Client planning insight

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A brighter way

How to add venture capital to a portfolio whilst considering risk

Written in partnership with HARDMAN & CO.

Early-stage unlisted businesses are becoming an increasingly important part of some client portfolios. Discover why and find out how private market investing could help your clients.

The big shift to private markets

Once the preserve of large institutions, investments in early-stage unlisted businesses are becoming an increasingly important part of client portfolios.

Investors are hungry for targeting inflation-beating returns, diversification of a portfolio skewed towards listed equity and bonds and opportunities to back exciting companies with high growth potential. You only need to look at the growth in crowdfunding platforms to see evidence of this.[1]

With so many investors looking to invest in early-stage companies off their own back, it follows that financial advisers have become proactive and are increasingly advising clients on this area of investing.

This whitepaper covers:

- The case for venture capital in client portfolios.
- Allocating to venture capital while being mindful of a client's overall risk appetite.
- Ways to access investments in early-stage businesses with high growth potential.

Why early-stage businesses can outperform

By investing in venture capital, clients gain access to early-stage unlisted companies. Because of where these businesses are in their growth cycle, they have significant potential for growth. Investors are also taking on more risk when investing in these businesses, because early-stage companies have a higher rate of failure when compared with more mature businesses.

Importantly, microeconomic factors, such as supply and demand or new regulation, can be a significant driver of growth and success for early-stage companies. Uncertain economic environments can also provide opportunities for early-stage companies, because they can be more nimble than bigger established players.

Dr Brian Moretta, Head of Tax Enhanced Services at Hardman & Co, explains: "Macro effects can work either way for venture capital companies. A positive economy can make it easier for a business to scale after product-market fit is found. Recessions can force companies to look harder at how they do things and look for cost savings. For example, the pandemic saw an accelerated uptake of many digital products but devastated some travel start-ups."

What to expect from an early-stage portfolio

Investors looking to access venture capital often buy shares directly in early-stage companies. With this approach, returns are only realised when underlying companies are either sold to another company or list on a stock exchange. Naturally this takes time and investors are unable to access their investment prior to realisation so investors should usually have a 5-10 year investment horizon and an understanding that their investments are illiquid.

By their nature, early-stage companies also have a high rate of failure so it is important that investors are appropriately diversified in their exposure to companies and that they understand how their investment might work.

Investors should expect performance from portfolio to portfolio of early-stage companies to be varied. Returns are likely to be driven disproportionately by certain companies, while others lose all value. For illustration purposes, consider a strongly performing portfolio of ten early-stage companies, which over the course of 5-10 years returns as follows:

- Two companies provide a 10x return.
- Two provide a 3x return.
- Two return capital invested.
- Four companies are written off to zero, for a complete loss of capital.

[1] Mordor Intelligence, Crowdfunding market – growth, trends, Covid-19 impact and forecasts, August 2022.

Bear in mind that this scenario is provided for illustrative purposes, to show the nature of potential returns in a portfolio of early-stage companies. A portfolio could return more or less, potentially falling to nil, and would be affected by fees and charges.

Allocation based on risk appetite

Clients with significant wealth, the appropriate objectives and risk profile may be comfortable taking on more risk with a portion of their assets. Adding investments in early-stage businesses to an existing portfolio lets a client target high-growth and build a riskier portfolio to suit their appetite.

However, newcomers to venture capital investing can wrongly perceive that this is the only way to approach investing in early-stage companies. This potentially ignores the diversification benefits of venture capital within a well-balanced portfolio.

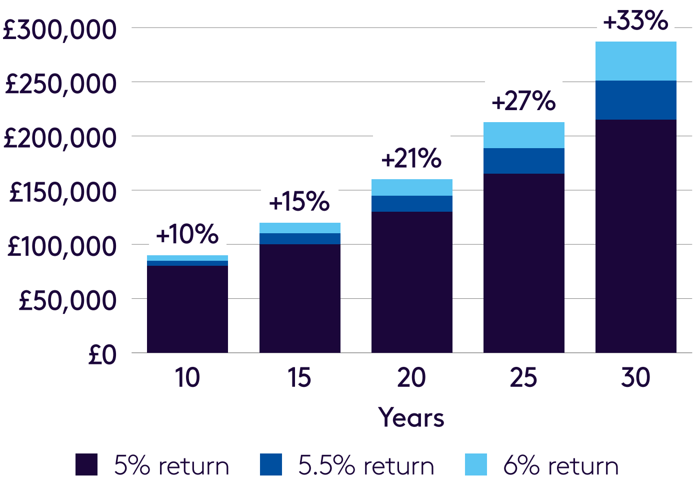
When considering a client's exposure to early-stage businesses, it's important to take a holistic view of a client's portfolio. We need to recognise that a portfolio can be made up of assets that have different risk profiles and different degrees of correlation, while the overall level of risk in the portfolio is at an appropriate level for the client.

Adding venture capital to a portfolio without increasing overall risk

Dr Moretta researched the effect of adding venture capital to client portfolios. Using market data and established research for venture capital, he applied Modern Portfolio Theory to determine optimal asset allocations.

Modern Portfolio Theory looks at risk through the lens of variance (the volatility of returns for each asset class) and uses this to establish the optimum allocation, producing the best return for a given level of risk across a portfolio.*

Fig 1: Effect of adding 0.5% or 1% to annual returns on a £50,000 investment



Source: Hardman & Co Research. November, 2021.

