

UKSA Report on Venture Capital Trusts (VCTs)

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This report has been produced on behalf of UKSA because of the clear dissatisfaction among many holders of shares in Venture Capital Trusts with respect to the performance of some of these funds over the last few years. They also suffer from various failings in corporate governance and other weaknesses that prejudice the interests of shareholders and make it difficult for shareholders to get a clear picture of what is happening to their investment.

The United Kingdom Shareholders Association is the main voice for private shareholders in the UK. In contrast to the situation in most quoted companies, private shareholders are the predominant holders of VCT shares. The author of this report actually has holdings in over 15 VCTs, and is somewhat dismayed by the poor attendance at the Annual General Meetings of these companies and the apparent lack of interest by investors in improving their performance. Unfortunately many shareholders do not realise the failings of some VCTs, and are unable to differentiate between good ones and bad ones. This report is intended to rectify that situation and stimulate more public debate on the governance of such companies.

UKSA has produced a separate document, entitled “UKSA Guidelines for Venture Capital Trusts”, which embodies our proposals and the discussion below is organised and enumerated to match the format of that document. This document simply explains the background to those proposals and gives specific examples for reference. Every attempt has been made to ensure that information provided herein is accurate but if you notice any errors or significant omissions then please telephone or email the author (contact details are above). Likewise if you have any comments on our proposals, or additional suggestions to add to the “Guidelines”, then we would be glad to hear them.

0. The Performance of Venture Capital Trusts. Before looking at some of the UKSA proposals, it is worth reviewing their performance. Have they been a good investment for private shareholders? The answer is yes, so long as you chose the right fund! That is particularly the case if you take account of the generous tax reliefs and the comparative poor performance of the stock market in general over the last few years.

There are several sources of information on VCT companies but one of the best is the Allenbridge Group (see www.allenbridge.co.uk - click on “Tax Shelter Report” - or telephone 0800-33-99-99). They produce very useful reports of comparative performance.

They show for example that at the time of writing, for the VCTs launched in the tax years 1995 to 1997, the Total Return (Net Asset Value plus dividends reinvested) range from 171.90 pence for the best (Close Brothers VCT) to 45.80 pence for Advent VCT. Both had an issue price of 100 pence.

Clearly the latter case is a dismal performance, and represents a negative annual return of minus 10.2% per annum. In fact about half the funds launched in that period show a positive return which is probably acceptable taking into account the tax reliefs available. On average, they have done as well as investment in the FTSE All Share, but obviously shareholders in many funds will have been somewhat disappointed.

If it were possible to improve the performance of the weaker funds to be comparable to the best, then they would all be very sound investments. Alternatively, if investors had some way of identifying those funds that were likely to show better performance, or those that had a better cost structure and sounder management, then likewise there would be fewer concerns. This report and the UKSA Guidelines for VCT companies may help in those processes.

1. Information on Investments. One of the most frustrating aspects of being a shareholder in a VCT is the difficulty of identifying why some funds are under-performing. There is no consistent presentation of information on the contents of the investment portfolio in the Annual Reports of VCTs, with some providing quite comprehensive data, but others much less.

Unfortunately those funds which exhibit comparatively poor performance (such as some of the Murray and Quester VCTs), are also some of the worst in providing full disclosure of the contents of the investment portfolios and background on investee companies. This may not be a coincidence of course.

The FSA Listing Rules for VCTs provide that information on the 10 largest investments (or those representing more than 5% of the fund) is provided in the Annual Report, but that is barely adequate. Sometimes you get the bizarre situation that one of the largest holdings in the prior year is abruptly written down in value with few comments, and therefore it drops out of sight from the Report. Likewise, past large investments that are now almost worthless can be concealed.

UKSA would like to see a complete list of investments, the nature of the investment (whether equity, loans or preference shares with basic terms) and some background information on the investments. It is important to see the terms attached to investments - in the case of Guinness Flight VCT it is otherwise difficult to understand why they have an income of only £250,000 in the last financial year generated from £8.2 million of loans and preference shares (the reasons are apparently because some of their investments have “rolled up” benefits in terms of enhanced conversion or redemption terms, plus there are some “non-performing” investments).

