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Value vs growth in volatile markets

Close Inheritance Tax Service

Last summer, we explored how investors could use Business Property Relief (BPR) to help mitigate the impact of Inheritance Tax (IHT) on their legacy. By investing in qualifying companies quoted on the Alternative Investment Market (AIM), full relief from IHT, currently levied at 40%, is possible in as little as two years. The Close Inheritance Tax Service (CITS) has enabled access to this attractive relief since 2001 in simple, transparent portfolios with investors retaining access to their capital.

Over the last 10 years, investing in smaller companies has been a successful strategy during an extended bull market which drove equity returns higher. Quantitative Easing (QE), low inflation and low interest rates were at the heart of this run, which was particularly evident on AIM. The two structural reasons for this, namely the inherent volatility of smaller companies and the faster growth profile of AIM constituents, saw the market post strong returns until October 2018.

The liquidity injected by QE caused numerous distortions across almost every asset class. One of these distortions saw AIM, in common with a number of other global equity markets, become a "two-speed" market, where high growth businesses garnered ever higher ratings and lower growth companies were overlooked by investors. This has seen what are commonly referred to as "growth" companies markedly outperform their "value" peers over the last few years.

There is a logical explanation for this divergence in performance. In financial theory, the most reasonable way of valuing an asset is to estimate its future earnings (or cashflows) and discount these for both the cost of borrowing money and the risk of holding those assets instead of cash. By doing so, one can ascribe a present value to an investment. A low interest rate environment places greater emphasis on earnings several years in the future, favouring high growth companies. Their future earnings are greater, and with a lower discount rate (borrowing costs are lower), their present value increases. Where a company's profits are projected to grow at a slower pace, these future earnings (from the same hypothetical base) would be lower, and as such have not seen such an appreciation in the value ascribed to them by investors.

Ultimately, markets have risen as participants have become accustomed to using a lower discount rate for the cost of borrowing and extrapolated that this rate will stay lower for longer, providing a rising tide for all assets. As has happened many times throughout history, many investors became complacent and less interested in how much they were paying for assets and more concerned by how quickly assets were appreciating. We opined that this was a market driven by momentum, not valuation, and that those companies with the most stretched (in some cases stratospherically so) valuation multiples were priced for perfection.

In the last quarter of 2018, investors increasingly questioned the sustainability of a low interest rate environment. The Federal Reserve raised US interest rates four times in 2018 and reduced the size of its balance sheet (Quantitative Tightening) throughout the year, increasing the costs of borrowing in the world's reserve currency. September's Federal Open Market Committee minutes removed a longstanding reference to "accommodative" policy. The European Central Bank (ECB) stopped its latest QE programme in December. All the while, the impact of tariffs on the global economy started to bite, reducing corporate earnings forecasts. These had the combined effect of spooking equity markets and setting off an abrupt correction.

As one might expect, the fastest growing companies, which had been ascribed the highest ratings, were the worst hit. While there was some indiscriminate selling on AIM, there was also a discernible pattern. In spite of unchanged guidance from Fevertree Drinks, boohoo and Hutchison China Meditech, their share prices fell by around 30%. Where high growth companies downgraded their earnings (or posted higher losses than expected), the impact of a lower forecast was a particularly dramatic de-rating. Blue Prism and ASOS (the largest company on AIM in September 2018) saw their share prices drop 53.4% and 60.5% respectively. Between these five companies alone, £7 billion was wiped off the value of AIM.

Against this backdrop, the Numis Alternative Markets Index fell by 20.4%, its biggest quarterly fall since the fourth quarter of 2008. The brunt of this was borne by the biggest companies in the index, with the largest 50 companies on AIM falling by 26% on average. While this was a painful time for all investors on AIM, including CITS clients, there was a large dispersion of published returns from IHT services on the market. The average CITS portfolio returned -13.3% over the quarter, with other providers losing in excess of -25% during the same period.

As it had during the corrections of 2008 and the third quarter of 2011, CITS offered relative protection against sharp falls on AIM. At the heart of this outperformance has been our disciplined approach to investing in smaller companies. By using our own conservative forecasts and using a consistently high discount rate (reflecting long-term average interest rates) we seek to reduce the risk of getting caught up in market hype. This does not mean that we do not invest in fast growing companies, more that we will only do so at a price that represents a discount to their intrinsic value. Although the service has not been immune to indiscriminate market falls, we will never overpay.

Fundamentally, we approach short-term volatility as an opportunity to invest in companies with robust, cash-generative business models at more reasonable levels. Recent falls have meant that the number of companies that fulfil our valuation and quality criteria, many of which we have followed for a number of years, has grown; this has enabled us to diversify and strengthen portfolios. We are confident that this patient approach to investing on AIM will continue to serve our clients well.

Since the turn of the year, more dovish commentary from the Federal Reserve and a new round of stimulus from the ECB have seen markets recover some of the ground lost in the fourth quarter. But where does that leave valuations? If central banks stick to their targets of normalising interest rates and unwinding QE over time, then we can expect further volatility in equity prices as participants acclimatise to a shift in policy that some of them will not have encountered before. For the reasons previously discussed, rising rate environments are positive for companies with strong balance sheets and “value” stocks, especially following an extended period of relative underperformance versus their “growth” peers.

The correction has reminded us that, while certain AIM shares carry some attractive tax reliefs, the market can be a cruel mistress for inexperienced investors. Perceptions of “normal and reasonable” market returns have been reset. Given that investors have a potential 40% “headstart” for IHT, we would suggest that they focus on mitigating downside risk wherever possible. There are a number of ways in which this can be achieved, but consideration should be given to services that offer diversification, a long track record of capital protection in all market cycles (in the context of smaller company investment), an experienced team, reasonable fees and an unblemished record of achieving BPR.

With the potential for more volatility on the horizon, why put your clients’ capital at more risk than is absolutely necessary?