Rathbones Specialist Tax Portfolio Service (STPS)

Business relief (inheritance tax relief) mandates

Q2 2021 report

Commuting with confidence

Gaining popularity is the return of the commute - a dose of routine and normality. Flexible work patterns and full vaccinations have set the scene for the greatest (pandemic-induced) PR makeover of all time: travelling to work (every now and then) is cool again. Of course, this novelty factor will soon give way to the weightier matters of carbon footprints, cost and reliability.

Recent major changes should provide commuters with optimism. Enter Great British Railways — a state-owned entity taking responsibility for the UK's national rail infrastructure and ticketing marks a major step forward in the accountability of rail transport. The proverbial two buses have arrived at once with the publication of the government's Decarbonising Transport: A Better, Greener Britain plan creating a 'green-print' for the transport sector with emphasis on electrification.

Siemens estimates 300 miles of rail track must be converted to electric each year to reach the government's carbon neutral goal by 2050. Overhead line electrification expertise is central to the decarbonisation theme. Engineering company **Renew Holdings'** June acquisition of Scotland-based Rail Electrification Limited, which works in both light and heavy rail sectors, seems a smart move in this context. This renewal and maintenance of UK infrastructure is now essential for the government to hit its promised goals, which is good news for Renew. And for its shareholders: Renew was a major contributor to our performance this quarter.

Inflation — a storm in a teacup?

Upgrading GDP forecasts the Bank of England (BoE) has signalled a remarkable economic comeback - boosted by confident Brits spending heartily and businesses feeling secure enough to invest. Consumer confidence has rebounded back to healthy levels.

So what are the facts? Consumer prices climbed 2.5% in the year to June 2021 against the Bank of England's averaged long-term inflation target of 2%. Expecting inflation to peak just over 3%, the Bank's Governor, Andrew Bailey, is promoting patience: "Expect this rise in inflation to be a temporary feature of the bounce-back." Deutsche Bank economists expect a peak at 3.9% this year end, with excess price pressures lingering until mid-2022 before falling back to target.

But how relevant are these inflation readings? A year ago was a low point for consumer prices as lockdowns were widespread and manufacturing had slowed to a crawl. Comparatives may become tougher - or less easy to overshoot — from here.

The inflation debate continues to rage, pitting two equally adamant camps against each other: those who believe price rises will be 'transitory' and those who expect it to become more problematic. Interestingly, both sides' arguments are based on continued good economic times. The 'transitory' camp supports the status quo of a gradual reduction of monetary policy because it believes the market has more than enough excess factories, workers and money to meet any supply shortfalls that crop up. Meanwhile, the 'problematic' camp believes that any hint of sustained inflation will cause a world of hurt in markets as investors readjust values, especially for bonds and shares with prices at high multiples of profits. They think central banks will be forced into a snap tightening of interest rates, pushing up the cost of government borrowing. This at a time when government borrowing is the highest it has ever been in peace time. That would crimp the government's ability to spend, but also make it more expensive for it to roll over the old debt as well.

There is sympathy for the BoE's call for patience; the UK economy is still 3% smaller than February 2020 and unemployment, at 4.8%, is still above pre-pandemic levels, protected as it is by the continued furlough scheme (currently at 2.4 million down from a peak of 9 million). Staff shortages have meant backlogs, pushing up prices and job creation is running at its fastest rate in seven years.

Why does inflation matter to stock markets? Since the great financial crisis interest rates and inflation have been historically low, rich ingredients for investors in growth opportunities and, until recently, central banks had little need to change this narrative. Higher inflation means any cash you are set to receive in the future won't buy you as much as if you had it in your hand today. So any assets that throw off that cash are worth less when inflation rises — unless they can increase the cash they earn to offset the rise in prices. Take a 'risk-free' asset — an NS&I Income Bond — which gives you 0.01% in interest over its term. Inflation is eroding the value of those interest payments (and the therefore the bond itself), encouraging investors to take more risk to maintain the purchasing power of their money. If prevailing interest rates sat at 5%, there would be little appetite for riskier investments unless there were outsized returns.

As the debate over inflation and interest rates rages, keep in mind research by Elroy Dimson and Peter Marsh suggests smaller companies deliver superior long-term returns. We believe businesses' best defence against inflation is continual investment in innovation and new products.

