Rathbones Specialist Tax Portfolio Service (STPS)

Business relief (inheritance tax relief) mandates

Q4 2019 report

Portfolio strategy

Our strategy is to invest in AIM-quoted companies that should qualify for relief from inheritance tax. We invest new money quickly to ensure investors reach the two-year holding threshold for tax relief as soon as possible. A near-fully invested position is held throughout the portfolio's lifetime and we take a long-term investment approach.

The Alternative Investment Market (AIM)

AIM launched in 1995 to help smaller companies access capital with greater regulatory flexibility than the Main Market. Since December 1995 AIM has grown from 10 companies with a total value of £82 million to 863 companies valued at £104 billion in December 2019. AIM remains a venue for early-stage company initial public offerings (IPOs) while home to 16 companies valued at over £1 billion.

The Rathbones investment philosophy

We prefer profitable and established UK-based AIM-quoted companies with sustainable growth and strong competitive advantages, whether secured through acquisition or investment in innovation. These are companies we hope to be talking about for decades to come, so having confidence in management's abilities is vital. Our portfolio is spread nationwide and across sectors, generating a meaningful proportion of its revenues from doing business overseas. Most of our holdings have relatively little direct exposure to consumers.

Market commentary

A decisive Conservative election victory brought the political deadlock to an end. Euphoria proved short lived, however, as the reality of formulating substantial trading relationships quickly set in. Prime Minster Boris Johnson's preference for a 'bare bones' deal to conclude the process by the end of 2020 still leaves the door open to the possibility of a no deal. Growth in services has been muted and manufacturers were hit by deferral of investment and periods of idleness driven by Brexit-related stockpiling. Still, this did little to deter investors: UK equity fund inflows surged to their highest level in five years. Household spending had been a bright spot for the economy, but this dimmed towards year-end.

Increasing geopolitical tensions, trade barriers and domestic policy uncertainty were largely to blame for the IMF's downgrade to global growth projections in October. Although, the IMF may have moved too soon. In December, there was a notable de-escalation of trade tensions between the US and China, who outlined an interim deal that cancelled planned new tariffs. Published in December, Absolute Strategy Research's quarterly survey illustrates the power of a trade truce and supportive central banking policy: investors cut the chances of a recession by 13%, encouraging news for risky assets.

Financed by low costs of borrowing and large capital inflows from pension funds or sovereign wealth funds, private equity buyouts rose 4% globally to $479 billion in 2019, the highest value of buyouts since 2007. Managers are under pressure to deploy capital, resulting in fierce competition for good quality - and often quoted - companies. This trend is unlikely to reverse in 2020.

Investment manager's commentary

Small and mid-cap stocks, generally perceived to be most sensitive to the UK's domestic economy, have felt unloved by investors since the Brexit referendum in summer 2016. Often cited as a barometer for the health of the wider British economy, AIM IPOs were lower than any other year since the launch of the market. December's resounding election result boosted confidence in the UK's economic prospects, helping the UK-centric AIM All-Share and the FTSE 250 indices surge 10.2% and 10.4% over the quarter. Renew Holdings (+40%), a provider of engineering services that repairs and maintains critical UK infrastructure such as rail and waterways, proved to be a beneficiary of this improving domestic sentiment. Renew is well placed on longer-term, highly visible maintenance contracts and has potential to grow through making acquisitions as well.

Over 2019 we added several new holdings, including Keywords Studios and Sumo, which both operate in the fast-growing and overlooked UK video gaming sector, part of a global market that's estimated to reach $178.2 billion by 2021, according to the NewZoo 2019 Global Games Market

Report. Both Keywords and Sumo are lower-risk plays on the sector because they aren't dependent on the success of individual game titles – something that can be problematic for investors trying to value future cash flows. Big video game producers, like Microsoft, Google and Tencent, increasingly outsource development to well-resourced, specialised operators such as Keywords and Sumo.