Our Guideline Number 1 is therefore intended to set a standard for complete disclosure of the information required by a shareholder in order to form a proper view of the past performance and future prospects of the investment portfolio (and of course to provide therefore a view on the Fund Manager's capabilities).

It has been argued that it would be prejudicial to some investments to disclose their current valuation in that it might hinder disposal or further investment. But this seems very unlikely to the author and if that argument was maintained then why not conceal the information for all holdings? It is surely better to have honest and full disclosure rather than sweep the bad news under the carpet, as happens at present.

2. Provision of Trading Information. For similar reasons we would also like to see some information on the recent trading of the investments and some basic financial information. This would enable VCT shareholders to get a proper view on the quality of the investment portfolio, which is not always clearly indicated by the valuations done under BVCA guidelines.

Incidentally, the Fund Manager has some options and discretions concerning the way venture capital investments are valued, and there is a potential conflict of interest here in that Fund Manager's fees are often based on the Net Assets of the fund. This can lead to over-optimistic views of the value of investments. For example, if trading is below expectations, is a sufficient write-down taken, or is the investment still valued at cost? Shareholders should be in the position to form their own opinion on these matters.

3. Disclosure of Fund Manager's Payment Terms. This should be provided under the Listing Rules in the Annual Report, but it is sometimes not as specifically defined as it could be.

4. Disclosure of Fund Manager's Contract Terms and Termination Rights. This information is rarely provided, but is clearly critical if there is dissatisfaction with the performance of the Fund Manager. For example, Quester VCT3 has a 7-year minimum contract term with their Fund Manager which hardly seems to be in the interest of shareholders, is not disclosed in the Annual Report, and was not disclosed in the mini-prospectus which is all most of the original investors will have seen before applying for shares.

5. Variation of Fund Manager's Contract. It is usually not necessary to consult shareholders at present about changes in the Fund Manager's remuneration. If such a change is trivial, or there is a likely reduction in the Fund Manager's charges, then needless consultation should be avoided. However, such changes are often done, and frequently seem to be more in the interest of the Fund Manager than of shareholders. In fact this is just one symptom of the domination of VCT boards by the Fund Managers. For example, the recent change to the "performance related" element of the Fund Manager's remuneration at Baronsmead VCT2 seemed to be argued partly on the basis that the original basis would never result in any payment (i.e. the expected performance was not achieved so let's make it easier for them to do so in future).

Now an incentive that is never likely to be achieved is a poor incentive, and there were possible arguments for changing to a “Total Return” basis from a “Distributed Profits” basis, but UKSA believes that where such a major change is being proposed, that shareholders should vote on it. After all, they mainly subscribed on the basis of a prospectus that spelled out the charging structure, and they are locked in to a large extent, so changes should not be made without full explanation and consent.

6. Fund Manager’s Contract Period and Termination. This item simply provides recommendations to match the discussion of item 4 above.

7. Continuing Appointment of the Fund Manager. It seems anomalous that an annual vote is taken on the reappointment of the auditors to the company, whereas the capabilities and diligence of the Fund Manager are probably just as critical, if not more so, to the performance and the security of the investment in a Venture Capital Trust. We therefore propose an annual vote on the reappointment of the Fund Manager.

8. Recommended Limits on Fund Management Fees. When VCTs were first created, it was expected that the returns on the funds would be substantially higher than have actually been obtained. In reality the average Total Return per annum (change in Net Asset Value plus dividends) for generalist funds started in the years 1995 to 1997 has been 0.27%. Incidentally this is substantially worse than reported by the British Venture Capital Association in their PriceWaterhouseCoopers Survey for UK venture capital investments over the last 5 years, but is better than their figures for early stage and technology investments in the same period (and VCTs have a high concentration in those types of investment).

Clearly Fund Managers Fees, which typically are about 2%, reduce the returns substantially, and total charges including administration costs can be as high as 6% (for example at Pennine AIM VCT2). This compares with general investment trust charges which are normally less than 1%.