Dr Moretta's research found that by adding relatively small exposures to venture capital, investors can improve potential annual returns by 0.5% to 1%** without changing overall portfolio risk.

While this might not sound like much, the impact of compound returns is significant. The chart in Fig 1, taken from the research shows the effect of adding either 0.5% or 1% to a £50,000 investment returning 5% annually over 30 years.

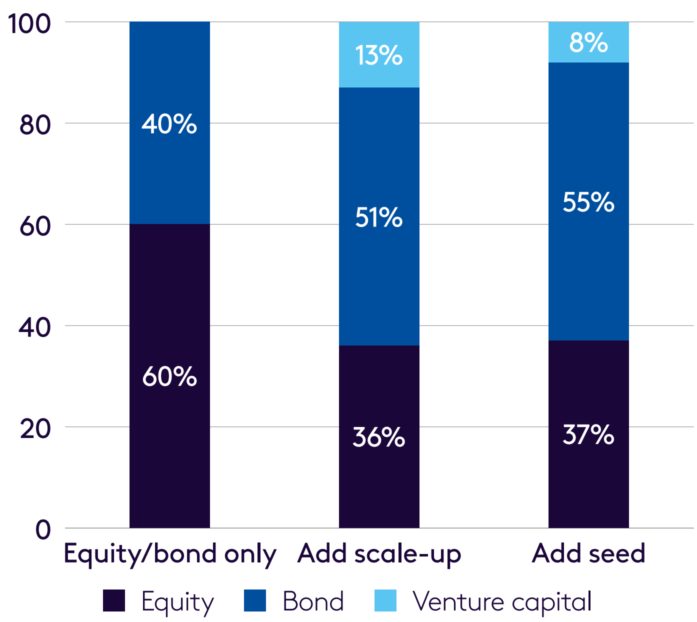
Rebalancing a 60:40 portfolio when adding venture capital

When a portfolio's asset allocation changes across a mix of lower and higher risk investments, the portfolio's overall exposure to risk will change too. However, careful rebalancing can mean that this can be avoided.

The chart in Fig 2 taken from Hardman & Co's research shows how asset allocation might change from a 60:40 equity and bond portfolio when venture capital is introduced, where a client wishes to keep the same level of overall portfolio risk. Allocations are shown for the addition of seed capital (where companies are in product development and finding their first customers) and scale-up capital (investing in distribution having established a product and market).

Dr Moretta explains: "We are adding a riskier asset to the portfolio. It's not simply a matter of leaving the rest of the portfolio unadjusted, or even selling down equities to invest in venture capital. We have to reduce equities by even more and increase the bond proportion to keep the same overall risk."

Fig 2: New portfolio allocations when keeping risk constant and adding venture capital



Source: Hardman & Co Research. November, 2021.

*Remember, Hardman & Co's research assesses risk in terms of variance. Other risks and considerations for suitability will need to be considered, for example liquidity and investment time horizon. Nothing in this document should be viewed as advice. Any suitability decisions should be based on a comprehensive review of your client's objectives, needs and attitude towards risk. **This return figure doesn't consider the impact of any tax reliefs that may be available when investing in venture capital.

How clients can access venture capital

With the inclusion of venture capital in a diversified portfolio, you can potentially raise expected returns while being mindful of an investor's overall risk appetite.

Direct access to early-stage companies for clients outside of family office levels of wealth can be difficult. However, the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) are an attractive and accessible route to diversifying client portfolios with investments in smaller companies. These investment structures make it possible for clients to invest in private companies and claim tax reliefs to compensate for some of the risk they take.

It's worth noting that the potential impact of tax reliefs is excluded from the analysis in this document, making these types of investments even more compelling within a long-term investment portfolio.

> **"There are limited options for retail clients to invest in venture capital. The main options are those available through the tax-advantaged schemes of EIS and VCTs."**
>
> **Dr Brian Moretta**
> Head of Tax Enhanced Services at Hardman & Co

Key risks

- Investments offering exposure to Venture Capital, such as VCTs and EIS, will place capital at risk. Investors may not get back the full amount they invest.
- The shares of small unlisted businesses are high risk, their price may be volatile, and they are harder to sell than listed shares.
- Tax treatment depends on individual circumstances and tax rules could change in the future.
- Tax relief depends on the portfolio companies and Venture Capital Trusts / Enterprise Investment Schemes maintaining their qualifying status.

EIS

Investors in an EIS portfolio own shares directly in a number of early-stage companies, targeting high growth over the long term. Investors can claim generous tax reliefs because of the risks involved. Investors can claim 30% upfront tax relief up to £1 million invested each tax year. Importantly there is also relief on both the upside and downside, whereby gains are tax-free and loss relief can be claimed when a qualifying company returns a loss even if the portfolio is profitable overall. Investors have to hold shares for at least three years and the company must remain EIS-qualifying for three years.

VCTs

VCTs are listed companies that invest in a diversified portfolio of early-stage companies. Investors benefit from the VCT owning small stakes in a large number of companies, typically across different sectors. VCT investors can claim 30% upfront income tax relief up to the first £200,000 invested each tax year, provided shares are held for at least five years. The dividends paid by a VCT can generate a tax-free income.

Acknowledgements

This document draws on the research of Hardman & Co. You can read the full paper here.

Dr Brian Moretta
Brian Moretta is Head of Tax Enhanced Services at Hardman & Co. He is an actuary turned fund manager, who then moved into equity research, and has analysed many EIS funds, VCTs and companies, both listed and unquoted.

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