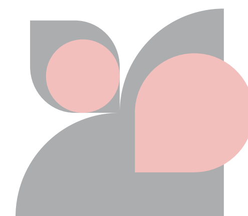

Rathbones Specialist Tax Portfolio Service (STPS)

Business relief (inheritance tax relief) mandates

Q2 2022 report

A tough six months, but grounds for cautious optimism

There is real regime change happening. And we're not talking about the resignation of Boris Johnson!

In economics, 'regime change' means the prevailing circumstances of past years have changed and markets may not react as they have in the recent past. That may mean different tax rates or regulatory frameworks, new technologies or altered economic influences. Today, after years of slumber, inflation is at multi-decade highs and not so transient. Central banks are driving up interest rates to keep prices anchored, and the war across eastern Ukraine threatens to derail a fragile post-COVID recovery. Things are finely balanced, the risks are material, and investors have been repositioning accordingly.

As for us, our strategy of investing in resilient, durable, and sustainable businesses is designed with exactly this kind of moment in mind. The macro turbulence might feel uncomfortable, but we hold quality companies with defensive characteristics: resilient revenue streams, attractive profit margins, and on-going investment in themselves and new tech that can be covered by internal cash flow. When supported by wider growth themes, like the revolutions in technology and healthcare, we believe these attributes should translate into superior long-term returns.

Unfortunately, that doesn't insulate us from share price falls. Interest rates, now at 1.25% in the UK yet still some way below the 9.1% inflation figure, are profoundly important for valuing assets. They affect how we 'discount' future cash flows, with higher rates meaning future cash flows are worth less today - and so stock prices come down. So when there's uncertainty about the path of interest rates, it becomes harder to know what anything should cost - particularly if you expect it to pay off far out in the future. And so we find ourselves in the midst of a rather painful period of price discovery. That doesn't mean our portfolio companies' future prospects are any less dim.

In fact, fundamentally, we suspect our portfolios are rather undervalued. The past six months was the worst first-half of a year on record for global stock markets, down roughly 20%. Sentiment remains poor but, with three acquisition bids in the period, our portfolios have clearly never looked more attractive to informed buyers.

Corporate activity

In our previous report we speculated that the takeover of cash-generative, quality UK companies could continue; this proved correct, and we sense there's still potential for further mergers and acquisitions. A combination of sterling's devaluation, a compression of valuation multiples and fears of an earnings recession - the UK economic outlook has "deteriorated markedly" according to the Bank of England - leaves good quality smaller companies trapped and vulnerable to predators. Portfolio companies that have been bid for (and will in time leave our portfolios) are **Ideagen, EMIS**, and **CareTech;** these quality businesses follow Sumo and Clinigen, which were taken over in the first quarter.

Investors will receive £3.50 for each share of Ideagen, a healthy 52% premium to the closing price on 11 April. The Nottingham-based software company's focus on programs for heavily regulated industries, like banking, aviation and healthcare, makes its revenues much stickier. This is, of course, quite attractive to suitors in these uncertain times.

EMIS is an NHS stalwart. Its software continues to drive immense value for the NHS and, consequently, everyone in the UK. Having supported EMIS at its IPO in March 2010, it is one of a number of holdings we've held for over a decade. At £19.25, the 49% premium to the closing share price of the day before the announcement is a useful boost for shareholders, but we would have been just as happy to sit tight in this stock and support its growth. We are sad to see it go.

Rathbones
Look forward

CareTech rounds off the current list of bid-for companies in our portfolios. Having started off in 1993 with a single care home, it has done a fantastic job of building up to a 5% share of a £12 billion market. In providing individual support and mental health services to disabled adults and children, its work is incredibly valuable. The bidding group, led by founders Farouq and Haroon Sheikh, believes private ownership will allow management to focus on operating the business for the long-term, including expansion in the Middle East. We wish it luck in that endeavour.

A note on other holdings

Judges Scientific, the specialist in acquiring and developing scientific instrument businesses, continues to execute on its exceptionally successful long-term strategy, ably directed by CEO David Cicurel. Most recently, the group has acquired the remainder of Bordeaux Acquisition, and its carefully curated pipeline of niche growth companies - available typically on single-digit multiples - sets the stage for further growth.

Craneware makes financial and operational modelling and analysis tools for US hospitals and pharmacies. We want to see it return to double-digit annual sales growth rates, and we feel that last year's transformational Sentry acquisition will be an important part of the puzzle, but for now it's navigating present headwinds better than most. It has pricing power across a product suite unrivalled in breadth and depth, and we feel that the strength of the enterprise is underappreciated at its current share price.

