Rathbones Specialist Tax Portfolio Service (STPS) Q&A – Business relief mandates

April 2022

What exposure do your portfolio companies have to Russia/Ukraine?

War in Ukraine has raged since 24 February and the human impact is vast. As events unfolded smaller-cap UK share prices collapsed despite minimal exposure to Russia. We engaged with our portfolio companies and the overall exposure was indeed minimal. The most affected was Strix, which has a 30% share of the kettle controls market in Russia, yet that is just 3% of group sales and is serviced through its Chinese operations. Growth in Russia is not a key driver of our longer-term investment thesis for Strix and we don't expect the company's overall sales growth to be materially disrupted.

How do you expect the conflict to impact the UK small cap space?

Since 24 February - the start of the war in Ukraine - to 6 April the FTSE AIM All-Share Index has increased 4.0% and the FTSE SmallCap Index 2.8%. Both lag the 'oil rich' FTSE All-Share Index's 5.0%. A paper from the US National Bureau of Economic Research reports that equities are 33% less volatile during periods of major conflict. This is based on defence spending and corporate profits; improved economic outlook bolsters sentiment and increases business investment, all of which is supportive of smaller companies most sensitive to that overall spending narrative.

Are there any specific winners or losers based on current market movements?

An indiscriminate rotation away from 'growth' and high-risk businesses has resulted in a major valuation reset regardless of quality. Recent results from portfolio companies are proving this is a contraction of multiples not earnings - i.e. profits are rising, but investors are valuing those cash flows less. The relentless focus on macroeconomics in 2022 has left good quality growth assets oversold, in my opinion. Therein lies the opportunity.

Will current and growing inflation have a particularly damaging impact on the portfolio? If so how are you adding protection?

Inflation resilience is a theme we cover in the Q4'21 STPS commentary. Opportunities most sensitive to galloping inflation and a higher interest rate environment are long-duration, 'jam tomorrow' assets - these are not Business Relief mandate investments. We avoid those opportunities with back-end loaded earnings, or unclear medium-term profitability. Think of our mandate portfolio companies as 'jam today' - high visibility of revenue, high operating margins, limited debts relative to overall assets. And, at the same time, they are compounders with attractive cash flows and high returns on capital.

There has been quite a bit of sell side research suggesting quality small/mid-cap UK companies could end up performing particularly well over the coming months, what are your views on this?

Macro factors dragged down sentiment and valuations of smaller companies/riskier assets in the first quarter. A continued buyers' strike of riskier assets is common when investors turn their attention away from long-term opportunities to the 'here and now' safe havens of cash, gold and oil. The sell-off has been indiscriminate and good quality growth assets have been massively de-rated. Some of this will no doubt be due to fund redemptions leading to asset sales - likely at the wrong point. This also operates in reverse in better times when inflows find their way into shares.

Howard Marks, the founder of Oaktree Capital, recently told the FT that "great investments are often made when you're willing to do something no one else is." Sometimes that can be a matter of doing nothing. Research by stockbroker Numis argues that since 1955 smaller companies have delivered about 3% better capital returns than larger companies. The case for remaining invested - if the strategy is right - is strong.

As a final note, the AIM All Share - a proxy for smaller companies - has fallen 13.9% year to date (to 6 April). Any hesitation from investors on valuation has been removed: the UK economy is now 0.8% above its pre-pandemic level, and after the Nil Rate Band freeze in 2021, Inheritance Tax receipts are expected to reach £6.8 billion by 2025 , with a substantial increase in estates being caught in the net.

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