Investment Manager's Report

This report covers the first quarter of the financial year, 1 October 2014 to 31 December 2014.

Investment Report

Major global equity markets endured three volatile months as investors grappled with continued weakness in the Eurozone economies, deflation, collapsing oil prices, Ebola and a slowdown in China. At the same time, the Federal Reserve continued to tighten monetary policy through the winding up of its quantitative easing programme. Meanwhile, the UK continues to look attractive with further evidence of strong and sustainable growth in the economy, strong employment data, sustainably low interest rates and falling food and energy prices. One could argue that the outlook for UK households is better now than at any time since the financial crisis. The same could be said of UK small companies were it not for a few key risks, including the UK election.

It is our view that companies like to invest against a backdrop of regulatory and fiscal stability. To that end, the highly uncertain outcome of the UK election creates risk in the short term as decisions on capital expenditure and employment become more susceptible to delay. Of course, election risk is not unique to small companies; in fact, many possess market opportunities and business models that are well insulated from election risk.

Unfortunately, and despite our cautious optimism, it's been a more difficult market for UK small caps. For the most part, this can be attributed to the general weakness in UK equities that persisted for much of 2014. However, we believe there were two other factors at play within the most recent quarter: (1) elevated market volatility tends to drives investors away from small caps – the so called 'flight to quality'; (2) exposure to oil and gas and related products and services.

In the three months to 31 December 2014, the NAV decreased from 80.31p to 78.11p. No dividends were paid, giving investors a total return of -2.20 pence per share, which translates to a loss of -2.7%. During the same period, the FTSE AIM All-Share fell 6.4%.

The qualifying investments made a net contribution of -1.99 pence per share with 23 out of the 64 making gains, 9 marking time and 32 losing ground. The balance was a mixture of non-qualifying portfolio gains, costs and income.

Advanced Computer Software (+19.9%, +0.70 pence per share), one of our oldest investments, was the top performing qualifying investment following its takeover by a US private equity firm. The acquisition price of 140p per share represented a premium of 17% to the undisturbed share price and a return of 724% over the book cost. Other stocks that made a significant contribution included Cohort (+17.8%, +0.54 pence per share), Abcam (+15.5%, +0.32 pence per share) and Animal Care (+20.4%, +0.28 pence per share).

The biggest loss within the period came from Audioboom (-39.4%, -0.93 pence per share). After a very strong six months which saw the shares rise 1100%, the Audioboom share price suffered a gradual but persistent decline through the quarter as early exuberance was replaced by a more realistic assessment of the challenges the company will face as it seeks to commercialise its foothold in the market for digital audio content. We had thought a material consolidation quite possible and pre-emptively sold a significant number of shares during the initial run higher. Pressure Technology was another that had a particular poor quarter (-43.8%, -0.73 pence per share) as investors priced in the impact of the collapse in the price of oil. Whilst we did not forecast the collapse in oil, concerns about the high valuation had led us to reduce the size of the holding by 25% within the quarter. Looking ahead, the company has released guidance that is consistent with our revised expectations and we feel confident the shares will track higher once the price of oil starts to recover.

We invested a total of £0.9m into four qualifying issues over the quarter, including two additional investments into existing qualifying companies and two IPOs.

The follow-on investments included Advanced Power (electronic component distribution and energy efficient products) and Ideagen (information management software for governance, risk management and compliance).

The IPO investments were Gfinity (eSports competitions) and Midatech (drug delivery technology that uses gold nano-particles).

We made no complete exits from the qualifying portfolio over the quarter. We made partial disposals of our investments in Audioboom, Pressure Technology and Ilika after strong gains in their share prices.

Portfolio Structure

The HMRC investment tests are set out in Chapter 3 of Part 6 Income Tax Act 2007, which should be should be read in conjunction with this section of the interim management statement. Funds raised by VCTs are first included in the investment tests from the start of the accounting period containing the third anniversary of the date on which the funds were raised. Therefore, the allocation of qualifying investments as defined by the legislation can be different to the portfolio weighting as measured by market value relative to the net assets of the VCT. The investment test, as currently measured, excludes monies raised by the Company after 30 September 2012.

Hargreave Hale AIM VCT 1 is comfortably through the HMRC investment test and ended the period with 95.6% of its funds invested in qualifying holdings as defined by the legislation. By market value, the VCT had a 73.6% Weighting to qualifying investments as a percentage of net assets.

The allocation to non-qualifying equity investments increased from 6.5% to 9.8% of net assets, representing the funds small participation in non-qualifying equity issues and IPOs at attractive valuations. We maintained our investment in the Marlborough Special Situations at 0.9% of net assets. The non-qualifying investments contributed +0.06 pence per share to the overall gains. Fixed income as a percentage of the fund fell from 2.7% down to 2.4% and cash ended the quarter at 13.8%, higher than last quarter's 10.9%, following the receipt of funds related to the 2014/15 offer for subscription.

Post Quarter Update

Deal flow has been relatively quiet since period end, two additional qualifying investments have been made in APC Technology Plc and Angle Plc.

Joint Offer for Subscription of Ordinary Shares

On 2 October 2014 the Directors of Hargreave Hale AIM VCT 1 plc and Hargreave Hale AIM VCT 2 plc announced the launch of a new joint offer for subscription of new shares in both VCT's to raise up to £10 million into each company.

Since its launch on 2 October 2014 and the date of this report the offer has resulted in funds being received of £5.5 million by Hargreave Hale AIM VCT 1 plc, and the issue of 7.1 million shares.

Buybacks

In total, 545,418 ordinary shares were purchased between 1 October 2014 and the date of this report, at a total value of £393,204.

Dividends

A final dividend of 2.50 pence per share was paid to shareholders on 28 January 2015 following approval at the Annual General Meeting.

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