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MARKETS

Mutual Funds' Embrace of High-Profile Unicorns Backfires

Looking to beat benchmarks, funds expanded their holdings of private tech startups only to mark down values after disappointing IPOs

Shares of Peloton Interactive, which went public last month, are languishing below their IPO price of $29. **PHOTO:** MICHAEL NAGLE/BLOOMBERG NEWS

By Jean Eaglesham and Coulter Jones

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Mutual funds that invested billions in big technology startups are now suffering losses in newly public companies and are being forced to mark down their holdings of private companies that are no longer investor darlings.

The collapse of the initial public offering of WeWork parent We Co. and the steep decline of Uber Technologies Inc. UBER **4.36%** ▲ shares and other recent IPOs have backfired on funds that hoped big stock gains would give them market-beating performances.

Mutual funds have stepped up their exposure to unicorns—private companies valued at more than $1 billion—and other stocks that don't trade in public markets. Funds owned $6.7 billion worth of shares in We, Uber, Lyft Inc., LYFT 4.73% ▲ image-search platform Pinterest Inc. and fitness startup Peloton Interactive Inc. PTON -3.24% ▼ as of April. That is an increase of $2.7 billion from two years earlier, according to a Wall Street Journal analysis of valuation data.

Around six out of 10 mutual-fund companies hold private shares in their portfolios, up from about three in 10 five years ago, according to a survey this year by accounting firm Deloitte & Touche.

When private-market valuations were soaring, funds marked up their holdings, some more than others. We was valued at $102 a share in July 2018 by mutual fund giant Fidelity Investments, and $110 a share in November 2018 by Hartford Financial Services Group Inc., John Hancock Investment Management and Principal Financial Group.

That $110 price tag—67% higher than the figure some other fund managers at that time valued the same type of We shares—matched the value put on the office-sharing company by its largest investor, SoftBank Group Corp.

The valuation turned out to be overly optimistic. Before We pulled its IPO last month, its bankers were looking to price the offering at well below $55 a share, according to people familiar with the matter.

Fidelity marked down its We holdings to $54 a share in March, nearly half its valuation eight months earlier. The company said in a statement it doesn't comment on funds' individual holdings, adding that the firm has a "thorough valuations process as outlined in each fund's statement of additional information." Representatives of Hartford, John Hancock and Principal declined to comment.

Others have said We is worth even less. Jefferies Financial Group Inc. in August valued its stake in We at the equivalent of about $38 a share, half what it valued the stock in November, the firm said in a filing this month.

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A review of hundreds of mutual funds' pricing of five big unicorns—Lyft, Pinterest, Peloton, Uber and We—since 2013 revealed big quarterly swings in the values put on some companies, as well as sharp differences in pricing between different fund managers.

Active fund managers have embraced private companies to boost returns and differentiate themselves from index funds, which are raking in the bulk of investor cash.

"The managers hope to hit these home runs and so outperform some benchmark," said Larry Swedroe, chief research officer of the Buckingham Family of Financial Services, St. Louis-based investment advisers.

The mutual fund cash benefited some tech startups by letting them delay public debuts and "probably pushing up their valuations," said Will Gornall, a finance professor at the University of British Columbia who has studied unicorn valuations.

Mutual funds have to value each of their holdings daily—a daunting task for shares in private companies that, unlike public stocks, can be traded infrequently and at inconsistent prices. "Mutual funds are not experts in valuing unicorns properly," Mr. Gornall said. The Journal's analysis used data from the Center for Research in Security Prices collated by Mr. Gornall.

Vanguard Group valued Uber at $56.02 a share in March. Uber went public in May at $45 a share, and this week traded below $30 a share. A spokeswoman said Vanguard doesn't comment on individual fund holdings, adding that the firm uses an independent committee to value private companies.

The Securities and Exchange Commission polices how managers value private stocks, allowing for the inherent difficulties of arriving at a price tag. "We look at whether the pricing makes rational sense," Jay Clayton, the SEC chairman, said in an interview.

After the dot-com bubble burst nearly two decades ago, the SEC stepped up its scrutiny of how managers were pricing these shares. Fund firms are required to have written policies, setting out how they arrive at a "fair value" for each stock.

The SEC also requires mutual funds to hold no more than 15% of their net assets in hard-to-trade investments including private companies, and managers typically go nowhere near this limit. More than 90% of mutual funds holding private companies had less than 3% of assets in private companies, a 2016 study by Morningstar Inc. found.

"We recognize, in general, it's harder to value shares accurately in private markets than in public markets," Mr. Clayton said. "One of the reasons we have such a [15%] limit is pricing."

Funds can inadvertently get closer to that limit and increase their risk when they suffer redemptions. Managers sell publicly traded stocks to raise cash, leaving them with a bigger portion of their portfolio in private companies. Three funds had 4% or more of their assets invested in Uber as of this spring, according to the review of the Center for Research in Security Prices data.

Putnam Capital Spectrum Fund, where Uber accounted for 5.4% of assets at the end of August, has seen its profit on the investment wiped out by the stock’s swoon after its IPO. The fund bought 1.2 million shares of Uber for $33.82 each in February 2015. As Uber revved up for its IPO, Putnam marked its holding up to $48.77 a share at the end of April—a 44% profit on the original investment. Despite the boost, the fund still posted a loss for the five years ended in April. A Putnam spokesman declined to comment.

Even with the current slump in the IPO market, some of the mutual funds’ startup bets are doing well. More than 20 funds held shares in Pinterest as of March, for example, with a total value of $600 million. The stock is up more than 30% from its April IPO price.

—Maureen Farrell contributed to this article.

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