RATHBONES

RATHBONES SPECIALIST TAX PORTFOLIO SERVICE (STPS)

The Specialist Tax Portfolio Service team

Q2 2023 REPORT

STAYING THE COURSE

We are in a very different environment to the ultra-low interest rate era that followed the Great Financial Crisis of 2008. Interest rates in the UK are expected to rise to close to 6% early next year, a level not reached since 2007. As a result, depositors have not had it so good for some time and bonds are back on the agenda. Investors continue the rotation away from 'risk-on' assets in response to the uncertainty presented by inflation. Asset allocation remains a stock market headwind: June marked the 25th consecutive month of outflows from UK equity funds, meaning fewer institutional buyers of UK quoted companies, and the volume of shares traded on the AIM All Share is currently down by around 50% year-on-year.

This leads to a sense that the UK market is unloved and under-owned, with fewer institutional buyers of UK smaller companies. The second quarter was another difficult period and the Bank of England's interest rate hike to 5% - a response to persistent inflation - fuelled greater interest in the risk-free asset category in June. Over the three months, the FTSE 100 declined 1.8% but the AIM index fell by a much sharper 6.3%, illustrating how the market is judging riskier assets. The AIM 100, which tracks the largest companies on AIM, dropped by 7.3%. Yet UK recession has been avoided and the bottom-up picture shows that valuations are unarguably attractive by historical standards.

Furthermore, management teams now have better visibility for earnings forecasts, with many reporting an easing in supply chains, global freight costs normalising to $1,500 per container (from a peak of more than $20,600 per container in 2021) and inflationary pressures de-escalating. In the closely watched Purchasing Managers' Index (PMI) surveys, global manufacturers have reported falling input costs – the price they pay for goods and materials – for a couple of months. This has put a lid on consumer pricing. A stronger pound also exerts extra downward pressure on imported goods prices. Supply shocks that contributed to surging inflation last year are fading, energy price inflation has dropped and there are signs food inflation will ease too.

For smaller companies whose appeal to investors is typically closely linked to the domestic economy, these are all helpful conditions to stem sliding confidence. However, asset allocators will need proof that interest rates are in fact approaching the peak before reassessing the economic temperature.

A pressure point has been UK household and commercial loan refinancing over the next 18 months, as lending terms tighten. There's less emphasis on the political risk in the UK as we approach a General Election, with investors' focus remaining firmly on inflation as the core threat to the economy. However, Andrew Bailey, the Bank of England Governor, has given guidance that inflation will fall "markedly" by the end of the year following an "unacceptably high" rate of price rises.

We are mindful that investors' view that the UK backdrop is tough will do little to lure investors away from the 'risk free' trade, despite negative returns after adjusting for inflation. Travelling to a recessionary environment often proves more uncomfortable than arriving and depressed share prices, exacerbated by forced share sales, can lead to wrongly priced opportunities – opportunities which canny investors are taking advantage of. A careful selection of resilient, predictable, and well-equipped market leading businesses with sound growth prospects shouldn't be confused with those on the cusp of failure, but often during times of market stress investor caution overrides company fundamentals.

Smaller companies historically lead market rebounds because their illiquidity is favourable to valuations in a recovery – because of the shortage of shares available to buy, even a moderate rise in demand can push up share prices sharply. Moreover, over the longer term, quality small caps deliver superior returns. Maintaining conviction in the investment policy should prove well placed and rewarding in future years. "Things will get worse and there will be massive opportunities", stated Katie Koch, CEO of US asset manager TCW, in a May 2023 Financial Times article. "The greatest wealth creation opportunities come out of a recession and excesses."

MAKING THE HEADLINES

Rathbones' STPS composite fell by 2.7% in the quarter, outperforming the AIM index by 3.6 percentage points. Stocks that held back portfolio returns in the quarter included **Learning Technologies**, **RWS** and **Keywords Studios**. Below we explore developments at these companies.

Learning Technologies (LTG) helps large corporations create digital learning systems to improve workforce productivity. Its stock has underperformed the market in recent months because customers are taking longer to decide to use Learning Technologies services – a common trait of more cash-conscious climates. Its integration of GP Strategies also encountered challenges in the first half of the year, but management has reacted swiftly, and these issues are now resolved. We believe these are temporary obstacles being navigated but, at an all-time low valuation of 8.7 times next-12-month earnings, the market is unfairly valuing the company as no longer a growth stock. Even after factoring in recent challenges, LTG still expects to generate roughly the same level of profit this year as in the previous financial year and is forecast to slash its still modest debt pile by 35%. The market's discounting of the company feels excessive, but a catalyst is required to change the market's mind. Our case for investing in the company is based on LTG's potential to profit from its enlarged scale, its policy of filling in gaps in its services through quality M&A and a continued move away from one-off to regular revenues. With the financial strength to make acquisitions, and against the backdrop of a growing $107bn global digital learning market, we believe LTG has a good chance of continuing to grow earnings per share for shareholders.

RWS uses artificial intelligence-enabled technology and human expertise to help companies translate content (such as patents) across many countries and languages. As with LTG, its business has been impacted by softer demand and "slower decision-making" across some segments as customers pause spending amid evolving financial conditions. The debate currently centres around whether these are temporary or more permanent setbacks. We lean towards the former. Management suggests headwinds should ease in the second half of the financial year and has recently reported strong levels of customer retention. At current levels, a return to modest organic growth – growth without acquisitions – could drive a meaningful share price recovery. The company is a leader in what remains a large, fragmented market growing faster than GDP. We are encouraged by RWS buying back up to £50m of its stock and continue to monitor it for signs of underlying improvement.