Ergomed, the fast-growing pharmaceutical services company, has suffered share price declines over the past six months. We believe this is due to concerns around potential wage inflation across its substantial workforce. The company still has highly attractive growth prospects, however, and we see good momentum in the business given the sub-sector's tailwinds and a growing proportion of revenue coming from the US, with the added benefit from recent strengthening in the dollar.

A robust strategy built to handle turbulence

When we consider the quality of stocks we hold and the much more attractive valuations in the market, we are quietly optimistic. After deep corrections, the beginning of a new cycle tends to bring about the best vintage of returns should history repeat itself. While we can't be sure if the nadir has been reached - and there could well be further difficult times ahead - we believe this is an environment in which good future gains may be on offer.

Bear markets are psychologically painful, but it's at moments like this that we must put our emotions to one side and objectively appraise our situation. There are notable risks, and conditions could deteriorate further - that's a possibility, as it always is. Yet stock markets are forward looking - 12 to 18 months, typically - and a raft of bad news is already priced in; the inverted yield curve that we discussed in our last report has forecast all of the last 10 recessions with only two false alarms (where it inverted but no recession was forthcoming). Yet the average time between inversion and eventual recession was 14 months - and sometimes as long as two years. That's a long time to avoid a market.

Cathie Wood's ARK Innovation ETF is an example of how out of favour early-stage technology investing has become, along with Baillie Gifford and Liontrust managed funds in the UK. US stock market volatility as measured by the VIX Index surged three times during the first quarter, peaking on 7 March at 36.5 - a rapid rise from 17.2 at the end of 2021 - and finished June at 28.7. The AAII sentiment survey released on 23 June shows that investor pessimism neared 60%, a level last seen in 2008. Short-term optimism fell below 20%, a level not seen since 2009.

Recession is no certainty, but neither are there any clear catalysts that might lead to a decisive swing in sentiment. Our portfolios are constructed to weather just such conditions. We look for strong market positions, reliable and easily forecast revenue, durably high margins, healthy cash generation, robust balance sheets and underlying opportunities for growth that don't rely on wider economic expansion. When we find that rare combination at an attractive valuation, we buy and hold tight.

You'll be pleased to hear that this hasn't changed over the past six months and, as we seek to deploy the proceeds from the recent acquisitions, we are enthused by the opportunities presented by the market.

Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment.

Stewardship

As a responsible investor, Rathbones prioritises engagement where we can make the most impact in addressing systemic environmental and social challenges and add value to clients' portfolios. During the reporting period, Rathbones engaged with five portfolio companies on a variety of ESG (environmental, social and governance) issues. Following engagement we will be monitoring diversity, director independence, director over boarding, remuneration and pre-emption rights. Pre-emption rights are central to investor protections, the rights of first refusal on new issues of shares; Rathbones encourages investee companies to commit to follow the Pre-Emption Group guidelines to protect existing investors' interests. We look forward to updating you further on our stewardship activities.

Portfolio strategy

This portfolio takes a long-term approach to investing. Rathbones take the approach of investing in AIM traded companies that stand up on their own right while qualifying for relief from inheritance tax.

Alternative Investment Market (AIM)

AIM set out in 1995 to provide smaller, growing companies earlier and more efficient access to the public markets. In June 2022 AIM hosted 835 companies with a combined £105 billion in value; 20 ventures are valued at over £1 billion, co-existing with a vibrant venture capital market and early-stage opportunities. Environmental factors are being prioritised by investors and The London Stock Exchange's Green Economy Mark recognises ventures generating over 50% of revenues from sustainable activities. Many AIM companies are transitioning to a low-carbon economy and account for 43% of companies with the Green Economy Mark. From September 2018 all AIM companies adopted a governance code and then 'comply or explain', increasing disclosure and confidence.

The Rathbones investment approach

Profitable, established, cash generative AIM-traded companies with growth characteristics and strong competitive advantages - a preference for quality opportunities that should stand the test of time. This is a bottom-up stock selection approach favouring highly visible revenue streams in growth markets with little direct exposure to the consumer, avoiding airlines, retailers, and pawnbrokers. Banks, resources, recruiters, and car dealers also don't meet the criteria.

Benchmark

In the second quarter of 2022 the FTSE AIM All-Share Index declined 15.5%. As a benchmark for Specialist Tax Portfolio performance though it's not ideal and not a like-for-like comparison. Not all AIM shares qualify for Business Relief meaning the relevance of the index is limited for this tax-advantaged portfolio strategy. The FTSE AIM All-Share Index is highly concentrated: 1.3% of constituents account for 18.0% of the index's total value. The index really has limited application other than a rough indication of smaller company performance.

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For further information (including the amounts covered and the eligibility to claim) please refer to the FSCS website www.fscs.org.uk.

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