Although UKSA recognizes that managing a portfolio of unquoted venture capital investments requires significantly more effort than managing a quoted company portfolio, these costs must be controlled if high investment returns are not being achieved. Otherwise the value of the portfolio is gradually eroded.

Our recommendations for maximum Fund Management Fees are we believe fair and reasonable for well managed funds, and are those currently paid in many cases. Where funds are too small, and hence their costs relatively high, such that they exceed our guidelines, then we believe those funds should take steps to wind-up, merge with others, or increase in size (although the latter two are problematic because often funds are small because they have shrunk from poor performance).

In respect of additional performance-based fees, we do not object to those so long as they are simple to understand, require significant excess performance over a “safe” investment, provide a true incentive and are paid in a straightforward way. Note that on past performance, few funds would qualify though as they would not meet the criteria of exceeding the return on a “safe” investment (ie. that on index linked gilts plus 2% to allow for the risk being taken on, or above say 7% per annum at the time of writing).

Note that there is the question of whether performance fees can be justified when fund performance can fluctuate wildly from year to year, simply from general factors in the wider economy. If fund performance fees are paid purely on annual performance, this can lead to distortions as large losses in the fund in one year can be succeeded by large gains, thus producing a perverse payment of a performance fee. It is probably therefore preferable to take performance over several years, or a “smoothed” Total Return, as the best measure. We don’t believe this should be accumulative back to the start of the fund, or for more than 3 years, because of the disincentive that might give to fund management staff (and should of course be reset if the Fund Manager changes).

We are opposed to the grant of options to Fund Managers as UKSA is generally opposed to the use of options as an incentive device on several grounds. They are difficult to evaluate and it is better to reward excess performance with cash or share grants.

9. AGM Resolutions. One bad practice that the author has seen is combining a resolution to approve changes to the Fund Manager’s remuneration with other resolutions (such as the issue of more shares). This makes it difficult for shareholders to approve the latter (which is generally sound practice as many VCT funds are too small), while opposing the former.

10. Votes for Continuation of the Company. UKSA believes that it is good practice for investment trusts to have regular wind-up votes. This has a positive effect on the large discounts to Net Asset Value often seen in investment trusts, and at least ensures that shareholders have the opportunity to put the poorest performing trusts “out of their misery”. Otherwise it is rare for directors of such companies to propose that they should put themselves out of a job for reasons one can easily understand. In the case of VCTs, many shareholders will historically have claimed roll-over capital gains tax relief on their investments, which would roll back out on such a wind-up. Therefore they would be unlikely to vote for this action. But even then it would be in their interests to do so if they were not convinced that the trust had any future and feared their investment would continue to be eroded.

Incidentally we would also suggest that government legislation should change so that when a trust is wound-up or merged, that capital gains roll-over relief is not lost so long as investors reinvest the realised amount in another VCT.

11. Share Buy-Back Programmes. One of the problems seen in many VCTs is the large discount to Net Asset Value that the shares trade at in the market. For example British Smaller Companies VCT currently trades at a 35% discount (mid-price to NAV), or 39% on the bid-price. Guinness Flight VCT has been on an even higher discount in the past, although they have managed to narrow it more recently. Such numbers would surely have put off investors if they had known that this was to be the case.

The problem here, which also affects market spreads as discussed below, is the simple lack of trading in VCT shares. Because investors lose their tax reliefs if they sell, the main sellers are the estates of deceased persons, and other “distressed” sellers. But there are also few buyers because private investors only get the main tax reliefs from buying new shares, not existing ones. So if investors want to hold an interest in venture capital shares, they may as well buy into new funds. Institutional investors are unlikely to be interested either because of the small quantities of shares that may be available. The result is that one of the few buyers of VCT shares is the company itself, and buying shares back at a discount to NAV enhances earnings per share and NAV so it’s good business. Therefore VCTs should ensure they have an active buy-back programme.

Note that we recommend a specific maximum discount at which buy-backs should take place. Unfortunately it can be in the interests of the company to buy back shares at the lowest price they can achieve because it improves the Net Asset Value per share further. However, it also reduces the Net Asset Value of the fund which is contrary to the interest of the Fund Manager whose fees are typically a percentage of the NAV so it is also important to have a clear programme of buy-backs in place.

