The last straw that broke the camel's back.

This saying is very pertinent in the environment we have at present. Few managers have delivered a positive return above their benchmark over the past three years and it disturbs investors. Advisers and clients alike feel like boxers being punished in a fight with too many rounds, willing the financial underperformance to stop.

It is in times like these that 'new' products appear with the messianic promise of being able to deliver amazing returns through their unique 'angles' of approach.

Private Equity has been one such solution. Private Equity has been around since before listed companies and clients have invested in tranches offered by a number of investment managers, both here and in the UK, that have delivered good results, but quite a number of funds are experiencing slow-downs in expectations. The reasons for this are simple. Investors make money when Private Equity entities list. In difficult economic environments, Private Equity companies prefer to defer an intended listing and thus the accelerated returns expected towards the end of a tranche are postponed and an investor is either disappointed or needs to wait longer than the targeted investment period of up to 12 years.

Managing a Private Equity solution is a huge undertaking, involving a specialised team, working long hours, attending numerous Board meetings, sifting through financials which do not necessarily follow rules applicable to listed companies, and analysing possible competitor or technological changes which could influence the profitability of the underlying companies aggregated in the solution. Gaining an understanding of the ventures, inside and out, while remaining part of all decisions and management activities as well as being aware of changes and the significance of these, all forms very much part of the process. A Private Equity team needs to understand the total risk involved and often facilitates the process to get the venture to the listing stage. It is a costly exercise and there is a charge that these specialists extract for the value they add.

We have analysed some of the structures currently on offer, and their underlying holdings, and we need to caution investors against a wave of interest that often ends in tears and/or disappointment, especially where it involves a tax loophole. Ask, does the analysis work properly? Obtain more than one view and understand the investment thoroughly. A thorough understanding of the involvement of the Private Equity team is critical. Are they merely doing a 'due process' on the underlying funds, or are they intricately involved in the inner workings to ensure that the diversification is real and that the value they add is more than superficial.

The Section 12J

In South Africa it has recently become fashionable to hold Private Equity in a portfolio and the section 12J tax beneficial structure has contributed to this current popularity. The s12J structure allows the investor to deduct the total amount invested from their taxable income, but the investor must keep the funds invested in the structure for at least five years otherwise the tax benefit received will immediately become taxable.

Continued overleaf...

Most Private Equity products offer an inflation + 9% to 10% return, albeit few have delivered this of late. But what is more concerning than the possible (probable?) underperformance is that at presentations the tax saving aspect takes up most of the content and is explained in glorious detail, whilst the underlying instruments are not treated with the same level of diligence or understanding. The message out there often is: Investors save 45% at the marginal tax rate, so even if they get only their original money back, they win. Or the 'risk premium' is only 55% of the investment.

The problem is this: At inception investors get the 45% (only if this is their marginal tax rate) rebate, but their original capital amount for Capital Gains Tax (CGT) purposes is zero. Once the investment pays out, investors will be taxed (CGT) fully on the pay-out. Paying 18% (effective rate for individuals and special trusts in South Africa) on the total amount is a painful reduction in the final proceeds.

Thus, a fair comparison of the hypothetical returns and tax efficiency of all specialist and non-conventional investment instruments requires thorough and specialist analysis and comparisons on a like-for-like basis with more conventional and less subject-to-change investments such as retirement annuities, pension funds and mutual funds all of which have substantial protection for the investor written into legislation and are overseen by management boards of trustees or similar custodians.

Also be aware that Private Equity solutions carry substantially more risk than conventional investments and the investment team's involvement, diversification of the underlying instruments, both by business sector and geography, should be present to alleviate this risk. Legal opinions on the soundness of the offering should be available as well.

We have seen presentations on numerous s12J fund-of–funds offerings and while some of these are managed by experienced people, one has to question that at the minimum amount required for investment (often substantial), annual administrative costs that can amount to 5% or more on top of the underlying investment fund's costs. How an investor can hope to get a net return of inflation + 9%/10% is optimistic. With those costs, the manager is more assured of a return than the investor!

MitonOptimal are not tax advisers and independent tax advice should always be obtained.

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