Rathbones Specialist Tax Portfolio Service (STPS)

The Specialist Tax Portfolio Service team

Q1 2023 report

Smaller companies miss out on markets' very narrow rally

Market conditions proved painful for smaller company investors in 2022 and this quarter was equally difficult; we recognise the drawdowns make uncomfortable reading for many clients joining the service in recent years. Between the start of 2022 and the end of March 2023, the FTSE AIM-All Share - a reference point for the performance of UK-based smaller companies - fell by 33.78%. The FTSE 100, by comparison, rose by 3.19% over the same timeframe. That stands in stark contrast to the 15-month period from 30 September 2019 to 31 December 2021, during which the AIM All-Share's 39.40% capital return far surpassed the FTSE 100's 0.32%.

The outperformance of the FTSE 100 was driven by its ten largest constituents, and principally by the two biggest AstraZeneca and Shell, as investors sought "safe havens" for their capital. This skew towards the largest stocks intensified in the first three months of this year, which saw the narrowest leadership of any quarter in the past 30 years (by 'narrowness', we mean the contribution the largest stocks in an index make to its performance overall). A slim band of larger companies is masking the pain felt elsewhere. A similar trend is evident in the US, where the ten largest constituents of the S&P 500, for example, drove 90% of its performance in the first quarter (the norm is somewhere between 20% and 40%).

We believe these divergences are related to global macroeconomic headwinds and investor decisions at times being driven by macro data points rather than longer-term business fundamentals. Elevated levels of inflation and resulting interest rate-hiking cycles have increased the risk of recession in investors' minds. This is particularly the case in the UK, which has a higher inflation rate than any other G7 country while Britons also contend with one of their highest tax burdens since the Second World War. One consequence of all this is that investors have been withdrawing assets from UK equity funds at pace for almost two years. The total outflows from UK equity funds amount to £13.86bn, more than it's ever been this century. These withdrawals are indiscriminate and, as a result, we believe that our companies' good progress is currently not being recognised or reflected in their share prices.

Although the year began with hopes for recovery in sentiment towards small caps, the collapse of decent-sized US lenders Silicon Valley Bank and First Republic Bank, plus Swiss banking giant Credit Suisse, have trimmed these green shoots of confidence. We hope the relatively swift and decisive response from the US Federal Reserve, US regulators and its US banking community have stabilised the resulting 'deposit flight' from smaller US banks.

Markets are nervy: our companies are down but far from out

In the first quarter of 2023, STPS portfolios underperformed the FTSE AIM All-Share, which fell 2.4%. The drivers of this three-month underperformance are two-fold: first, a market rally in more speculative and cyclically sensitive names in January; and, secondly, the share prices of core holdings medical software developer Craneware and patent support specialist RWS came under pressure in March. Additional negative contributors in the quarter included Ergomed (which runs clinical trials for drugmakers) and wound care specialist Advanced Medical Solutions, both of which remain well-run businesses in defensive end-markets with strong growth prospects.

Craneware and RWS both now trade at or close to 10-year lows in terms of their earnings multiples despite the strength of their market positions and competitive advantages. We were not surprised to see Craneware, whose software is used in over 12,000 hospitals and pharmacies, announce a share buyback programme in April. In its own words, "the current market price does not reflect the substantial potential of the large addressable market opportunity... nor the significant operational progress [the group] has made."

We met with portfolio company management teams 30 times in the quarter and note a marked divergence between share price performance and operational progress. The market seems to think all AIM-traded smaller companies have little to no growth prospects. We strongly challenge this super-bearish thesis and believe that selecting good quality growth opportunities remains the best route for investors looking for exposure to what we continue to regard as an exciting asset class.

Portfolio company overview

We continue to closely monitor our companies and assess their investment cases in light of new information, particularly where there have been large share price movements. In most cases we do not see any fundamental deterioration and believe that, in time, sentiment will recover.

Our strategy of investing in companies with strong business models, pricing power and attractive growth opportunities positions the portfolio well to weather more turbulent conditions while delivering attractive capital growth over time. Most of our companies have net cash positions and have managed to grow revenue and earnings per share over the past three years regardless of shifting sentiment.