As an aside, if discounts are large, and the fund is otherwise performing well, then buying shares in the market can be a bargain. For example, it was possible recently to buy Northern Venture Trust, a high yielding investment with a good historic Total Return of 3.2% per annum, at 67p, a discount of 27% to the current NAV, and you still get some tax reliefs.

It is also worth noting that one of the difficulties of relying on company share buy-backs is the fact that frequently the company is unable to trade because it is in a “close period” (e.g. prior to results publication). Market makers may be reluctant to acquire shares when it knows the company cannot act, so private investors wishing to sell may need to watch that point.

Another possibility that VCTs should consider to minimise discounts is to have a semi-annual buy-back offer from the company directly to shareholders. A few normal investment trusts have recently introduced such a mechanism and have guaranteed to do so at a 2% discount to NAV.

12. Spread Minimisation. Another common problem with VCT shares are large bid-offer spreads (for example 70p to 90p on Rensburg AIM VCT recently) and small “Normal Market Sizes” (eg. 1000 shares, representing £600 on the same shares). This discourages any active market in the shares.

Even when the spread is more reasonable, the Normal Market Size may be small, and the reality is that when you ask for a price it is often a disadvantageous one. This is really a case of getting your broker to hassle for a better price when buying or selling (for example when buying, look at the price that the company itself is buying at - such purchases are given in RNS announcements).

UKSA would like to see much more effort put into ensuring that quoted spreads and market prices are realistic and that active trading takes place, and the VCT itself can do much to encourage this. At present it's a vicious circle - with high spreads, trading is deterred, and with little trading, spreads have to be high. Although legally VCTs have to be publicly listed, parallel markets to the LSE might be one way to ensure economic trading volumes. For example by using matched bargain facilities or other electronic trading facilities such as Sharemark.

UKSA believes that more encouragement of market buyers is required to maintain a healthy market in the shares of such trusts. More promotion of the merits of such purchases and more tax reliefs are probably required for purchase of existing shares if the market is to be viable.

13. Trading by Directors. UKSA believes it is prejudicial to the interests of ordinary shareholders and morally wrong if directors appear to be taking advantage of their privileged position. For example, the author would not have been aware that Northern Venture Trust could be purchased at the advantageous price mentioned above, if he had not noticed that two directors of the company purchased shares at 66 pence at the same time and at the same price as the company. This was on a day when the shares closed at a spread of 65p-80p (ie. they all purchased considerable quantities at just over the bid price and nowhere near the nominal offer price).

14. Encouragement of Mergers and Acquisitions. Some VCT companies get into financial difficulties or are too small to be economically viable - often the latter results from historic poor fund performance, which also stops then raising more funds. In the normal world of investment trusts, such trusts would be wound-up or merged with others. However VCTs have been difficult to treat in this way in the past because of legal difficulties and the risk that investors might lose their tax reliefs. However, new regulations that have recently been enacted have now made this practical, so for example, the Chrysalis VCTs have now merged and the Quester VCTs are also considering a merger.

Note however that wind-ups or mergers of VCTs are never going to be easy. Winding up an unquoted venture capital portfolio is a difficult, expensive and long-term process. Even for AIM investments, it is difficult to dispose of large blocks of shares quickly. Mergers are also problematic as corporate financial advice, legal and accounting costs could be more than £300,000, and who would want to acquire a poorly performing VCT portfolio?

Some people have suggested that VCTs should have a minimum fund size of say £10 million. However UKSA does not agree with that as an absolute rule as it would exclude funds such as those managed by Oxford Technology, which do not have excessive costs. The problem is more those trusts who have small funds, but cost

structures that are more relevant to larger funds. But certainly it is true that where there are VCTs that are relatively small in size, a merger with other similar VCTs can have a positive effect on the cost structure and the expenses of the merger can usually be recovered relatively quickly.

The larger the VCT, the more economical are its administration and fund management, and the larger the fund, the more the risks can be spread over multiple investments. UKSA therefore is generally in favour of merging VCTs where circumstances arise to justify it.

