Rathbones Specialist Tax Portfolio Service (STPS)

The Specialist Tax Portfolio Service team

Q3 2022 report

And the wise men said, “this too shall pass”

In a medieval Persian fable, a powerful king asks the wise men of his court to bring him a magic ring that can make the sad man happy and the happy man sad. The king thinks it impossible, yet they return with a ring engraved with the words, “this too shall pass.”

The reminder that all things, good and bad, are fleeting is as apt today as in the first spread of the COVID-19 pandemic, and before then during the Great Financial Crash, all the way back to the 1200s and before. Evolving central bank monetary policies in response to global inflation indicate that we are in a period of economic transition. It has been a painful process, but markets appear to have largely digested the prospect of UK interest rates rising from practically zero to a forecast 3% in Q2 2023. Short-term volatility, while uncomfortable, really does tend to pass and drawdowns are historically fleeting in nature. Of the past 37 years, 25 have delivered positive returns while 12 have been negative, and yet 28 have seen intra-year falls of 10% or more.

Over the last 75 years, long-term investors (in the market for 10 years or more) have rarely suffered losses. Not only that, but the range between best and worst returns narrows as holding periods lengthen. A great deal of worry is now reflected in corporate valuations and we do have a potentially difficult winter ahead of us. However, profits have been resilient in many cases and companies are often now trading at valuations well below their five-year averages, some dramatically so. This has traditionally been a positive indicator for future returns.

Considering the above and points explored further below, we remain enthused about our portfolios’ prospects.

A tricky quarter for all, but small-caps more than most

In our last quarterly report we noted the market effects of the awful war on Ukraine and increases in inflation and interest rates. This has only intensified this quarter, with the Bank of England hiking its base rate to 2.25% and CPI inflation hitting 10.1% by end of September.

This quarter was one of economic and political transition, with rising food and utility prices pushing UK inflation to a 42-year high, and a ‘normalisation’ of interest rates towards pre-2008 levels driving stock market volatility. Fiscal policy announced by now-deposed Prime Minister Liz Truss and Chancellor Kwasi Kwarteng in the ‘mini-budget’ further destabilised markets. Investors, understandably, soured on riskier assets as a result, so small and medium-sized companies remained out of favour.

Amid all this, UK equity funds are experiencing high levels of net outflows, meaning some managers are selling down certain positions to meet redemptions rather than buying while share prices are depressed. In August - the 13th consecutive month of outflows - UK funds saw net retail outflows of £1 billion compared with £564 million taken from European equity funds and £505 million in North America-focused funds.

These two trends - the ‘risk-off’ move away from smaller market caps and a more general rebalancing out of UK equities - make it a particularly challenging, but also opportune, environment to invest in UK small-caps. We believe this backdrop will pass as we proceed through the economic cycle. The UK might be out of favour with global investors for now, but we believe this nation remains a fantastic incubator of companies with world class potential.

The AAII Sentiment Survey of investors shows that pessimism “continues to be unusually high” and is double the historical average. This cautious stance is blocking investment in various ‘risk assets’, including smaller, higher growth equities. The FTSE AIM All-Share Index, while not a benchmark for our portfolios, captures sentiment towards smaller companies. That index is trading 34% lower now than at the start of the year, buoyed to a degree by strong performance by its oil, gas, metals and mining sectors. The Refinitiv Venture Capital Index is down further, falling 58% for the year to date.

We still believe the current environment presents attractive opportunities for those investors with a longer time horizon. Howard Marks, co-chairman of Oaktree Capital, compares investor sentiment to the movement of a pendulum as it swings back and forth, noting that “great investments are often made when you’re willing to do something no one else is”. We share this sentiment. While others spend time tactically repositioning, we remain steadfast in our search for high-quality companies with sustainable growth prospects and durable profit margins. The thesis that such investments will outperform over the long-term is unaffected by the current backdrop, in our view.

Structural growth trends and revenue visibility give comfort and security

Our portfolios remain comprised of profitable, financially sound companies with attractive growth prospects that we believe will still be here in 10 years' time. Well-managed businesses with strong balance sheets allow for reinvestment and potential acquisition opportunities in fragile economic conditions, thus increasing the opportunity over the long term.

Take Ergomed for example, a contract research and pharmacovigilance specialist (it spots adverse side effects with new medicines and treatments). This is a long-standing portfolio holding that began life in Rathbones' Enterprise Investment Scheme (EIS) portfolios in July 2014, when we supported the IPO. Recent results show sustained strong momentum, despite underlying biotech market weakness, with half-year revenue up 25% due to geographical expansion, foreign currency tailwinds and a major contribution from a strategic acquisition (ADAMAS).

Ergomed's near-term prospects are sound, supported by a record £285 million order book that gives good revenue visibility. While there are risks – for instance the pharma industry is under pressure – forecasts for Ergomed are, we feel, conservative given the group's track record. The group's reputation as a specialist in oncology and rare disease research leaves it well placed to win additional mid-tier pharmaceutical clients around the world.