A key development in this quarter was the decision to sell out of our shares (where possible) of UK health records software supplier EMIS, a long-term holding, following a bid for the company that made it the greatest contributor to the FTSE AIM All-Share's returns in 2022. We thought we might make a small gain by holding on to the shares if US healthcare provider UnitedHealth's bid went through. But there was a chance that the Competition and Markets Authority (CMA) watchdog would refer the bid to a phase two investigation due EMIS' important role as a large supplier of data management systems to the NHS. On balance, we felt that risk was to the downside.

Soon after we decided to sell the shares, the CMA announced that it would have to carry out further investigations before allowing the bid to go ahead and EMIS' share price duly corrected. Our mandate means we must remain fully invested, so proceeds from the sale of our EMIS shares have been largely reinvested into qualifying investments with strong balance sheets and good organic growth prospects. These new companies, detailed below, provide exposure to various attractive themes.

AB Dynamics

AB Dynamics is the first of two new portfolio holdings. Founded in 1982 as a vehicle engineering consultancy, ABD is a home-grown UK success story headquartered in Bradford-on-Avon. It is a well-respected global leader in automotive vehicle testing products and its driving robots are the industry benchmark, used by the 25 largest vehicle manufacturers worldwide as well as government authorities to develop the next generation of advanced safety systems in vehicles. Regulation and testing are only going one way, thanks to people's increasing expectations that new cars and trucks will be safer than ever before and also to the increasing complexity of the technologies involved in Advanced Driver-Assistance Systems (ADAS) that seek to make driving and parking safer. We have seen ABD mature as an enterprise in recent years and believe it's well placed to capitalise on its promising opportunities.

GlobalData

Data analytics firm GlobalData is another new entrant to portfolios. This c.£1.4bn company has been a tremendous success on AIM, with plenty of runway for growth under the experienced leadership of group founder, industry veteran and significant shareholder Mike Danson as it aspires to become the "Bloomberg of industries". Its proprietary data across 20 different sectors is increasingly in demand and used by the likes of Heineken, Ikea and Lockheed Martin to make faster, more informed business decisions. With a significant internal development project now complete, the group is well placed to drive its organic revenue and operating margins to new heights.

Cerillion

Cerillion, which provides a range of "mission-critical" software services to the telecoms industry that enables them to bill customers and bundle services such as TV, mobile phone and broadband into a single plan, performed well in the quarter. It continues to generate extremely strong double-digit organic revenue growth and margin expansion amid strong demand. Encouragingly, the group recently won a c.£10m contract with an established customer which validates the strength of these products and highlights its ability to drive revenue growth from its existing base.

Learning Technologies

Learning Technologies' has grown from humble roots providing training manuals for airline cabin crew to become a global organisation deeply embedded in enterprise-wide training and solutions. It has detracted from portfolio performance over AI concerns, and the stock currently trades at all-time lows across several valuation metrics despite strong relationships with the likes of KPMG and Coca-Cola. The company remains at the forefront of the digital learning and talent management market, with multiple areas for potential growth from recent acquisitions. While it remains too early to take a view on just how recent developments in AI might change this industry, we believe technological shifts that alter workflows and drive the need for reskilling generally represent growth opportunities for Learning Technologies. The integration of US rival GP Strategies, a world-leading talent transformation specialist, is progressing ahead of expectations. In October, the group unveiled new strategic goals of achieving annual revenue of £850m and earnings before interest and taxes of £175m by the end of 2025. The experienced management team here has built up a solid track record of meeting such targets.

