Rathbones Specialist Tax Portfolio Service (STPS)

Business relief (inheritance tax relief) mandates

Q4 2020 report

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. Today AIM hosts 819 companies with a combined £131.1 billion in value; 24 ventures are valued at over £1 billion co-existing with a vibrant venture capital market and early stage opportunities in the lower tiers. In contrast to most UK indices the FTSE AIM All-Share Index delivered remarkable returns in 2020; existing AIM companies raised £5.3 billion of fresh capital in 2020, mainly for 'in demand' technology and healthcare names at attractive entry points, contributing to AIM's positive returns. A receding influence of miners and oil and gas ventures compared with a decade ago supports the junior market's growing maturity. A continuing theme has been the lack of new entrants to AIM, however. In 2020 AIM attracted the fewest this century, accounted for, in part, by companies shying away from listing in such volatile times.

The Rathbones investment approach

Targeting 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 it's vital we have confidence in their management. This is a bottom-up stock selection approach with little direct exposure to the consumer, avoiding airlines, retailers and pawnbrokers. Banks, resources, recruiters, and car dealers also don't meet our criteria.

Benchmark

As a benchmark for Specialist Tax Portfolio performance, the FTSE AIM All-Share Index isn't entirely ideal. Not all AIM shares qualify for Business Relief meaning the relevance of the index is limited for this portfolio strategy, whose principal motivation is the tax concession. The FTSE AIM All-Share Index is highly concentrated: 1.4% of constituents account for 24.2% of the index's total value; retaining these high-value names affirms AIMs reputation, but significantly influences overall performance of the index. To sum up, an AIM quotation is a key characteristic of our offering, however, the index has limited application other than a rough indication of smaller company performance.

Market commentary

The fourth quarter's early mood music was sombre. Economic momentum stalled as the domestic economy, heavy in the service sectors, was again pummelled by localised lockdowns. Pace of pharmaceutical progress proved too slow, the inevitable cycle of lockdowns threatening the solvency of domestic leisure and hospitality sectors gasping for state aid and some promise of vaccine. Civil unrest in the US brewed as elections neared and Brexit tensions rounded off the many stressors building doubt and chaos for an uncertain few months ahead.

November delivered the hope of a panacea. Positive vaccine news upended sentiment as trials for the Pfizer/BioNTech inoculation showed over 90% efficacy. The sunny uplands of a post-pandemic world with free movement and improving economic growth came into view and markets responded firmly in 'risk-on' mode. Vaccine approvals in December ramped up optimism on a COVID-19 exit in a month of crushing economic reality. Democrat Joe Biden was confirmed as President-Elect, with Republican calls of voting fraud were largely discounted accordingly. Mr Biden pledged to re-join the Paris agreement and bring the US to net zero emissions by 2050, boosting international climate action. Christmas Eve's welcome conclusion of the EU/UK trade negotiations helped sterling's recovery; curiously, since June 2016 Sterling has fallen 8.8% against the Euro.

Rathbones
Look forward

Investment manager's comment

Smaller companies rallied in Q4, sentiment improved on positive news flow and capital continued to flow to riskier assets. This last point has been a feature ever since governments and central banks' massive interventions earlier in the year reversed the fear of collapse to a 'fear of missing out'. Your quarterly portfolio returns were particularly strong, as were those for smaller company indices; in the difficult first quarter of 2020, our portfolios generally outperformed those indices due to our model's preference for quality, well-resourced growth stocks. This provided a degree of defensibility in a risky asset class. However, in the final quarter, assets displaying conservative profitable growth and cash flows have largely been sidelined in favour of high-sales-growth-at-all-cost ventures consuming vast sums of capital. No longer weighed down by Brexit a rotation towards the 'value' trade and lowly rated domestic cyclicals has been vaunted by brokers; however, this has not led to any changes in our thinking or style.