We have started buying Cerillion, a small but growing software-as-a-service company with a strong market position in telco billing, built up over decades. Here it supplies mission-critical software to a sticky client base of blue-chip customers. Cerillion sells a range of tried-and-tested 'off-the-shelf' options that can be used by its clients. Switching costs are substantial and churn rates are low. There are attractive long-term growth drivers supporting demand, primarily around the expanding provision of broadband to end customers.

The group's circa £172 million pipeline for new customers (as of 31 March 2022) suggests that it could grow into a substantially larger enterprise in the years ahead, while a robust back-order book provides good shorter-term revenue visibility and highlights the defensive nature of group operations. It is increasing its market share and winning larger contracts. Those larger and more complex contracts bring with them enhanced execution risk, but this experienced and talented group no doubt embraces the challenge.

Long-term innovation in global growth markets

Investors continue to watch inflation data closely. We cannot be certain when interest rates will peak or inflation will start to fall, but both will eventually happen. In the meantime, we are avoiding companies exposed to the most economically sensitive industries and sectors, instead prioritising those names whose earnings should be more resilient in the face of these headwinds. Such examples can be found in the clinical testing and wound care markets, which are both supported by increasing healthcare spending, rising global wealth, expanding middle classes and aging demographics.

Bioventix develops monoclonal antibodies (laboratory-grown proteins) from sheep for use by its customers in diagnostics, and can do so at notably high profit margins. Encouraging growth in revenue from Troponin testing (which diagnoses heart attacks) is enhancing the long-term investment case beyond Vitamin D testing, as are other products aimed at supporting the treatment of acute cardiac care and Alzheimer's. The company has a promising pipeline of new products, a great culture of innovation and research and development, a long-term outlook, and – in the current environment – a useful net exposure to the dollar. Of course, this could become a vulnerability if sterling strengthens against the greenback.

We recently headed to Winsford, in Cheshire, to meet the management team of Advanced Medical Solutions (AMS), another company helping to push healthcare forward, this time by using innovative tissue-healing technologies to create advanced wound care products. The US remains a key market for AMS, which has several new products at various stages of clinical trial and regulatory approval. If they manage to clear these hurdles, all have the potential to contribute meaningfully to revenue growth. The group continues with its commendable goal of directing c.10% of annual revenue towards research and development.

Other existing holdings, such as Craneware (revenue management software supplier to US pharmacies and hospitals), Learning Technologies (workplace digital learning specialist) and Next Fifteen Communications (tech and data-driven growth consultancy), also offer material dollar earnings and have grown profits strongly in recent years. Like many companies, however, their share prices have fallen in 2022, despite meeting or exceeding analysts' expectations. Interestingly their valuation multiples now look compelling and we still believe their long-term prospects to be sound.

Indeed, many of our preferred holdings look well positioned to bounce back strongly once the current economic storm passes. Volatility remains a feature and there are undoubtedly substantial challenges to navigate, but we can see long-term value and a path to better returns – perhaps catalysed by evidence that inflation has peaked and/or central banks eventually pausing for breath on rapid interest rate rises.

Undervalued UK assets continue to attract bids

A key feature of 2022 has been the marked increase in takeover activity. The combination of a weak pound and depressed UK equity markets prompted a raft of bids for our preferred AIM companies in recent months, especially from large US-based corporates and private equity firms. In the past year we have lost Clinigen (healthcare) and Ideagen (compliance software) to takeovers, while bids have been announced for EMIS (software for the NHS and chemists) and CareTech (specialist care for children and adults with disabilities).

The share price of EMIS, which has been a core holding in our portfolios for many years, held up well in the quarter as it prepared to leave the market. It's worth noting that Optum's offer to pay £19.25 per share in cash values EMIS at 32x forecast earnings for the 2022 financial year. There is similar quality elsewhere in our portfolios that, for now, trades on far more modest multiples. This will not persist indefinitely, and we expect quality stocks to rerate in time.

The departure of EMIS means we will have cash to redeploy once the competition watchdog approves the deal. Proceeds will likely be distributed across existing portfolio holdings with attractive valuations and used to establish new positions in companies with strong growth prospects and robust revenue visibility.

So how does the current outlook affect our portfolio positioning? We are checking the revenue visibility and financial health of our companies, focusing on defensive growth, and limiting exposure to consumer disposable income. That said, our fundamental investment style is unchanged. We do not swing from greed to fear, and we remain as optimistic about the potential of the portfolio companies as we were last year, and the year before that.

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 three 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 September 2022 AIM hosted 827 companies with a combined £93 billion in value; 14 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 45% 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 third quarter of 2022 the FTSE AIM All-Share Index declined 4.8%. 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: 2.8% of constituents account for 30% of the index's total value. The index really has limited application other than a rough indication of smaller company performance.

Rathbones
Look forward

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Important information