Keywords Studios, which provides services for video game and interactive content companies, has seen its stock fall 33% as investors consider possible disruption to its business model from artificial intelligence. For this reason, the company's market cap is down £714m from its peak. We believe this reappraisal is premature because of the company's good track record of evolving with, and integrating, new technologies. As with RWS, Keywords has been incorporating artificial intelligence into its products and services for several years. It retains its position as the largest player in a vast and growing market for outsourced services in the video games industry. That said, this is a fragmented market – even as the largest developer, its market share is only 5%. This leaves plenty of room for growth.

The equity performance of these companies has been frustrating, but there are signs of real value in this market. As with Learning Technologies, on a next-12-month basis, Keywords Studios' stock has never been so lowly valued (15.4 times earnings). RWS is at 8.8 times, its lowest multiple since 2008. Morgan Stanley has recently noted in The Telegraph, that "British companies are the cheapest in the world"; we think this discount will diminish as overseas buyers of UK stocks re-emerge.

THE CONTRIBUTORS

Companies whose share prices have risen in the period include **Renew Holdings**, **Craneware**, and **Judges Scientific**.

Renew Holdings continues to demonstrate a resilience in its business that we believe is underappreciated. Its trusted position as a major player in the UK infrastructure sector, where it maintains critical assets, ensures a steady flow of work. Meanwhile, the commercial terms of its framework agreements have enabled it to handle inflation well. The group's stock valuation suggests to us it remains underappreciated despite strong operational performance. The amount of cash generated by a company after all its expenses are covered is a valuable measure for investors, as it shows cash available for company management to redeploy into internal growth opportunities. This measure remains highly encouraging in Renew's case – testament to the management team's excellent capital allocation discipline over the years. We believe this company deserves more credit so should continue to provide a good return on investment for shareholders in the years ahead.

Craneware's share price has recovered some 27% from its March low. Its Trisus software is critical to thousands of hospitals across the US, and its resilient recurring revenues – revenues from continuing contracts rather than one-off deals – is an attractive feature of the business. However, organic growth – growth without M&A – has moderated in recent years after a period of exceptional growth and its professional services division has encountered headwinds due to a lack of staffing at hospitals, exacerbated by people leaving healthcare because of COVID-19 burnout. The positive share price performance is welcome but further progress requires a return to higher levels of organic growth. We believe Craneware has the expertise and market position to accomplish this but appreciate that its US hospital customer base is still working through some post-

COVID pressures. Recent company commentary gives cause for optimism here, with early signs of recovery.

Judges Scientific buys and invests in profitable, growing scientific instrument businesses. The recent large acquisition of Geotek, which enables mining and energy companies to analyse samples of rock and sediment, has driven strong results over the past year, adding evidence of this management team's ability to buy smartly and grow earnings over the long-term. The near-term outlook looks promising as the strong order book is set to be converted into revenue. With the founder and CEO David Cicurel continuing to hold a large stake in the company – currently 11.4% – we are confident that Judges will retain a keen focus on growing shareholder value in the coming years.

STILL GOOD PROGRESS

Importantly, portfolio company fundamentals remain strong. Profits are still growing, and corporate finances remain in good shape (over half have no debt whatsoever). Valuations don't reflect these strengths. Many companies held by us but not covered in this report have met or exceeded expectations with their profit announcements this year – and often raised guidance for profits in the year ahead. These companies include Cerillion, Bioventix, CVS Group, Alpha Financial Markets Consulting, Smart Metering Systems and Elixirr.

Our strategy remains proactive. The portfolios have limited exposure to the high street, the over-extended consumer and sectors prone to controversy. We instead focus on quality, growth companies with sound long-term prospects that we believe will offer profits resilience even against a more recessionary economic backdrop.

We see extreme investor caution in the market right now, with sentiment dominated by inflation risk. Catalysts for an improvement in conditions likely include further evidence that inflation is moderating and that we are at, or near, the peak in terms of interest rates. We would also expect markets at some point to start looking beyond the current set of economic challenges, towards recovery and growth. When this happens, smaller companies should once again start to deliver the kind of returns that they have historically been capable of. In the meantime, compelling value exists at current levels.

STEWARDSHIP

As a responsible investor, Rathbones prioritises engagement where it can make the most impact in addressing systemic environmental and social challenges and add value to clients' portfolios. During the reporting period, Rathbones engaged with a number of portfolio companies on a variety of ESG (environmental, social and governance) issues. Following engagement, we will be monitoring diversity, pre-emption rights, director independence, director-over boarding and putting remuneration reports to 'Say on Pay' shareholder votes.

PORTFOLIO STRATEGY

This portfolio takes a longer-term approach to investing. Rathbones invests in AIM traded companies that stand up in their own right while qualifying for relief from inheritance tax.

ALTERNATIVE INVESTMENT MARKET (AIM)

AIM set out in 1995 to provide smaller, growing companies earlier and more efficient access to the public markets. In June 2023 AIM hosted 792 companies, a fall from 816 in December 2022 due to a subdued IPO environment – six IPOs were completed in the second quarter – and trading related de-listings or acquisitions. The market cap of AIM's constituents totalled £81.4 billion in June 2023 – a decline from £150 billion at the close of 2021. This testified to a continuing difficult period for growth companies. There are 10 ventures valued at over £1 billion, co-existing with a vibrant venture capital market and early-stage opportunities.

From September 2018 all AIM companies adopted a governance code and then a policy of 'comply or explain' with the UK Corporate Governance Code. This increased disclosure is building confidence in this market.

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 second quarter of 2023 the FTSE AIM All-Share Index declined 6.3%. We use this as a benchmark for Specialist Tax Portfolio performance though it's not ideal because it's 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: the 10 largest constituents account for 18.8% of the index's total value. The index truly has limited application other than as a rough indication of smaller company performance

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For further information (including the amounts covered and the eligibility to claim) please refer to the FSCS website www.fscs.org.uk.

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