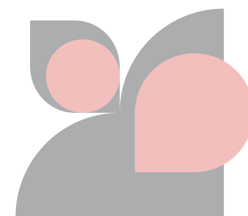

Rathbones Specialist Tax Portfolio Service (STPS)

Business relief (inheritance tax relief) mandates

Q1 2022 report

Previous commentaries have begun with the long view - highlighting difficult-to-solve problems and how companies in our portfolios are well positioned to address them. We believe the UN's 17 Sustainable Development Goals provide guard rails to tackle structural issues - antimicrobial resistance, an obesity pandemic, slowing global workforce productivity - which helps spot companies that should still be relevant in 10, 20 years' time and beyond.

The horror of war

As 2022 began, anticipation of conflict in Ukraine and rampant inflation swung the attention pendulum from the long view to the here and now. As Ukraine was plunged into war, distressing scenes of destruction and a growing humanitarian crisis weighed on hearts and markets; the conflict has led to economic instability, widening geopolitical fault lines and a measure of paranoia on both sides, summoning ghosts of the Cold War. In markets, this intense focus on near-term tragedy created a noisy, crowded rush for certainty in uncertain times that led to soaring demand for some assets while others became less than compelling to the masses. Many commodity prices skyrocketed, as did the companies that supply them. Meanwhile, 'growth' companies that forego profits today in the hope of delivering much greater returns further down the road were sold aggressively. US stock market volatility as measured by the VIX Index surged three times during the quarter, peaking on 7 March at 36.4, a rapid rise from 17.2 at the end of 2021.

As the human cost in Ukraine ratchets up, sanctions are rippling through Russian society. The Russian economy is expected to shrink between 8% and 10%, while inflation is expected to average roughly 20% this year. Meanwhile, much of the central bank's foreign reserves have been frozen, limiting Moscow's ability to make international payments. Fast-spreading Omicron infections have led to lockdowns in Shanghai and other important Chinese cities - yet another shock to battered global supply chains.

The US central bank raised interest rates by 25 basis points in March to cool the economy and rein in inflation. This pushed up short-term bond yields, leading to worries about a hard landing. It's possible that interest rates will be calibrated just so, reducing inflation while preventing economic contraction. The Ukraine war has complicated this, however, sparking a surge in prices of oil, gas and food. Investment bank JPMorgan believes the probability of recession is between 30% and 35%. The brief inversion of the yield curve - when short-dated bond yields exceed those with longer terms - signalled doubts on the economy's longer-term prospects . This phenomenon has generally been a reliable predictor of past recessions - albeit with a long and growing lag - but not necessarily a trigger of recession.

While the mood music is downbeat right now, this is only a point in time. Sentiment is weak and stock markets have already priced in very difficult times ahead. 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 staying put.

A tough quarter for small cap UK (again)

Smaller company yardstick, the FTSE AIM All-Share Index, dropped 14.2% over the quarter, with January proving particularly difficult, declining 9.9%. The hardest hit were quality growth companies - those with above average quality and growth in earnings that typically command premium valuations. They experienced the greatest de-rating in this rotation, which meant they handed back a proportion of 2021's exceptional gains. Sentiment towards smaller companies weakened as central banks started winding down their quantitative easing asset purchases. This has pulled capital away from high-growth businesses whose prices tend to be more sensitive to changes in prevailing interest rates (or 'long duration' in the lingo).

Fund managers have retained an underweight UK position for many moons now. Yet over the last 12 months sterling has fallen 4.5% against the dollar, reflecting the UK's deteriorating economic outlook and potential for a misstep for interest rate policy. Since quarter end the pound's fall has accelerated, down 5.7% as of writing. UK assets are increasingly better value for large US private equity

Rathbones
Look forward

investors, whose inflows surged 48% in the second half of 2021 compared with H2 2020, according to consultant PwC,with uncommitted capital growing 17% a year since 2015 reaching a record $1.8 trillion in January 2022.

Businesses are feeling the pain as dynamic pricing strategies kick in to recoup higher costs. The cost of UK haulage has especially rocketed, hurting British importers. Developments like these could change capital allocations and investment decision-making. The impact of inflation and disruption has not entirely derailed UK GDP, which rose 0.1% in February, putting it 1.5% higher than February 2020, albeit largely attributed to COVID-related healthcare spending. Forecasts suggest a recession can't be ruled out and that stagflation is a clear and present danger.

Inflationary concerns continue to linger – the Office for Budget Responsibility expects inflation to reach 9%. Interest rate rises, a tool to control output and temper demand, are expected to peak at 1.8%, requiring multiple rates rises from 1.00% – longer term ambitions of 2% inflation could require more substantial upfront moves, which would further unsettle markets.