I'll mention interest rates, operating at near or below zero, after inflation is accounted for, and set to remain so for the near term. Low interest rates are designed to stimulate activity in the wastelands of COVID-ravaged economies. Frail economic growth is likely until at least herd immunity sets in and meaningful levels of inflation elude us. A golden combination of lower interest rates and inflation, an oversupply of capital and a growth mindset is supportive of our profitable growth-orientated strategy. Those explosive growth ventures we mentioned before could well continue to feed off boundless optimism, yet we don't like the risk of a stampede for the exit when profitability never arrives. Elevated pricing is often justified in a low interest rate environment as investors seek out higher risk-adjusted returns, creating the disconnect between stock markets and economic reality. Considerable risks remain to the stabilisation and growth of economic activity, questions on solvency and the impacts of changing global supply chains remain unanswered. And central to all these considerations is the co-ordinated global rollout of the vaccines.

Post-deal, UK stocks should now attract asset allocators, especially given the devaluation of sterling against the euro since June 2016, which is helpful for cross-border transactions. Remember, private equity dry powder remains high and the cost of capital is low, which is supportive of M&A; UK asset pricing and competition for assets is elevated too, leading to low absolute returns. The picture for 2021 is far from clear. While macro conditions are supportive, there will be a day of reckoning for overvalued assets, and the cycle will roll round once again.

Our strongest contributor in the quarter was Ergomed. Earnings were upgraded again following its December acquisition of MedSource, a US-based clinical research organisation specialising in oncology and rare diseases. Management continues to perform well against strategic goals, increasing exposure in the fast-growing North American markets. Ergomed is rapidly becoming a specialist mid-tier operator with clout.

Lockdowns encouraged many kids – and more than a few adults – to boot up games consoles and buy videogames. This has simply accelerated videogaming's multi-year shift to the mainstream, a theme we have been investing in for some time. Keywords Studios' focus on acquisitive growth has increased its earnings and boosted market share. Developer Codemasters, one of the oldest British studios, attracted two takeover approaches, most recently from US giant Electronic Arts at 604p. Investors sense the probability of a counter bid in a fast consolidating sector is elevated, as the shares were trading at premium to that offer. Shareholders vote on the deal on 3 February.

Internet sales now represent 36% of total retail sales in the UK. Unsurprisingly, retailers are actively increasing their online marketing campaigns. A direct beneficiary of this is our holding Dotdigital. This marketing platform allows retailers to communicate with customers by email, mobile, social media, website or chat, and helps companies stay in front of its customers to generate sales. Dotdigital received two upgrades in Q4, confidently stating expectations for the full year would be exceeded – a benefit of its highly visible revenue model and continued investment in new products.

Our primary detractors were consumer-exposed Churchill China and Nichols. Churchill makes ceramic tableware. It has taken the opportunity to deploy the masses of cash it stored up for most of the year, investing it to grow market share, yet over-servicing clients at a point when competitors are bleeding capital. This made some investors nervous, but we have faith in the longer-term strategy. Nichols' core Vimto cordial business is trading well, but its out of home business has been hurt by shuttered cinema chains and trampoline parks, where its Starslush slushie drinks are distributed. Solvency risk for both Churchill and Nichols is low with liquidity levels high.

Learning Technologies Group (LTG) – a leader in the workplace digital learning and talent management market – announced acquisitions, consolidating its share of the attractive open-source Learning Management Solutions market. To do this, it invested part of the £81.8 million raised in June 2020. Meanwhile, LTG's earnings were upgraded and more acquisitions are anticipated in 2021. Continuing the educational theme, Tribal Group has been added to our buy list. Tribal is a UK leader in providing student management systems to the world's leading educational institutions, including Oxford University and Russell Group universities. In December, Tribal announced an eight-year £16.9 million contract with Nanyang Technological University, in Singapore, that covers the entire student journey. These contracts are long-term and highly visible, and contract momentum is building for Tribal's strategically relevant online product set.

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