EIS
MEASURING PERFORMANCE

PUBLISHED
8th May 2014

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Introduction

One of the biggest obstacles to investment in the EIS sector is the lack of independent, accurate performance information. Without this information advisers and investors are putting their money in a blind pool and trusting that the manager will be able to produce the kind of performance they are promising, but with no verifiable track record to assess the veracity of their claims.

At the moment, most managers are prepared to share some top level information: how much money they have under management, how much they have deployed and how many deals they have done. It is also very common to come across case studies of underlying businesses that have been invested in, which bring some life and colour to the abstract investment process – and of course show EIS investing in a very favourable light.

This cherry-picking of information to share does not give investors the accurate picture they need to make systematic, objective judgements.

The Holy Grail of EIS Performance Measurement

The holy grail of EIS performance measurement would be a full performance look-through for each fund.

- The performance data would list all of the underlying companies that have been invested in, how much was invested, when was it invested and an up to date valuation (or price achieved on exit). This would allow calculation of the performance of the underlying companies and allow investors to assess if the fund manager's style and see which investments were driving the performance
- It would also capture how much cash was in the fund. This shows if the manager is deploying the capital or if there is a cash drag on performance.
- Finally the manager would need to confirm that each of those underlying investments had retained its EIS qualifying status. Any loss of status would of course have a big impact on the final returns to the end investors.
- Performance would be calculated gross and net of the manager's charges.

Presenting performance information in this way would allow investors to make meaningful comparisons between funds. It is much closer to the way mainstream equity fund performance is presented and we believe that it would invite much more new investment.

The Reality of EIS Performance Measurement

Most managers are reluctant to share any more information. However, there are important and understandable reasons why managers are reluctant to share this level of detail. In many cases the exit from an underlying investment will depend upon a sale: making the internal valuation of the company public would make negotiating the sale and achieving the best deal for investors very difficult.

Depending upon the stage the underlying companies are at, valuations can be quite esoteric and open to manipulation anyway: valuation models can be adjusted to give quite different outcomes depending on the assumptions, projections and methodology used.

Further, EIS funds can have very different investment strategies of course. A fund with a focus on a particular sector, or that is targeting a particular risk/return profile will obviously have very different performance results – returns, variance in the valuations, timing of exits, deployment of cash – to a fund that is has different objectives. This can make some managers hesitate to share information as they fear that their fund might appear to underperforming, when in fact it is doing exactly what it should do, based upon the strategy and objectives of the fund. The key is to always make sure that you are comparing apples with apples – the problem is common in the mainstream fund sector, but it dealt with by grouping similar funds in IMA sectors (for example).

Another difficulty for managers is that to date there have not been that many exits to report on, certainly for some of the newer managers. And indeed, the exits themselves are also more complicated than they look at first glance. Most exits are asset sales rather than company sales as these are quicker and simpler (buying the assets is preferred as a company purchase may mean taking on the company's liabilities as well). However, this process attracts a CGT charge for the company, which obviously reduces profits. It also means that the fund has to distribute the cash to investors: if that takes the form of a dividend then it incurs income tax. For these reasons, these kinds of exits can be costly and have big impact on performance.

And of course, as long as managers are reluctant to share performance information, there will always be a suspicion that they are hiding something – poor performance from the underlying investments, a failure to secure deal flow and deploy cash or a failure to pick investments where exits can be achieved.

One final note: AIM listed EIS qualifying companies will be obliged to provide a lot more detail than non-listed companies. This is one way advisers and investors can ensure they can have more performance related information on an EIS investment.

Possible Ways Forward

There are a couple of possible ways forward from this stalemate:

✎ **Carry on as we are.** Not really a way forward, but it is clearly satisfactory for a number of participants in the industry – particularly the current incumbents who already have the largest market share and don't have much incentive to support change: however, they run the risk of getting complacent and being disrupted by new entrants.

✎ **Report top level fund performance.** This would allow calculation of the performance of the underlying companies, allow investors to assess the fund manager's stock picking skills and see which investments were driving the performance. However, it does keep the valuations of the underlying companies out of the public domain, making negotiating sales easier.

✎ **Provide a full performance look through, but only to selected parties on a confidential basis.** Perhaps organisations that control significant amounts of investment capital such as IFA firms and wealth managers could insist upon access to the full performance look though on the basis that they would keep this information confidential. This would give these firms a competitive edge, which means the playing field is not level for all investors – although these firms may argue this is simply an advantage of their size and scale.

✎ **Full performance look through**. The EIS managers and underlying companies will have to bite the bullet and accept that the valuations will be public knowledge. Any astute buyer of these companies would presumably have a very accurate valuation of what they are about to purchase anyway, so perhaps the argument that putting this information in the public domain makes exits difficult is a smokescreen EIS managers are using to avoid further scrutiny.

Conclusion – Everybody Wants to be Second

Overall, it seems that most of the operators in this market want to be second. Understandably nobody wants to unilaterally disclose performance information. It needs a continued effort on behalf of the industry to reach a consensus on this point. There will be an advantage for some managers who do disclose more information though – many investors would feel more comfortable going for a manager who perhaps promised less or had slightly worse track record, but was more transparent about what they have been doing with their investors' money than a manager that promised much but had little verifiable evidence to back up their claims.

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