Does Consumer Duty oblige you to add venture capital to client portfolios?

This article is a summary by Brian Moretta of his Hardman & Co white paper for advisers entitled "How much should clients invest in venture capital?". It was originally published in IFA Magazine's "Enterprise Investment Scheme Report 2023".

Suppose you were told that you could add an asset to client portfolios that would improve expected returns without increasing portfolio risk. Wouldn't you be interested? Wouldn't Consumer Duty force you to be interested?

Now, what if you were told that asset was venture capital? Perhaps some objections immediately come to mind, and, if they do, they probably relate to risk in some way. It is true that individual venture capital investments are riskier than the usual quoted equities or bonds, even after the excellent tax reliefs that SEIS, EIS and VCTs bring. But as a whole, they are also a diversifying asset class, and this is the key to making them essential investments.

Venture capital as a diversifier

Venture capital offers the opportunity to diversify a portfolio

Investors who come to venture capital from quoted equities sometimes think of these companies as smaller versions of listed stocks. However, this isn't right: the companies in which venture capital invests are doing fundamentally different things – for example, startups (seed investments) are trying to find that first customer or product/market fit while scaleups are effectively pushing a new product into a market. How easy or hard these are is almost independent of what the economy is doing, unlike the stock market.

However, returns aren't completely independent. Venture capital companies are largely unquoted, and the main route to exit for investments is a sale to a larger, often quoted, company. There is more demand and higher prices when the latter is doing well, which is usually when the stock market is strong. The net effect is that venture capital is partially correlated with the stock market: academic research suggests the correlation is just under 0.5. For reference, bonds are just under 0.4. So, venture capital is a pretty good diversifier.

Adding venture capital to portfolios

60/40 investors could improve expected returns by about 0.5% p.a. without changing total portfolio risk

In our white paper, we asked the question, "how much should your clients invest in venture capital?" We took a standard asset allocation model, and investigated what happens when you add venture capital with no tax reliefs to a portfolio of quoted equities and bonds. In the paper, we did this for a range of asset allocations, but we focused mostly here on the classic portfolio split of 60% equity/40% bond. This also allows for venture capital being a risky, but diversifying, asset class.

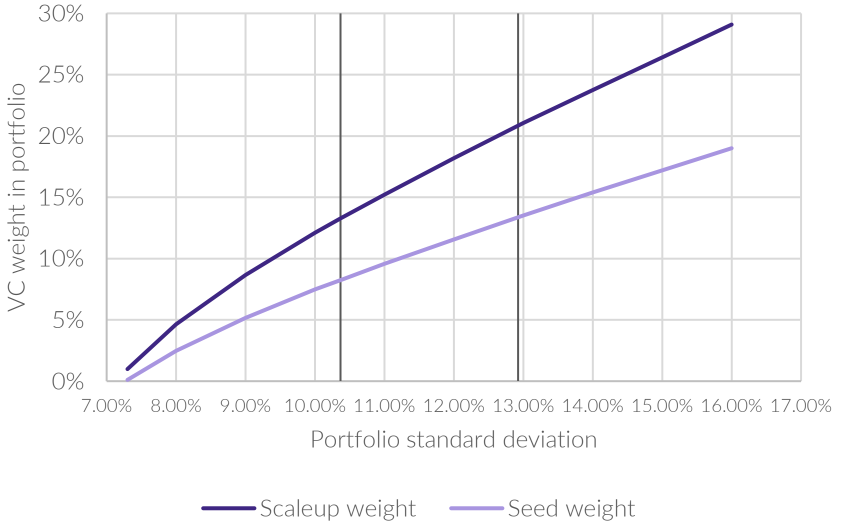
The net result was that 60/40 investors could improve expected returns by about 0.5% p.a. *without changing total portfolio risk*. For 80/20 investors, that improvement becomes 1% p.a. Over time, these compound into meaningful additions to portfolio returns: an extra 0.5% a year is 10.4% more cash after 20 years.

