Rathbones Specialist Tax Portfolio Service (STPS)

Business relief (inheritance tax relief) mandates

Q3 2021 report

Accelerating inflation, stressed supply chains, staff shortages and wage inflation are all bearing down on business leaders. More than ever, in the digital age employees are an organisation's most valuable asset and wages a significant chunk of operational costs. So what happens when wage demands increase from a workforce that is ever more likely to find something better?

Meeting wage demands is hardly a sustainable solution on its own. Businesses face deep-rooted and structural issues when it comes to the workforce. Pay inequality remains for women and minorities. Also, there is a huge geographical divide in wealth, infrastructure and institutions that flows through to pay, opportunities and productivity and quality of life. Demographics are not favourable - an ageing workforce means an ever-shrinking pool of talent and experience. Recent policy changes, combined with a post-lockdown surge in demand for labour, have brought a taste of this phenomenon into the present. It has helped push wages and inflation higher as well. Yet the pandemic has sparked a revolution in work that could help ameliorate these labour problems by making work more accessible and efficient.

Let's get productive

Sustainable businesses are those that focus on continuous improvements, on striving to do more with the same resources of money, tools and people. Keeping this edge on competition is tough and never ending, but this is what productivity looks like. Arm in arm with this is meeting the workforce's own needs. A work/life balance, job security, genuine career progression, an enjoyable role. Good businesses realise that employers and workers typically benefit and suffer together on this point: happy workers are more engaged, relaxed, better decisionmakers and more likely to interact well with clients; angry, stretched and underpaid ones tend to make mistakes and gripe to potential leads.

Often businesses can squeeze workers in their attempts to eke out that improved productivity and better profit margins, but this isn't a solid long-term strategy. Talent and skills are lost to more enticing employers and the business ends up giving back its unsustainable, short-term operating improvements in greater staff turnover and associated costs.

As with most things, this means investment in proper tools for the job. These days, that overwhelmingly means digital transformation, something that the better businesses have been working on for some time already. The pandemic has just made the lesson even more abundantly clear. But throwing money at problems is never enough: accelerating and maximising digital transformation still requires an engaged, continually up-skilled workforce and thoughtful management.

This post-pandemic flurry of flexibility could be a once-in-a-century opportunity to reform the way business is done. The Fordist system of mass production redesigned employment with the promise of higher wages and job security - breaking with convention. Ultimately, business leaders need to consider the long term and what first-class employment looks like. To get there they will need to listen to employees, communities and customers. Encouraging talent management and learning strategies that are effective and measurable leads to a continuous reskilling essential in adapting to ever-changing market conditions.

Learning Technologies Group (LTG) is a leader in the high-growth workplace learning and talent industry, guiding its clients through training strategy and offering analytical insights into their human resources. Online learning is incredibly efficient and LTG uses games and new technologies to make complex subjects engaging for global audiences. Everything from climate change and sustainability issues to enterprise skills and compliance topics. LTG's tools help companies achieve workforce equity, by optimising affirmative action, diversity and inclusion programmes. The $394 million purchase of GP Strategies follows a well-executed acquisition strategy by LTG since its flotation in 2013 that establishes it as a leading global workforce transformation business. GP Strategies enhances LTG's proposition, adding expertise in new growth areas and creating cross-selling opportunities across 6,100 customers. This should lead to better profit margins and significant improvement in earnings per share.

Rathbones
Look forward

Sterling's pounding

In the final week of September the pound slipped by 1.8% against the dollar, erasing all of sterling's 2021 currency gains as uncertainty mounted on Britain's economic prospects.

While that's bad news for the pound in your pocket, it was good news for several of your investments that make much of their sales in the US. Trading internationally has many advantages, from larger addressable markets to a wider pool of workers and suppliers. Foreign exchange movements can be another advantage, with the power to supercharge earnings, but they can be sting on the downside as well.

Earlier this year, sterling marched ever higher and in June hit highs not seen since 2018. The stronger pound meant sales made in dollars converted to fewer pounds, crimping earnings growth. However, this works in reverse as well. So the more recent sterling weakness gave these foreign-earning businesses a tailwind over the third quarter: clinical research organisation Ergomed +12%, LTG +14% and technology-enabled language and intellectual property services provider RWS Group +11%, compounded by all of them making major North American acquisitions in the past couple of years.

Spiralling energy bills from Europe-wide gas shortages add an unwelcome brick in the inflation wall of pain, chipping away at households' spending money. This discretionary cash is vital to the consumption-led recovery. Without a fix, record high gas and electricity prices will add to inflation and likely cause knock-on price increases because of higher input costs for goods and services, that would themselves drive demands for higher pay.

Pressure is mounting on central banks to raise interest rates to counter this surge in inflation. According to investment bank Citi, Brits expect UK inflation will average 4.4% over the coming year. Bank of England Governor Andrew Bailey's stance moved from 'patience' - as inflation continued to press ahead of the 2% inflation target - to a belief inflation will experience 'some levelling off'. Likely bristled by reports of stubbornly high rates Governor Bailey conceded 'we must act' as the Bank revised up near-term inflation expectations steadily throughout the year. The possibility of a rate hike as early as November was priced in; however, Governor Bailey has since rowed back from this.

Still, expectations of multiple interest rate rises by the end of 2022 are baked into UK markets. There's a growing belief among investors that, despite the urge to tighten interest rates, it would be a policy misstep. Rates could well peak in 2022 then ease in 2023 when the demand-supply imbalances level off. Many observers note that interest rate rises can't cure labour or energy shortages; interest rate levers are effective against managing demand not supply.

Borrowers are in the best of times. Access to credit is very easy, interest rates are super low and the real value of debts is being eroded by very high inflation. Private Equity aren't the only buyers or borrowers in town, well-financed corporates have been buying up businesses as well. Take for example healthcare administrative systems supplier Craneware which shelled out $400 million for a Florida-based rival; Ergomed which bought Ashfield Pharmacovigilance for $10 million in cash; RWS Group's £622 million all-share acquisition of SDL; and, of course, LTG's previously discussed purchase of GP Strategies.

Major reinvestment programmes often still receive the cold shoulder from public market investors because near-term profit margin is given up for the longer-term productivity gains. However, as we discussed before, this is crucial for businesses to sustain any success. This investor short-termism often tends to give us better opportunities to add to our holdings; however, it really needs to be addressed if our British companies are to grow into giants on the world stage.

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 835 companies with a combined £148.7 billion in value; 28 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 £4.5 billion raised in the first nine months. New entrants to AIM has also increased with £1.2 billion raised by new entrants to AIM so far this year. 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 third quarter the FTSE AIM All-Share Index declined 0.1%. 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 19.7% 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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