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On your honor

The Woodford Patient Capital Trust plc (WPCT on the London Stock Exchange) needs no critics from across the sea. The fund is controversial enough in the City as it is, and so is the name of its founder and guiding light, Neil Woodford.

We write not to recycle old foreign news, then, but to draw attention to how Woodford's plight may foreshadow trouble in America's illiquid-securities business.

Patient Capital is a £728 million ($939 million) closed-end fund trading at a 12.7% discount to net asset value. In 2014, the *Financial Times* heralded Neil Woodford as the "UK's most celebrated fund manager." Living up to that reputation, the fund founder announced he would charge his investors no fees—the management company would rather earn 15% of returns above a cumulative 10%.

There have been no such returns. From inception five years ago, the net asset value of Patient Capital has dwindled by 8%, over which time the Brexit-diminished FTSE 100 has delivered a total return of 20.9%. Woodford, a declared value investor, has plenty of company in the ranks of the acolytes of Graham and Dodd.

The point of relevance is not that Woodford lost money but rather the ways in which it happened. You can think of WPCT as a publicly traded venture-capital fund. In 2015, management set a 60% limit of net assets in "unquoted," or private, securities. In 2016, that limit was bumped up to 80%. And in 2017, apparently on account of the manager's growing use of leverage, the threshold was again raised, this time to 80% of gross (not net) assets.

Curiously, Patient's unquoted companies have fared almost exactly as well as Patient's listed companies have fared badly. Thus, through year-end 2018, listed companies contributed losses (both realized and unrealized) of £140.7 million. Over the same span, unquoted companies contributed gains (both realized and unrealized) of £140.8 million.

How are these nonpublic positions marked? At cost or at the valuation from the companies' latest funding rounds, is the rule, but there have been exceptions. For example, the value of Kymab Ltd., WPCT's tenth-largest holding, a biotech startup, got a bump up to £29.4 million in 2018 from £16.9 million in 2017. "Price of recent investment/PWERM" is the rationale provided. Studious document readers will note that the acronym stands for "probability-weighted expected return method, which considers on a probability weighted basis the future outcomes for the investment." In other words, Kymab was "marked to model."

There are other sources of wonder in Patient's public documents. A glance at the 2018 annual report shows a decline in unquoted securities to 65% of gross assets by year-end from 68% in 2017. But a footnote reveals that £110.9 million of the £335.8 million in quoted securities is classified as "level 3." The explanation is as follows: "These investments are quoted, but there is no trading in these investments." The explanation for this paradox? A succession of complexities having to do with the International Stock Exchange in Guernsey. Adjusting for level-3 securities, unlisted companies totaled 77% of gross assets, and 92% of net assets, at year end.

Colleague Evan Lorenz placed a number of transatlantic calls seeking comment, all in vain. However, in a May 3 blog post, Woodford had these things to say. "I stick religiously to a valuation discipline," was one, and he noted that value is the greatest predictor of future returns. Even so, the investor conceded that it's hard to value a company that lacks not only earnings but also revenues. He went on to compare WPCT portfolio company Inivata Ltd., which focuses on liquid-biopsy technologies, to Amazon.com, Inc., the greatest example of survivorship bias from the dot-com era, and to Guardant Health, Inc., a listed competitor to Inivata that lost $97.2 million on $110.6 million of revenue in the 12 months ended March 31. If the point of the exercise was to demonstrate that there are no sure things in life, no one could dispute it.

The rocky listing of Uber Technologies, Inc. last week may or may not lead to a reassessment of lofty, private-company valuations in the United States. If so, WPCT is front and center for any VC-led correction. Its £150 million credit line matures on Jan. 16, 2020. It would take Woodford an average of 524 days to liquidate WPCT's portfolio of £224.8 million "level 1" listed equities (assuming he limited trading to 15% of the daily average).

For now, these are London's troubles. They couldn't happen here? Oh yes, they could.

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