15. Recommended Cost Maximums. As has already been discussed under item 8 above, fund management and administration costs in VCTs are higher than for most investment trusts. There are in fact large variations in the various elements of total charges between different trusts. For example:

a - Director's remuneration can vary in total from £26,000 for Oxford Technology 3 VCT to £79,000 for British Smaller Companies at the time this note was first written (the numbers of directors also vary from as few as 4 for many VCTs to 8 for British Smaller Companies, but why they needed 8 is not at all clear, and subsequently the number has been reduced to 4). Typically fees are £8,000 to £12,000 p.a. for ordinary directors plus more for the Chairman, with VAT and NI also applicable in some cases. This may not sound much but when fees in such large investment trusts as Dunedin Income Growth are only £11,000 p.a. for ordinary directors, and are even lower in other large investment trusts (the fund value of Dunedin Income Growth is £390 million when VCTs are often less than £20 million), one begins to question whether such high fees are reasonable. Oxford Technology 3 pays only £5,000 p.a. to its ordinary directors.

Or for another comparison look at Dunedin Enterprise, a quoted ordinary venture capital investment trust with net assets of £115 million where the non-executive directors' fees are £15,000 per annum - so the fact that VCTs operate in the venture capital field is not, by itself, justification.

a - Audit fees can range from less than £10,000 to more than £20,000. Why are the audit fees as high as £24,620 for Foresight VCT, or £22,000 for Quester VCT3, or £19,975 for Singer & Friedlander AIM2 VCT? These seem very high for what are ultimately small businesses, particularly in the last case where the holdings are AIM shares and the market prices and holdings surely easy to verify? In contrast, the audit fees at Dunedin Income Growth incidentally are £15,000, so it seems difficult to justify much higher fees. By comparison, Rensburg AIM VCT has an audit fee of £8,000 and Oxford Technology 3 VCT has an audit fee of only £5,000.

b - Non-audit fees payable to the auditors are even more variable. The AIM VCT pays £16,000 under that heading, where others seem to pay nothing. One wonders what these fees cover in all cases, although clearly it covers VCT status monitoring in some companies.

c - Other administrative costs vary from figures such as £54,000 for Rensburg AIM VCT and £24,000 for Oxford Technology 3 (admittedly both smaller funds) to £240,545 for Singer & Friedlander AIM 2.

Our proposals aim to at least establish recommended maximums, although clearly such matters as legal and accounting costs can be exceptionally high in some years if new share issues are being made or other restructuring is being undertaken. However our recommended maximums should be seen as being capable of being easily improved upon by a considerable margin, and not been seen as a target.

Note that we also feel that the Annual Report of a VCT should draw attention to whether the income of the fund exceeds its expenses on an annual basis. The structure of VCTs is such that they can maintain up to 30% in cash or other liquid investments, and initially substantially higher, and the attractiveness of VCTs should be that this minimises the risk profile. This should provide substantial on-going income, plus of course some investments can be made in the form of interest bearing preference shares, or ordinary shares with a minimum profit distribution under the investment agreement. Many AIM shares also pay a dividend of course.

It should therefore be possible for VCTs to ensure than income exceeds costs, but many do not, with the result that if capital performance is poor (as it often has been historically) the net asset value of the fund is eroded. For example the AIM VCT currently has total charges at 176% of income and Guinness Flight VCT has total charges of 268% of income (see above for some explanation of the latter).

Incidentally one thing that inflates the overhead costs in VCTs is that they are unable to recover VAT charged on fund management or administrative expenses (or even director's fees in some cases). This has been the subject of complaint by many investment trusts, as unit trusts and OEICS can recover the VAT proportion of such charges. UKSA would like to see all investment trusts be able to recover this VAT, as recommended in the Sandler report.

16. Expenses Breakdown. One difficulty for shareholders in trying to understand the cost structure of a VCT is the lack of information provided. There is often no breakdown and there is certainly no consistent format for displaying this information. Our proposals would ensure that shareholders get the data which would confirm whether the costs are reasonable or excessive, and enable meaningful questioning of the directors on these items.

