Rathbones Specialist Tax Portfolio Service (STPS)

Business relief (inheritance tax relief) mandates

Q1 2021 report

NASA's $2.2 billion Perseverance Rover descended on the red planet's Jezero Crater on a mission to find evidence of past life. Critical to microscopic rock sample analysis is an acousto-optic tunable filter engineered and supplied by our investment **Gooch & Housego**. This great UK business provides industrial optics for jobs where reliability, control and repeatability can't be compromised: undersea cabling for telecoms, wind farm directional sensing, Mars exploration and much more. Diversifying into aerospace and life sciences places less reliance on 'cyclical' industrial lasers, which are in any case now showing signs of a sustained recovery. This is just one of many fascinating enterprising businesses that fly, er, above the radar in the UK.

You would think that managing smaller company investments is all about the individual stories of specific stocks like Gooch & Housego – and you'd be right most of the time. Good quality growth companies emerge regardless of the cycle – but it's always wise having an eye on the wider economic picture, especially in our increasingly interconnected world. Gilt yields soared from 0.20% to 0.85% over the quarter, implying that a faster pace of economic recovery will push inflation higher. Meanwhile, pandemic-related supply shortages in semiconductors and commodities are also likely to contribute to an inflation spike. However, we think this should ease as trading normalises. This is important as there's an inverse relationship between a pick-up in inflation and asset pricing. It also encourages some investors to adjust their portfolios to try to take advantage.

Fund managers and larger investors who run bigger portfolios that include all sorts of different assets (rather than focusing on one area as we do) often use smaller companies as a proxy for investing in a domestic economy. Their idea of small is relative – typically any stock with a market value of £2 billion or less. With that in mind, you can see how macroeconomic developments that change the countries investors want to invest in can have an influence on the prices of smaller companies. Brexit disruption was initially contained by a boost to EU exports and stockpiling in late 2020. Traders appear to have adapted well to new conditions for goods. Sterling rose almost 5% against the euro over the quarter, the Brexit 'reset' helping our smaller companies with a UK economic tailwind. However, peeling back the layers, there's a proliferation of over-leveraged British businesses in significant financial distress: 723,000 according to RedFlagAlert. That's a jump of almost 100,000 in a single quarter, with double-digit increases in 19 of the 22 industries monitored. This underlines the need for us to be cautious about which companies we put your money in.

The main takeaway is that macroeconomics influences near-term decision-making and unloved styles – like 'value', which are more dependent on economic ebbs and flows – have their time in the sun. Smaller companies' superior returns over the longer term have been proven – albeit alongside greater risk and volatility. We believe our bias to quality, profitable smaller companies, that benefit from long-term growth themes like healthcare and technology should reward longer-term investors.

A shot in the arm

December's vaccination race gathered pace, though a resurgence of new COVID-19 cases in the UK left the government little choice but to lockdown on 4 January to avoid overwhelming the already pressured NHS. Britain outlined an immunisation programme to pave the way for a four-stage reopening 'roadmap' to 21 June, giving the greatest chance of a sustained recovery. Faced with links of the AstraZeneca vaccine to blood clots, regulators moved the narrative towards the benefit outweighing the risk. Vaccine nationalism – always a fear – raised its head as EU leaders considered export controls.

As lockdown restrictions eased, economists and bankers exuded confidence in a rapid near-term recovery. Markets continued their upward trend. A successful UK immunisation rollout has allowed the UK to stick to its reopening plan to date, potentially unleashing £180 billion of household savings into the reopened economy. That's about 9% of pre-pandemic UK GDP. News like this led investors to start aggressively buying those companies most exposed to reopening: retailers, leisure and industrials. Business and consumer confidence are approaching pre-pandemic levels, retail sales were stronger than expected during lockdown, and most economists are predicting a meaningful rebound in GDP in the second quarter.

