

Stock investment is the best hedge against inflation

Parag Parikh

STOCK markets are known for irrational exuberance. There is a lot of bad news in the market. However, at present the major cause of worry is on two fronts: Oil prices and Inflation. The markets have reacted very adversely to this news. Such irrationality provides good investment opportunities for an intelligent long-term investor.

In 2005 and 2007, the markets were going up as the perception of the people was very optimistic. During those times the price of oil moved from around \$40 to \$100, almost a threefold jump and the BSE index during that time tripled by moving from 6200 to 20000. Now in 2008, the price of oil has moved up just 35% from \$100 and the markets are down around 35%. What explains this behaviour? The investors have turned fearful. Greed is replaced by fear. The same investors who were chasing stocks at an index of 20000 are selling when the stocks are 35% cheaper. The perception has changed from optimism to pessimism.

One may argue that the new cause of worry is inflation. Stock investment is the best hedge against infla-

tion. When we buy a stock we are buying a part of a business of a company. This company has made investments in land, buildings, machinery, knowledge, people etc. It sells a product or a service at a profit. Some of this profit is distributed as dividends and the rest is ploughed back to grow the business. In times of rising inflation the investor is protected in two ways. The replacement cost of putting up similar plant capacities and

business infrastructure rises and thus the value of the investors existing investment also rises. This serves as a hedge against the falling value of the money. Secondly, the dividends distributed by the company make up for the cash flow. Any other asset class will not

protect your money like equities.

The best way for us to have money in the future is to make money in the future. So we need to really forget about which asset class will appreciate in the future but rather focus on owning a business that profitably sells products and services. Stocks represent ownership interest in businesses. Stocks should be the preferred asset class with rising inflation. Of course the choice of the industry would matter. Certain sectors would be hit as

consumers would stop splurging. Sectors which can be avoided are real estate, hotels, airlines, multiplexes, consumer durables, automobiles, and media companies.

The current rising inflation and the price of oil have changed the market sentiment from optimism to pessimism. In times of optimism the prices of stocks were going up faster than the rise in profits could justify. Today it is the opposite. This irrational exuberance made stocks unduly expensive and today the irrational fear will also make them unduly cheap. Look out for cash rich dividend paying companies. Defensive sectors like pharma and FMCG would be available at attractive valuations. People are not going to stop having a bath to save on soap, nor are they going to quit brushing teeth or stop taking medicines. Infrastructure, banking and technology stocks are also available at attractive valuations.

Stocks are the best hedge against inflation. It is the most tax-friendly asset. Dividends tax free and long term capital gains tax zero. Make your choice. Maintain your equanimity. Use your mind and not your heart to make decisions. It's only such times that offer good investment opportunities. Wait and you will be rewarded.

(The author is chairman, Parag Parikh Financial Advisory Services)

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INVITATION

