The duration is not yet clear, but even a modest rate of inflation going forward could have a substantial negative impact on margins and earnings if not quickly offset with higher prices and/or other cost reductions.

Because absolute valuations are high by historic standards, stocks are generally vulnerable to multiple compression should there be even a hint of unchecked margin pressure, let alone earnings disappointments. The average company doesn't have the ability to quickly address higher input costs with offsetting higher prices.

Seeking Winners and Avoiding Losers

Our quality investment approach seeks out durable business franchisees, which we define as companies that can drive revenue and earnings growth more consistently than their peers, regardless of the economic backdrop.

A key tenet of this methodology is identifying companies that have a differentiated set of products or services relative to their competitors. Why? Because these companies can adjust pricing based on the differentiated value they provide their customers.

That's something the average company, with undifferentiated products or services, can't do. And because the average company cannot adjust pricing with the same flexibility, it must eat the added ongoing costs for an undetermined period of time. This affects earnings.

In sum, we believe our quality, bottom-up investment philosophy and process will lead to more portfolio holdings with superior pricing flexibility, which are better positioned to meet the challenges of higher input costs, whether they be near-term or longer-term in nature.

Rob Lanphier, partner, is a portfolio specialist on William Blair's U.S. Growth & Core Equity team.

Disclosure:

This content is for informational and educational purposes only and not intended as investment advice or a recommendation to buy or sell any security. Investment advice and recommendations can be provided only after careful consideration of an investor's objectives, guidelines, and restrictions.

Information and opinions expressed are those of the authors and may not reflect the opinions of other investment teams within William Blair Investment Management, LLC, or affiliates. Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Information is current as of the date appearing in this material only and subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. This material may include estimates, outlooks, projections, and other forward-looking statements. Due to a variety of factors, actual events may differ significantly from those presented.

Investing involves risks, including the possible loss of principal. Equity securities may decline in value due to both real and perceived general market, economic, and industry conditions. The securities of smaller companies may be more volatile and less liquid than securities of larger companies. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks. These risks may be enhanced in emerging markets. Different investment styles may shift in and out of favor depending on market conditions. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result.

Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, and inflation risk. Rising interest rates generally cause bond prices to fall. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Sovereign debt securities are subject to the risk that an entity may delay or refuse to pay interest or principal on its sovereign debt because of cash flow problems, insufficient foreign reserves, or political or other considerations. Derivatives may involve certain risks such as counterparty, liquidity, interest rate, market, credit, management, and the risk that a position could not be closed when most advantageous. Currency transactions are affected by fluctuations in exchange rates; currency exchange rates may fluctuate significantly over short periods of time. Diversification does not ensure against loss.

There can be no assurance that investment objectives will be met. Any investment or strategy mentioned herein may not be appropriate for every investor. References to specific companies are for illustrative purposes only and should not be construed as investment advice or a recommendation to buy or sell any security. Past performance is not indicative of future returns.