Rathbones
Look forward

Put the kettle on

Strix, the kettle safety controls, water filtration and small appliances business, was a major contributor to our returns in the quarter. Commanding 55% of the kettle control market, Strix ferociously defends its intellectual property (IP) to prevent counterfeits – two hallmarks that haven't changed since my work experience there in 1991. Strix's acquisitions of IP-rich water product businesses Laica and HaloSource operate in high-growth and often-regulated markets improving household and agricultural water quality. As a bonus, this is helping society achieve the United Nation's Sustainable Development Goal of clean water and sanitation. Management has outlined an ambition to double revenue by 2025, which wouldn't be possible without a programme of continued innovation.

In 2020 we saw a rush of technology investment and digital transformation projects, putting in place infrastructure and products to provide services quickly, efficiently and cost effectively. Tightening public sector budgets and increasing demands accelerate the need for this investment and consultancy The Panoply's innovative solutions are helping this transformation. More than 70% of its revenues are from public sector. Local authorities use Panoply to streamline processes and outcomes in employment support and social care. One example is FamilyStory, a case management tool that improves social worker productivity by allowing them to collaborate, share experiences and reduce administrative burdens. Panoply has a strong social purpose message reinforced by non-executive director Isabel Kelly, founder of Profit with Purpose, who helped establish Nasdaq giant Salesforce's philanthropic foundation in the early 2000s.

Rolling out a mass vaccination programme has many logistical challenges, from manufacture and supply through to recording each jab. That record keeping is covered by the Outcomes4Health software owned by EMIS Health, one of our holdings. An innovative, digitised UK healthcare system that allows all parts to interact with each other benefits us all. EMIS will have much to do with this evolution, as it is the dominant supplier of software to UK GPs. Diagnosis of 80% of pancreatic cancer cases happen too late to save people; however using AI to analyse primary care data could bring forward diagnosis by up to two years. As the clinical data platform for more than half of British GPs, EMIS-X has enormous amounts of patient data available for analysis. EMIS is collaborating with large pharmaceutical companies to develop a neural network – a computer system modelled on the human brain – to discover early warning signs of atrial fibrillation (which causes irregular heartbeats). This is just one of countless potential projects that could make use of EMIS's data.

We felt the probability of an increase to games studio Electronic Arts' £6.02 per share all cash offer for Formula 1 videogames developer Codemasters was high. Yet as time passed, the lack of a counter-offer suggested a valuation ceiling had been reached. We are sad that we didn't get to see how far Codemasters could have gone on its own, but *c'est la vie*. As soon as the deal completed and the cash had landed we moved it quickly into other holdings. In these portfolios cash isn't your friend because it doesn't qualify for Business Relief meaning we don't have the luxury of a defensive asset to protect value during market downturns. As venture capitalist Bill Gurley says, "the best way to protect yourself against the downside is to enjoy every last bit of the upside".

We added another videogame developer to our portfolio this quarter. Frontier Developments is renowned for its genre-leading, engaging, cinematic simulation games, like Zoo Tycoon and Jurassic World Evolution. I've been positive on the increasingly mainstream and fast-growing videogaming sector for some time. The sector is moving swiftly to digital delivery (downloads not CDs) and it has the seeming ability to grow in any economic climate. Frontier is a 'hybrid', publishing both its own games and other studio's work under the Frontier Foundry label. This latter business is poised to scale up title releases. Frontier's 'launch and nurture' strategy meets customer demands and its record to date is impressive, with four successful titles under its belt.

The Budget

Chancellor Rishi Sunak's 'build back better' Budget created mass speculation, but the excitement was in the travelling, not the arriving. Manifesto promises and popularity preserved, there's plenty of room for tax rises in the autumn. Inheritance tax and capital gains tax reform have been placed in the spotlight by the Office of Tax Simplification – incredible when both contribute only a modest amount to the public purse. If starting from scratch, the Treasury wouldn't design the current system, but any wholesale reform – no easy task – needs to provide a solid return on investment for the Treasury.

Portfolio strategy

This portfolio takes a long-term approach to investing, targeting AIM-quoted 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 822 companies with a combined £137.3 billion in value; 27 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 £1.5 billion raised in the first quarter; a lack of new entrants to AIM has 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-quoted 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 the FTSE AIM All-Share Index returned 3.7%. 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 too: 1.4% of constituents account for 22.7% 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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Important information