17. Charging of Expenses. The charging of expenses is currently often done 25% to income and 75% to capital, presumably on the original expectation that most returns from VCTs would come in the form of capital growth. However, it would appear that a 50/50 split is more realistic and would be preferable as a more conservative way to present this information.

18. Repurchasing of Shares. It is useful for shareholders to see the improvement in Net Asset Value (NAV) per share that has resulted from share buy-backs as a separate element of the company performance. Most changes in NAV per share are the result of fund management activities (or previous wise or unwise selection of investments), but improvement from buy-backs is another matter.

19. Reporting of Impacts on NAV. It is useful for shareholders to see the overall changes in Net Asset Value per share, broken down by source. For example the following is a table shown in a presentation by Guinness Flight at their last AGM:

Reason for Increase (Decrease) in Assets	%
Permanent diminution of investment	(3.4)
Operating Costs	(2.0)
Sale of quoted companies	2.9
Share buy backs	1.0
Total Realised	(1.5)
AiM Revaluation	3.4
Revaluation of unquoted shares	6.8
Total Unrealised	10.2
Total Increase	8.7

20. Board Frequency and Attendance. The frequency of board meetings seems to vary considerably from as often as monthly to as little as quarterly, and few VCTs currently show the attendance of directors. When judging the level of board remuneration, one would like to know how much effort is actually put in by directors. For example, Nicholas Lewis of Downing is a director of ten VCTs which you might think fairly onerous, but he is also Managing Director of Downing Corporate Finance which provides services to VCTs and raises funds for them.

21. Performance Charts. It is of course useful to know how a particular VCT is performing in comparison with other Venture Capital Trusts, or with the market as a whole. Unfortunately there is no index of VCT companies although, as previously mentioned, Allenbridge and other companies produce useful reports listing all VCTs.

AIM companies tend to use the FTSE AIM Index as a benchmark, but this is grossly misleading as the AIM index consists of many large companies as well as companies involved in sectors such as mining, in which VCTs cannot invest.

At present UKSA believes that the FTSE All Share index is the best benchmark, with the FTSE Smaller Companies index also possibly useful. Total Return (growth in Net Assets assuming dividends reinvested) is the best measure, although clearly VCTs are difficult to sell at near NAV which needs to be taken into account. The British Venture Capital Association (BVCA) also produces regular reports which contain useful reference data on venture capital returns in the UK.

22. News Publication. The publication of news related to a VCT, particularly issues related to the investment portfolio such as offers for companies, or major financial difficulties, seem to be patchily reported at present. For example, several Quester VCTs had an interest in OD2 (On-Demand Distribution). An article on its acquisition by Loudeye Corporation appeared in the Financial Times on 23/6/2004 but the VCTs did not announce the news until 1/7/2004, even though it would likely have a substantial impact on such funds as Quester VCT3 (3.1% likely increase when announced although the company seems to be taking quite a conservative view).

Such “price sensitive” information should surely be disclosed and disclosed promptly.

23. Administration by Fund Managers. One of the factors that results in domination of VCT companies by the Fund Manager is the fact that they often provide the supporting administrative services. Typically the VCT itself has no employees and relies on the Fund Manager or an associated company to operate the business, although this is quite normal for investment trusts of all kinds. However, it means that the directors are often over-reliant on the Fund Managers for advice. For example, if you write to the Chairman expressing concern about the performance of the company, or on any other matter, you are likely to get a reply that may be signed by the Chairman, but was in fact drafted by the Fund Manager!

Therefore UKSA suggests that it would be wiser if administration was handled by an independent third party rather than the Fund Manager or an associate of the latter.

24. Administration Contract Terms. These recommendations simply echo the recommendations given above for the Fund Manager's contract terms, but with a shorter minimum period (Fund Managers should be given time to develop the initial portfolio, but administration requires no long term commitment).

25. Fund Manager's Costs and Other Income. There appear to be established practices in the venture capital industry whereby Fund Managers can charge some costs to the fund, but not others. Similarly they often increase their income by accepting "investment arrangement" or "introduction" fees, and on-going investment monitoring or directors fees which are not passed onto the fund. UKSA believes that any such arrangements should be disclosed, and preferably VCTs should not permit such arrangements without their consent and where it is clearly to their benefit to do so.

