Rathbones Specialist Tax Portfolio Service (STPS)

Business relief (inheritance tax relief) mandates

Q4 2021 report

Global emergencies are recognised as major catalysts for rapid innovation and acceptance of new technologies. The World Health Organisation (WHO), the United Nations' health agency, set a target for 70% of the world to be fully vaccinated by July. The first vaccine outside of clinical trials was administered on 8 December 2020. That's a tremendously swift pace.

'Superbugs', a silent pandemic

Global vaccine equality is needed to shift COVID-19 from pandemic to become endemic - where disease is constantly present with predictable and consistent levels - joining the ranks of the common cold, chicken pox and past flus. Many novel developments in biotech are overlooked by the well-resourced pharmaceutical giants because of the intensive and costly research and development (R&D) needed and the long payback profiles. They don't tend to get interested till the later stages when the science has been proven. The response by big pharma on COVID was a rarity, but a champagne example of a global emergency encouraging investment and development. There has been no such big bang development to combat antimicrobial resistance, one of the top 10 global public health threats recognised by the WHO and what the European Medicines Authority describes as a "silent pandemic".

The overuse of antimicrobials, allied with the power of evolution, has created drug-resistant pathogens, or 'superbugs', which leave antibiotics ineffective and even common infections increasingly difficult to treat. More than 1.2 million people died from drug resistant infections in 2019 and past predictions forecast 10 million deaths a year by 2050. That staggering number, five times the number of COVID deaths recorded in 2020, is now thought to undershoot the likely reality. This would be a huge hurdle for the world to hit the UN's Good Health and Well-being Sustainable Development Goals.

Superbugs aren't a recent development and the belief is that the pace of vaccine development should translate into tools for the fight against antibiotic-resistant bacteria. Antibiotics are needed to treat an enormous range of conditions. Not just sepsis or ear infections but also to reduce the risks of hip replacement surgery, organ transplants and chemotherapy. Healthcare options become extremely limited - or more dangerous - without antibiotics. So with existing medicines becoming increasingly ineffective in the fight against superbugs, the development of new antibacterials should be a massive priority. However, the clinical pipeline is limited. In 2020, the WHO identified 43 in clinical development, none of which are sufficiently innovative to address the problem.

Drug development innovation stems from small, mainly private companies with limited resources, not large well-resourced pharmaceuticals. It's seen as too high risk, particularly given the options to invest in assets capable of superior returns, such as blood pressure treatments. The destruction of an antibiotic-resistant pandemic has no precedent, and will require a coordinated effort, a fair allocation of resources, and the combination of impact investing and strong incentivising government policies. While this is an overlooked area, it is of vital importance, typically a confluence that makes for promising investments. It's a high-risk area, though, so we feel it's best to invest in the 'picks and shovels' of the industry - the suppliers of the gold rush, if you will.

Instem recognises life sciences' relentless drive for R&D productivity and counts all top-25 pharmaceutical and biotech companies plus chemical and contract research organisations, and research institutions among its customers. Instem supplies over 600 clients with breakthrough technology and services that help access, capture, manage and enrich a vast range of data and biological insights. Instem claims that approximately half of the world's pre-clinical drug safety data has been collected over the last two decades using Instem software. Instem's products and services cover the entire drug development cycle from discovery to market launch. This breadth has been strengthened through acquisition, most recently with The Edge and d-wise Technologies. Most of Instem's business is focused on enabling companies to gain faster and cheaper routes to market within strict regulatory guidelines known as SEND, essential in the approval process for new drugs. Instem is highly innovative,

Rathbones
Look forward

allocating £3.4 million into R&D during 2020, continuing a long-term approach that generated £2.5 million of profit before tax at a 9% margin of sales and brought in £6.9 million of net cash from operations.

Soaring infection and inflation

Dominant themes of inflation and interest rates carried over into the fourth quarter, with news of a potentially vaccine-resistant South African COVID variant, Omicron, sent markets reeling. Instinctively markets drew parallels with the Alpha and Delta variants as transmission rates rose sharply and renewed restrictions were implemented in several nations in early December. Omicron proved a less harmful strain than Delta, its partial vaccine resistance countered by an emphasis on booster jabs. Analysts believe that medium-term UK economic growth will be no worse off from the Omicron surge.

Britain's 2% mid-term inflation target compares with a 5.4% increase in the UK's cost of living in 2021. The Bank of England (BoE) is expecting inflation to hit "around 6%" in the spring. Goldman Sachs predicts inflation will peak at almost 7% in April as increasing energy bills fan inflation and a cost of living crisis - not all of the £260 billion lockdown savings are equally spread. Major economies have recovered quickly from the COVID waves of 2021, exposing low Russian gas stock levels. UK gas prices had soared 700% in the year to mid-December, before falling back to a level 200% higher than where they had started. Geopolitical tensions rose as accusations surfaced of Russia cutting gas supplies to exert pressure over Ukraine. Importing 90% of its gas, the EU - like the UK - must place greater emphasis on renewables, alternative generation and storage.

