Strategist's Corner
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A Simple Way to Think About Tariffs

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In brief

- Investing is simple but hard
- Who pays? The consumer or the producer?
- Businesses with low competition offer insulation

For manufacturers in developed markets, the allure of higher margins driven by low-cost manufacturing in far-away places fueled a multi-decade period of globalization. The result, of course, is a vast, highly integrated network of supply chains whose complexity, I think, is just being recognized by market participants.

Take a simple pair of jeans as an example. While some US producers source cotton locally, most denim comes from China, India and Pakistan. For some premium pants, materials come from Zimbabwe, Turkey and Egypt. A lot of coloring is done in China and Germany and the zippers come from Japan. While there is more to it, you get the idea.

Investing is simple but hard

Taking a step back, let's remember that investing is simple but hard. Simple because the range of potential cash flow outcomes for a business drives both its stock price and its volatility. The hard part is the future is uncertain and profits assumptions change, sometimes radically, when new information emerges.

In recent weeks, the combination of tariffs and policy uncertainty, along with a growing realization of the complexity of global supply chains, has raised doubts over future profits and increased volatility.

Is there a simple way to think about this risk factor?

Who pays? The consumer or the producer?

The word tariff is derived from an Arabic term which means "to notify" and was used in reference to customs duties approximately 1,000 years ago. Think of them simply as a tax or a toll.

While investors and market commentators are wrestling over possible economic outcomes, they should be concerned with financial outcomes. Somebody must bear the burden of this new tax. Since stock prices are derived from profit outcomes, the only question that really matters from an investment perspective is who pays the tax, the consumer or the producer?

Producers of goods with low demand elasticity can pass along price pressures to their customers. The reasons for the inelasticity include limited substitutes and superior quality. Whatever the reason, that economic moat affords the producer the ability to pass the tariff on to their customers. In this scenario, the consumer bears the burden, which is inflationary — and growth depleting — as there are fewer resources to go around.

Conversely, for goods that are price elastic because of viable substitutes, the additional cost burden falls to the producer in the form of margin compression.

While financial markets have increasingly been discounting the tariff impact on companies, there are likely other variables at play. I think the reality will be a mix of both, where customers pay the tax on things they cannot do without and producers with duplicable goods disappoint investors with profit weakness.

How might we think about this from a portfolio construction perspective?

Businesses with low competition offer insulation

Since we live in a capitalist world, where entrepreneurs seek returns and are always looking to disrupt, businesses with above average but also durable profit profiles do things that others cannot. High barriers to entry, whatever they may be, keep competition low and profit margins high. We have always felt, for example, that the producers of tools and equipment that sell to life sciences companies embody these characteristics.

These are the pickaxes and shovels of the life sciences and have historically been the best businesses in health care. They sell instrumentation, related consumables, services and other products to pharma and biotech companies, hospitals, laboratories, academia and governments. Their tools measure, separate, purify, quantify and diagnose. They're mission-critical across a range of projects from drug development, clinical trials, biomanufacturing and many more.

Keeping it simple, their business model is akin to the razor/blade model. They sell an instrument with a useful life of five to 10 years that requires the repeated purchase of consumables and service contracts. These are long-cycle businesses given the multi-year process it typically takes to bring a therapy or drug to market. Their customers, who care very much about quality, are willing to pay a bit more to ensure quality and reliability for something that is relatively low cost compared with the large expense of the broader endeavor.

While they too have complex global supply chains, and costs will rise as a result of the tariff war, the mission-critical nature of what they offer, combined with the trust their customers have in their goods, may insulate them from substitution risk, something that other industries lack.

We can make a similar case for electrical equipment companies who manufacture components for use across broad industrial end markets such as artificial intelligence infrastructure, energy and power transmission, electric vehicles and other secularly growing industries. The risk of substituting a cheaper good to save a few dollars often isn't worth the relationship risk to these large and well-funded customers.

Conclusion

While we don't know Socrates' exact quote about knowledge, I've always liked the version that reads "All I know is that I know nothing, and I am not quite sure that I know that." Even if we knew the precise level of tariffs, the complexity of supply chains renders trying to gauge the downstream effects on the economy difficult, if not impossible. At least, I think that is what Socrates would believe, and if so, I agree.

Instead, let's put our energy towards understanding which businesses will be able to absorb the levies and which will not. Because that's what will determine stock outcomes, and isn't that what we — as fiduciaries — get paid to do? I think the current environment will bring forward a paradigm shift to the value of discretionary portfolios with fundamental underpinnings.

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