20 MARCH 2020

Market update
Close Inheritance Tax Service

These are troubling times, not just for investors but also for the whole country. We trust that all of our clients and advisers are taking sensible precautions and are staying safe and healthy.

At the time of writing, AIM is down around 40% in March and is heading for its worst month since September 2008 in spite of massive, coordinated action from central banks and governments. There have been few places to hide as global equity markets, corporate bonds and even gold have failed to offer any protection. At times like this it is best to remain patient and to analyse the impact of the external shocks on individual assets. This is helping us to identify our holdings that are likely to experience significant financial distress and to find suitable entry points into great companies. That is where the team here has been focusing their energies.

The current market conditions mean that there are more companies that meet our strict valuation criteria, but there are specific reasons for caution. Obviously, the economic impact of the COVID-19 virus on businesses is foremost among our thoughts.

We will continue to manage the Close Inheritance Tax Service much the same as always, with a view to building diversified portfolios from a group of well-managed and well-capitalised, cash generative companies. Our main area of focus (as ever) is balance sheet strength. This has always been a core part of our approach; we expect to see businesses with a robust financial position and easy access to capital emerge from the current turmoil in a stronger competitive position. However, with an unknown timescale for a return to normal conditions, certain businesses will struggle to continue in their current guise, even once the benefits from the chancellor’s recent measures take hold. Some industries will inevitably face a more significant impact on activity than others.

With portfolios that are broadly diversified by sector, we have experienced heavy paper losses in some holdings, but these have been partially offset by other core portfolio holdings which normally have a negative correlation to other equities. Where we do hold companies in impacted sectors, we are closely monitoring their ability to trade through the disruption. This effectively means an even greater focus on companies’ financial positions and running stress-tested scenario analysis on our holdings, enabled by our in-house financial models.

With the adage “never catch a falling knife” firmly in our minds, we are taking a very cautious view to allocating capital for new clients and in those portfolios where cash balances were elevated following a number of takeovers at the end of last year. When allocating capital, we will do so in a graduated fashion, averaging in to positions. With more opportunities, we are likely to increase the number of holdings to the top end of our usual 25-35 holding range. We would expect to see an extended period of extreme volatility in markets and remind our clients that, in common with 2008/9, this means that prices can diverge materially from what we perceive as their intrinsic values in the short-term.

Although valuations are not quite at the point they reached after the global financial crisis, we see opportunities emerging, particularly for long-term investors like ourselves. It is important to remember that while a recovery to 2019 levels may take some time, the economic impact of the virus (albeit severe) should be relatively short-lived and, given the unprecedented swiftness of the market falls, the psychological impact may be limited.

Following the widespread falls, we will look to add to some of the higher quality companies (those exhibiting predictable earnings, with strong balance sheets, good returns on capital, high levels of cash conversion, excellent management teams, etc.) on AIM and will seek to diversify into sectors where valuations have previously been a limiting factor.

The unprecedented nature of the situation has elicited a huge response from the government and the Bank of England. The speed at which capital can be released into the economy will be vital – delays are likely to cause a slower return to normal once the transitory effects of the virus have passed through the system. Should current measures prove effective, we believe the current market offers an attractive entry point. Even in the event of a delayed recovery, we are confident that the intrinsic value of companies in our portfolios will shine through in the fullness of time.

Most importantly of all, we would like to reiterate our hope that all of our clients, their advisers and their families are taking sensible precautions and will stay safe and healthy. As a team, we are taking the precaution of all working separately, but are in constant dialogue with our investee companies and all of our colleagues here at Close Brothers Asset Management. We are, as ever, happy to field any questions that you might have in these difficult times.