26. Co-Investment by Fund Manager or Fund Manager's Staff. A common practice in the venture capital fund management industry is to allow for investment by the Fund Manager or their staff in the same companies in which the fund is investing. UKSA believes that all such arrangements should be disclosed. Such arrangements are not necessarily prejudicial but they can lead to unintended consequences. For example, they can encourage the Fund Manager to recommend further investment so as to rescue their own investment, when it might not otherwise be wise to make further such investment.

UKSA therefore believes that in general such arrangements should be avoided, and particularly that any differential arrangements (such as the grant of options in the investee company to fund management executives) should be avoided.

27. Independent Valuation of the Fund. One of the concerns with underperforming VCTs is that when performance is poor, the valuations of investments often appear to also be optimistic. In other words, the Fund Manager appears to want to flatter the performance of the fund. Unfortunately they always have a strong incentive to do so, as their fees are usually based on a percentage of Net Asset Value.

Although the valuations are usually done under British Venture Capital Association (BVCA) guidelines, there is still wide discretion allowed, and judgement required, in the valuation of unquoted companies. Such judgements are particularly difficult in early stage companies where there are minimal or negative profits and there is no easy reference to market value. AIM investments are less of a risk although even here, poor liquidity in the shares or lack of marketability requires judgement on a suitable discount to market price.

Although valuations are reviewed by the company's auditors, with little personal knowledge of the investments, they tend to rely on the views of the Fund Manager, particularly as the auditors may have little knowledge of valuing early stage companies. UKSA suggests that a system of independent review by staff experienced in the venture capital field be introduced for all VCTs so as to provide more reassurance to shareholders that the fund valuations are realistic (to minimise costs this should preferably be done by the auditors so long as they have such skills).

Summary and Conclusions. No doubt many VCT company directors and Fund Managers will suggest that the UKSA Guidelines for VCTs will require an excessive amount of work, and will be expensive to implement. However it is worth pointing out that almost all the information that we are asking for is provided by one or more existing funds. It's just that no VCTs provide all the information required and in a convenient and readily accessible format. The extra administrative costs should therefore be minimal.

However to minimise costs we do suggest that VCT companies look at the option of issuing "Summary Review" reports instead of a full Annual Report to all shareholders. The latter could simply be made available as an option (Baronsmead already do this). Alternatively the detail information could be made available on a web site rather than printed in the Annual Report (but referenced therein).

Clearly we also wish to try and reduce costs where possible, simply because UKSA does not believe that the past performance of VCTs has been good enough in all cases. Even the above average funds have not achieved the kind of returns that were originally expected, and the weaker funds are clearly a disappointment to investors. The cost structure of VCTs is therefore an important issue, because much of the performance of these funds depends on wider economic factors than simply good or bad fund management.

Note however, that we think VCTs should be more ready to review their existing Fund Managers and change them if required. There are clearly some who have consistently underperformed. All investors in unquoted companies are going to have some failures, but continuing to back losing managers is a poor strategy, however low their costs might be.

In terms of national policy, Venture Capital Trusts have been successful in bridging the “funding gap” for early stage companies to some extent, so it would be a shame if the investors in such funds perceived them as unsuccessful. They have contributed substantially to the success of many smaller businesses in the UK and to a more healthy environment and appreciation of the difficulties of start-ups companies. But now is the time to learn from past experience, and by introducing better information and more shareholder democracy into these companies, to improve their performance and corporate governance.

Regretfully, in many VCTs, the tail wags the dog, instead of the other way around. The Fund Managers create the VCT, it’s often named after them, they arrange the appointment of friends or associates as the initial directors, the Fund Management Contract often has long term and onerous termination rights and thereafter the Fund Manager has a dominant influence on the operation of the VCT.

That’s not to say that Fund Managers do not generally have the interest of investors at heart - their name on the fund often encourages that - but there are possible conflicts of interest and apparent over-reliance by directors on the advice they are given.

In conclusion, UKSA believes that Venture Capital Trusts are a useful and sound investment for private shareholders, but that improvements can still be made.