Strix

Isle of Man-headquartered Strix is the global leader in the design, manufacture and supply of kettle controls. Over 70% of UK households use its products every day, and the group is leveraging this dominant position to diversify into consumer goods (for example, water filtration with its brands Laica, Aqua Optima, Astrea, and Billi). The group's shares had a difficult time in

2022, driven by the disruptive impact of China's 'zero tolerance' COVID policy on some of its key customers, warehouse problems, customer destocking, and a slowdown in its core kettle controls market. Its acquisition of Billi (which produces boiling and chilling taps), while opportunistic and at an excellent price, increased leverage at a time of heightened market fears. We recently met with the management team and came away reassured on the outlook. With some green shoots observed in the kettle control market so far this year and a more relaxed approach to COVID from the Chinese government, we are hopeful that Strix can reduce its leverage in 2023 and demonstrate the value of this latest acquisition.

What might trigger a smaller company recovery?

We are regularly asked: what's the inflection point that might trigger stabilisation, recovery, and growth across our portfolio? Smaller companies tend to underperform in negative sentiment environments, when capital moves to larger more "risk off" investments. Right now, we believe quite a lot is priced into smaller companies' valuations. When confidence returns and businesses invest for growth once more, those same smaller companies can outperform dramatically. We remain fully invested ahead of any such change in sentiment.

In the meantime, UK equities continue to look attractive compared with international markets and trade well below their 10- and 20-year average forward PE ratios (despite prudent UK earnings forecasts relative to other countries). Sentiment headwinds persist, but valuations of UK small companies are more attractive than they have been for some time. If this isn't being recognised by investors, then we could see higher levels of acquisitions as others take advantage of prices. That aside, higher quality smaller companies should benefit when risk-on sentiment recovers: we remain well-placed for such a development.

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 multiple 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 longer-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 March 2023 AIM hosted 807 companies, a fall from 816 in December 2022 due to a subdued IPO environment - three IPOs were completed in the first quarter - and trading related de-listings or acquisitions. AIM's constituents owned a combined £90.2 billion in value in March 2023 continuing a difficult period for growth companies, declining from £150 billion at the close of 2021. There are 14 ventures 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 46% 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 first quarter of 2023 the FTSE AIM All-Share Index declined 2.4%. 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: the largest 10 constituents account for 22.1% of the index's total value. The index really has limited application other than a rough indication of smaller company performance.

The Specialist Tax Portfolio Service team
Telephone: 0151 236 6666

Important information

This document is published by Rathbones Investment Management and does not constitute a solicitation, nor a personal recommendation for the purchase or sale of any investment; investments or investment services referred to may not be suitable for all investors. No consideration has been given to the particular investment objectives, financial situations or particular needs of any recipient and you should take appropriate professional advice before acting. The price or value of investments, and the income derived from them, can go down as well as up and an investor may get back less than the amount invested. Tax regimes, bases and reliefs may change in the future. Rathbones Investment Management will not, by virtue of distribution of this document, be responsible to any other person for providing the protections afforded to customers or for advising on any investment.

Rathbones Investment Management, and its associated companies, directors, representatives, employees and clients may have positions in, be materially interested in or have provided advice or investment services in relation to the investments mentioned or related investments and may from time to time purchase or dispose of any such securities. Neither Rathbones Investment Management nor any associated company, director, representative or employee accepts any liability for any direct or consequential loss arising from the use of information contained in this document, provided that nothing in this document shall exclude or restrict any duty or liability which Rathbones Investment Management may have to its customers under the UK regulatory system.

We are covered by the Financial Services Compensation Scheme. The FSCS can pay compensation to investors if a bank is unable to meet its financial obligations.

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

Not all the services and investments described are regulated by the Financial Conduct Authority (FCA). Rathbones Group Plc is independently owned, is the sole shareholder in each of its subsidiary businesses and is listed on the London Stock Exchange.

Rathbones is a trading name of Rathbones Investment Management Limited. Rathbones Investment Management Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Registered office: Port of Liverpool Building, Pier Head, Liverpool L3 1NW.

Registered in England No. 01448919. Rathbones Investment Management Limited is a wholly owned subsidiary of Rathbones Group Plc. Head office: 8 Finsbury Circus, London EC2M 7AZ. The information and opinions expressed herein are considered valid at publication, but are subject to change without notice and their accuracy and completeness cannot be guaranteed. JN7978