The venture capital market is not homogeneous, with scaleup investment much larger than seed

Asset allocation

The chart below shows the asset allocation to venture capital required to make this change. We split venture capital into seed investments and scaleup investments. The latter dominate overall investments by weight of money, and the companies are generally better developed than seed ones. This means scaleups should fail less often than seed companies, but the expected return should be lower too (although still higher than quoted equities). We would expect most diversified venture portfolios to have mostly scaleup investments and a smaller proportion of seed ones.

Optimal allocation of venture capital in portfolio



Source: Hardman & Co Research

The vertical lines denote the 60/40 and 80/20 investor; the range in between should cover the majority of investors. You can see that the suggested asset allocation will be low double digits for a 60/40 investor, to approaching 20% for the 80/20 investor. Even lower-risk investors should get smaller allocations: the idea that high-risk investments are only for high-risk investors isn't true when assets diversify.

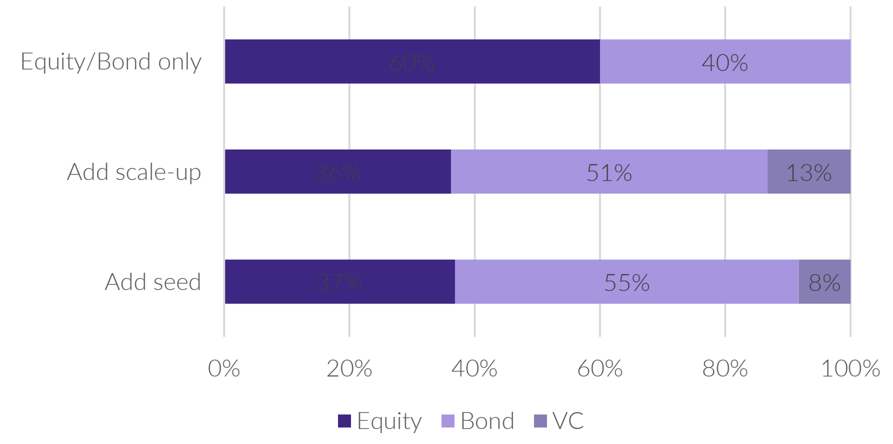
The key to keeping risk constant is to rebalance the other assets too

Rebalancing

However, the asset allocation process doesn't end there. The chart overleaf illustrates the optimal portfolio for our 60/40 investor when adding venture capital and keeping risk constant. It is not simply a matter of adding venture capital, or even substituting it for some quoted equity exposure: additional assets need to be moved from equities to bonds.

Intuitively, this makes sense. We have added a riskier asset; so, to keep risk constant, we need to reduce the risk elsewhere in the portfolio. Fortunately, recent moves in bond yields make that more palatable than perhaps was the case in 2021.

Effect of added venture capital on portfolio weights for 60/40 investor



Source: Hardman & Co Research

Tax reliefs

Find out more about tax relief in the full white paper

Venture capital is hard to access through pensions and mutual funds, so SEIS, EIS and VCTs are the main investment route. Although the tax reliefs are ignored in the above analysis, they are very generous and make investing in venture capital even more attractive!

The analysis also shows that the common strategy of investing solely in pensions until the limit is reached and then looking for the next tax break is damaging to clients: investors are being denied extra return potential. The tax breaks of SEIS, EIS and VCTs mean that venture capital can stand alongside pensions in tax terms, and investments in both should be made in parallel, not sequentially.

Exceptions

Limited exceptions require a different strategy

There are still some investors for who venture capital may not be suitable, but these are quite limited. We suggest three: i) the lowest-risk investors – those with 25% equity exposure or less; ii) venture capital is (mostly) unquoted, with investments being illiquid until an exit event occurs – so those with very limited liquid assets should be careful; and iii) investors with limited assets – they may not have a big enough portfolio to diversify the venture capital portfolio properly.

Summary

If past performance is replicated, you can improve expected returns without increasing portfolio risk

It may sound too good to be true but, if past performance is replicated, you can improve expected returns without increasing portfolio risk. A sprinkling of venture capital should be a normal part of most investors' portfolios. It means taking care with asset allocation, but this is how advisers add value.

To find out more, read the full white paper at *www.hardmanandco.com/tes-white-paper-how-much-should-clients-invest-in-venture-capital*.

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