So where does this leave smaller companies? An indiscriminate rotation away from 'growth' and higher-risk businesses has resulted in a major valuation reset regardless of quality. Recent results from our portfolio companies show that this is a contraction of price-earnings 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 our opinion.

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' assets of cash, gold and oil. Some of this sell-off will no doubt be due to fund redemptions leading to asset sales – likely at the wrong point. In better times this also operates in reverse, when inflows find their way into stock markets.

Not all bad news (again)

Consumer health and pharmaceutical company Alliance Pharma delivered double-digit organic growth, better-than-expected earnings and a significant step up in gross margin (sales/cost of goods sold). The improvements were assisted by Alliance' first full year of owning Amberen, the over-the-counter relief of menopause symptoms. Alliance has reliably delivered growth through innovation and development in consumer healthcare brands and cash-generative prescription medicines. This creates a robust base for financing acquisitions, most likely in the $260 billion e-commerce consumer healthcare market, which already accounts for 25% of Alliance's sales. The Group's growth ambitions centre on continued leverage of star consumer brands from a sustainability framework and a focus on supply chain management having achieved carbon neutrality in 2022.

Our portfolios have no exposure to two industries that experienced major uplifts over the period: defence companies that stand to benefit from increased defence spending over the medium term and the energy sector, particularly gas producers, that gain from sky-high fuel prices.

Connected healthcare software and services provider EMIS Group announced annual results that beat already upgraded expectations. EMIS Health owns a 58% share of the GP market and EMIS Enterprise commands a 39% community pharmacy share; however, it is EMIS X that could transform healthcare by accelerating efficiency and growth in these areas. The Hepatitis C Trust state that 69% of people who have the virus are currently undiagnosed – artificial intelligence is built into the core EMIS product to identify hepatitis C virus risk factors in patients to help NHS England and Ireland's ambition to eliminate the virus by 2030.

Legal services consolidator Knights Group highlighted the impact of COVID-related absences on productivity during a key trading period. Revenues to April 2022 are expected to be only marginally below expectations, but Knights has high operational gearing – it has a lot of fixed costs rather than costs that rise and fall as sales fluctuate. This means the small drop in sales will significantly reduce its profits. Analysts have slashed their guidance in response. Is Knights a canary in the COVID coalmine, or is it simply having trouble bedding in recent acquisitions? What's clear is that Knights has much to do to rebuild confidence and we continue to monitor developments.

RWS Holdings' recent trading update at the lower end of guidance was explained by weakness in the intellectual property service business ahead of the new EU Unitary Patent regulatory change. This is a cheaper and better standard for protecting new technology and ideas that has been on the horizon for many years. RWS has also been hit by reduced demand for Russian translations. Investment in growth at the expense of margin is often characterised as pushing the self-destruct button, yet RWS is a quality business investing up to 7% of revenue in capital expenditure to help its fastest-growing divisions maintain their competitive edge. This is why we're comfortable looking past the short-term disappointment in sales.

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.

Corporate activity

Triton's initial £8.83 offer for Clinigen increased to £9.25 valuing Clinigen at £1.2 billion. The takeover completed in the 2021/22 tax year and where relevant will be reflected in end of year tax statements. The proceeds were credited to accounts on 14 April 2022. We believe that takeovers of cash-generative, quality UK companies could continue.

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 issues. Specifically, board composition - centring on director over boarding, independence of the Chair, diversity, succession planning - and pre-emption rights, where Rathbones encourages investee companies to commit to follow the Pre-Emption Group guidelines to protect existing investors interests. We will be communicating further on our stewardship activities.

The Spring Budget

UK Chancellor Rishi Sunak presented the Spring Statement on 23 March, introducing a series of measures to support businesses and boost productivity and GDP growth by allowing companies to invest, train and innovate. An extension of the £1 million Annual Investment Allowance supports capital expenditure. No changes were announced on Inheritance Tax reform; the Treasury's response to the Office of Tax Simplification recommendations in November 2021 including consideration of business property stated, "the Government has decided not to proceed with any changes at the moment."

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.

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 844 companies with a combined £125 billion in value; 26 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.

From September 2018 all AIM companies adopted a governance code and then 'comply or explain', increasing disclosure and confidence.

Existing AIM companies raised £6.8 billion of fresh capital in 2021 second only to 2007's £9.6 billion. New entrants to AIM totalled 87 raising £1.8 billion in 2021 and reform of the UK capital markets regulatory regime should ensure capital raising in the UK remains competitive and in a dominant position in European growth markets.

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 fourth quarter the FTSE AIM All-Share Index declined 14.2%. 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 18.4% 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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