Central bankers' talk of transitory inflation has faded recently - the thesis remains that inflation effects are mostly short-term consequences of pandemic-related supply shocks. However, just how long they will take to unwind, and what knock-on effects they may have, is an open question. The BoE unexpectedly hiked rates to 0.25% from 0.1% in December after resisting earlier calls to do so. Investors are expecting several interest rate rises in the UK, perhaps as much as four more. Both the BoE and the Fed have made surprisingly aggressive changes to their policy stances at recent meetings, the Fed is targeting a taper of the scale back of massive pandemic stimulus by March 2022 as well as the first of multiple rate hikes.

A tough quarter for small-cap UK

The fourth quarter proved tricky for smaller company investors, with a clear disconnect emerging between 'growth' companies and large-cap, inflation beneficiaries like oil majors and miners. Smaller company yardstick, the FTSE AIM All-Share Index, declined 1.9% over the period rounding off 2021 +6.1%; the Rathbones IHT composite delivered a positive out-turn for Q4 and outperformed the AIM All-Share over 12 months.

Sentiment towards smaller companies weakened over the quarter, as the tapering of central bank asset purchases drew capital away from high-growth assets, especially those with back-end-loaded earnings that are most exposed to sustained inflationary pressures. Profit warnings from index heavyweights ASOS (-20.5%) and BooHoo (-43.0%) weighed on index returns.

According to a December survey by Bank of America, fund managers are still overweight equities, with a preference for conventional 'inflation assets', high earnings visibility, global leaders and structural growth themes. The UK remains an underweight position for most. This could be related to the longer-term consequences of Brexit discouraging asset allocators despite the attractively valued mergers and acquisition opportunities that abound.

A proxy for the health of the economy and business confidence is the number of smaller companies raising money. In the UK a total of 87 companies joined AIM, raising £1.85 billion in 2021. The net number of AIM companies added was 33, the largest annual increase since 2007.

Broker Berenberg quoted five attributes that indicate a company's inflation resilience: high operating margins, high margin stability, operating margins' sensitivity to inflation, a high degree of operating leverage (i.e. costs don't rise as much with higher sales), and high levels of R&D as a proportion of sales. These characteristics are echoed throughout your portfolio. Recent fundraisings to finance acquisitions across portfolio companies - more recently, Ideagen, Keywords Studios, GB Group - have diluted existing shareholders, but the benefits of well-executed acquisition programmes should be positive to longer-term growth and supercharging the above five attributes.

Not all bad news

A major contributor to our quarterly returns was Clinigen. Following a sustained period of difficult trading, earnings downgrades and high leverage, Clinigen received a takeover approach by a private equity buyer. Shares traded at a premium to the offer price, indicating that a further offer can't be ruled out. Another strong performer this quarter was Ergomed, whose upgraded interim results were accompanied by a reassuring trading update for its contract research organisation and drug safety business; analysts see near-term catalysts for an increase in the price-earnings ratios of further acquisitions, mindful of reversing foreign exchange headwinds now that US business accounts for 63% of revenues.

Our experience in the videogaming sector has been positive with two takeovers, specialist racing studio Codemasters in February 2021 and contract game developer Sumo, due to complete in January 2022. We adopted a basket approach to this sector, which has reduced the stock-specific risk profile of the multi-year videogaming growth story.

Frontier Developments announced that initial sales of two large title releases - Elite Dangerous: Odyssey and Jurassic World Evolution 2 - failed to meet expectations. Multiple game releases created congestion, increasing forecast risk over the key Thanksgiving and holiday season. Dotdigital's sharp multiple de-rating was at odds with 23% organic revenue growth in 2021, a 31% increase in recurring revenues and confident outlook. The expansion of Dotdigital's price-earnings multiple in the first three quarters of 2021, fuelled by investment, collapsed as management committed to margin preservation over 'growth at any cost'.

During the quarter, we have started to introduce new names to our portfolios. These companies are aligned to our interest in good quality, durable businesses whose markets are growing faster than GDP. Next Fifteen Communications is evolving from a digital media agency to a data and technology-led growth consultancy. GB Group provides digital identification services all over the world, benefiting from strong demand. Next Fifteen's strategic acquisition of Acuant, a US-based identity verification and fraud prevention solution, boosts its footprint in the important North American market. UK-based Smart Metering Systems enables the smart grid, delivering efficient power generation and consumption through index-linked smart meter rental contracts and an attractive grid-scale battery opportunity. CareTech is a UK-based care service provider with a sector-leading care model for individuals with complex physical and cognitive challenges. These are specialised services that local authorities can't deliver.

Recovery in elective surgery volumes and significant year on year growth in the surgical and woundcare divisions reignited interest in Advanced Medical Solutions. This year heralds several product developments, including a high-gelling bandage with antimicrobial biofilm activity that is on track for a launch in the US. This development of alternatives to antibiotics to help wounds heal and stave off infection is a fantastic development that should prevent the overuse of antibiotics.

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 852 companies with a combined £150.0 billion in value; 30 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. From September 2018 all AIM companies adopted a governance code and then 'comply or explain' increasing disclosure and confidence. Many AIM companies are transitioning to a low-carbon economy. Existing AIM companies raised £6.8 billion of fresh capital in 2021 second only to 2007s £9.6 billion. New entrants to AIM totalled 87 raising £1.8 billion in 2021. 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 1.9%. 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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