Are VCTs' juicy tax breaks worth the risk?

Activist investor

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Wealthy investors who fear further clampdowns on pension tax relief have been turning to venture capital trusts (VCTs), ploughing £731 million into these schemes last year, up from £269 million in 2012-13.

VCTs allow investment of more than the £40,000 allowance that basic-rate and higher-rate taxpayers can put into their pension — and much more than the £10,000 that some top-rate taxpayers are restricted to.

You don't get something for nothing, however. VCTs invest in small, illiquid businesses that carry a higher risk of failure than more established ones. They are not for the faint-hearted.

You can invest up to £200,000 in a VCT each year and receive tax relief of 30 per cent. Your money builds up free of income tax or capital gains tax, but you have to hold the VCT for at least five years. The managers invest in a portfolio of companies that must meet certain conditions. They must be unlisted, or on the Alternative Investment Market (Aim), be no more than seven years old and have less than £15 million of gross assets and fewer than 250 full-time employees. There is an exception for knowledge-intensive companies. These can be up to ten years old and have 500 employees.

Because of the high risk, VCT managers generally hold at least 30 companies in a typical portfolio. One of the attractions of investing is that, alongside the inevitable duds, you may have the chance to participate in the growth of some genuinely dynamic companies that go on to become household names and reward investors handsomely. Past examples include the property search site Zoopla, Virgin Wines and Secret Escapes, a travel company.

However, over the past few years HM Revenue & Customs (HMRC) has been tightening up the rules over what VCTs are allowed to invest in.

Alex Davies from the Wealth Club, an investment service for high-net-worth individuals, says that previously VCTs could invest in more established businesses such as pubs and wedding venues. But HMRC rules have forced a move towards more entrepreneurial companies, where investors' capital is more at risk. Dividends, which in the past could have reached 9 per cent, are now more likely to be about 5 per cent.

However, even a 5 per cent dividend, paid tax-free, plus the possibility of special dividends and capital growth, could look appealing to many high earners. Have VCTs delivered the goods, though, when it comes to performance? The Association of Investment Companies says that, for the five years to March 1, so-called generalist VCTs produced an average return of 35.8 per cent. VCTs investing in Aim stocks returned 48.4 per cent. As a rough, if imperfect, comparison, smaller company investment trusts produced an average return of 56.3 per cent.

Investors in VCTs would also have had the up-front 30 per cent tax breaks, which would have put them, on average, ahead of smaller company investment trusts.

However, over ten years the investment trusts do significantly better, with an average return of 303 per cent, compared with 151.8 per cent for generalist VCTs and 200.2 per cent for Aim VCTs.

One concern with VCTs is that there is little public information about the small companies that make up most portfolios, so it's important to pick a good fund manager. The Mobeus Income & Growth VCT has produced a return of 352.1 per cent over ten years, while Seneca Growth Capital, a healthcare VCT, returned 5.9 per cent.

£200,000

a year can be invested in VCTs

VCTs are an illiquid investment so can be hard to sell. They are traded on the stock market, but if you want to sell you are likely to have to do so at a discount. Some VCT managers will offer to buy back your shares, again at a discount. It is hard to value the small companies that make up a VCT portfolio and charges tend to be higher than for conventional funds.

There is an obvious attraction to VCTs for wealthy investors who have maxed out their pensions and Isas. Yet the tax breaks shouldn't be the defining feature of why you get into them.