We highlighted our concerns with M&C Saatchi in the third-quarter report, so it should come as no surprise that we sold the name in December. Saatchi issued a second profit warning following accountant PwC's review that unveiled a series of failings in Saatchi's financial reporting – much more than initially speculated by management. Saatchi had a history of strong cash generation and dividends; however, the reputational damage in a highly competitive industry increases forecast risk.

A comment on relief risk

The second half of the Office of Tax Simplification (OTS) review into inheritance tax was released on 5 July, sparking speculation on the future of AIM shares and Business Relief eligibility. As it stands the OTS's recommendations to the government for further consideration are entirely that: recommendations. There has been no response from the Treasury so far. The potential for removal or restriction of Business Relief is a feature of our higher-risk Specialist Tax Portfolio Service. Policy speculation tends to rise ahead of the Budget and Chancellor Sajid Javid's maiden statement will be delivered on 11 March 2020.

Liquidity risk

2019 was another memorable year for investors. Overall, stock markets did very well; however, many were burned by property fund freezes and the downfall of star fund manager Neil Woodford. In his heyday, the contrarian, outspoken manager took large positions in unloved stocks and had the foresight to sell banking stocks ahead of the financial crisis. All of which turned him into a household name. In 2013, after years of stellar performance, Mr Woodford left Invesco Perpetual to launch the Woodford Equity Income Fund the following year.

At its peak, Mr Woodford's fund boasted £10.2 billion, but flagging performance and a dubious amount of unquoted companies began a prolonged period of redemption requests. Having to sell the larger and easier-to-sell assets to meet these outflows made the proportion of illiquid and unquoted holdings swell further. Investor withdrawals continued which culminated in a liquidity crisis in June as Kent County Council attempted to encash their holding equal to 7% of the fund. Suspension of trading – in effect, trapping investors – was the only route to protect the fund and its holders from further, unsustainable withdrawals. Asset sales in poor market conditions rendered unachievable a planned re-opening of the fund in December; on 15 October the fund was closed for good and Mr Woodford was ousted. The first distribution from the wind-up of the fund is due in January, but realising unquoted positions has proven problematic, with delays and discounts likely. Little consolation for investors expecting 'bank account' like accessibility to their money.

This later stage of a bull market, accompanied by multi-year monetary policy easing, leads many investors to place greater value on instant access or liquidity when considering the downside risks. Potential contagion when one fund turns off the withdrawal taps has become a hot topic, leading open-ended, smaller-company funds to explain how they can cope with redemptions.

How accessible are our AIM IHT portfolios? Usually, AIM shares are treated as harder to sell so let's take two scenarios: 'business as usual' and then if the market is affected by some material policy changes.

- We remember all too well the rapid deterioration of market conditions in late 2018. The tide of capital pulled away from risky assets, sometimes at any price; yet this tide returned in early 2019. This is an example of how the illiquidity premium (the extra return you need to take on difficult to sell assets) changes with the sentiment towards risky assets. During the uncomfortable fourth quarter of 2018, however, AIM portfolio withdrawals were very small.
- Government policy is supportive of AIM and its entrepreneurial companies that create jobs, improve productivity and foster innovation. Inheritance tax (IHT) relief, ISA eligibility and stamp duty exemption go some way to encouraging longer-term investors to own these less-well-known smaller companies, which have lower levels of research coverage than larger companies. The IHT concession is a valuable component and the Labour Party's stance on IHT during 2019 prompted speculation on the future of AIM portfolios – as did the OTS review. Accurately gauging the impact on values from an outright removal of the relief is difficult as there is no precedent. AIM IHT portfolios only account for a modest-single-digit percentage of the AIM All-Share so a removal of the relief, while initially painful, would not necessarily put a stop to investment demand, and most companies would continue to still trade profitably regardless of any flux in their share registers.

In the case of Mr Woodford's fund, expectations of instant access to cash were not aligned with reality and rightly raised the profile of liquidity again. Smaller companies are inherently harder to sell, so they tend to attract patient investors prepared to commit part of their capital for long periods of time. AIM IHT portfolios add an extra dimension for patient investors who are willing to lock away their capital in exchange for a generous tax concession.

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Important information