It's no surprise the emotional pendulum continues to swing from one side to the other, taking markets with them. A major economic recovery comes with greater likelihood of inflation, and the mood music on central banks' quantitative easing bond purchases is already changing: the US Federal Reserve has signalled it may wind down its programme earlier than expected.

On the other hand, there are uncertainties on the road to recovery: a surge of new variants, an onset of 'pingdemic' related isolation that prevents factories from opening and stops workers earning money. Some business leaders say they sense the possibility of disruption into 2023. Many rule out any 'financial market bubbles', but economic overheating from excessive optimism and constrained supply features in their checklist of potential corrections.

Small, innovative and popular

A robust economic outlook bodes well for smaller companies, as they tend to be most sensitive to a domestic rebound. Continued inflows to UK smaller company funds signal that prospects remain strong. UK companies have long been recognised as undervalued, but recently the Brexit-induced discount slapped on them has reversed aggressively. This has coincided with a raft of new joiners to AIM, which is encouraging to see. To May's end, the Investment Association calculated an extra £760 million was allocated to the IA UK Smaller Companies sector of funds, the same period in 2019 saw £50 million outflows.

Having amassed gigantic amounts of 'dry powder' in recent years, private equity investors have recently pounced on grocery giant Morrisons, pharmaceuticals business UDG Healthcare, property trust St Modwen Properties and several other FTSE-listed businesses. Much smaller companies are also being snapped up, including Typhoo Tea. This buying spree is unlikely to end here - limited defence mechanisms for quoted companies lifts the risk of takeovers and mergers. Private Equity would cite onerous UK Governance and listing rules to tempt managers away from an IPO with the bonus of greater ownership. The private equity 'raid' is underway.

Is my password strong enough?

Cyber criminals are incredibly agile and innovative in exploiting weaknesses in company IT systems. Serious corporate hacks have only increased as more companies have been catapulted into greater digitisation by the pandemic and remote working. High-profile ransomware attacks have plunged many companies into shutdown, exposing their customers to fraud. Some of these companies never return.

The market for fraud protection software is worth an estimated $18 billion each year and is set to grow at almost 13% until 2025. Existing techniques can only go so far, with anti-tracking technology making it difficult for companies to understand customers' identity while meeting data protection and regulatory challenges. D4t4's Fraud Data Platform catches the fraudster before the fraud, helping businesses protect their customers. D4t4 builds a profile of each customer, whether their actual identity is known or not, analysing their behaviour in real time to detect payment, account opening and remote account takeover fraud as it happens. Your profile could include signals as subtle as screen touch pressure and swiping speed with your historical profile.

D4t4 has its roots in gathering real time data to analyse and understand customer behaviour, and ensure regulatory compliance. The group is moving to a higher rate of renewal revenue, which will provide greater visibility of earnings. The near-term drag on profits of investing in its own fraud prevention solution has opened up a significant market opportunity. Just the sort of innovation we love to see.

The Budget

Chancellor Rishi Sunak's March Budget left plenty of room for tax rises in the autumn. However, Mr Sunak's Autumn Statement and any accompanying tax rises may now be delayed until spring — potentially scrapping the third Budget in as many years. These delays allow the Office for Budget Responsibility a better picture of the job market as furlough comes to an end in September, and the latest wave of COVID-19 infections starts to crest.

Inheritance Tax reform is not limited to the UK, the OECD has recommended changes to support COVID-ravaged economies. IHT is in the spotlight as the UK's Office of Tax Simplification recommendations were released in 2018 and 2019 followed by the All-Party Parliamentary Group's 2020 report. Inheritance Tax represented 0.2% of national income in 2019/20, and while it isn't enough to plug the deficit, the government has committed to respond to the IHT recommendations in due course.

Portfolio strategy

This portfolio takes a long-term approach to investing, targeting AIM-traded companies to qualify for relief from inheritance tax.

The Alternative Investment Market (AIM)

AIM set out in 1995 to provide smaller, growing companies earlier and more efficient access to the public markets. AIM hosts 826 companies with a combined £147.0 billion in value; 25 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. Existing AIM companies raised £5.3 billion of fresh capital in 2020, and 2021 is continuing that momentum with £3.5 billion raised in the first six months. New entrants to AIM has also increased not dampened investor demand for new issuance. A receding influence of miners and oil and gas ventures from 47.1% in March 2011 supports the junior market's growing maturity.

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 the FTSE AIM All-Share Index returned 4.5%. 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: 1.4% of 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.

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