For the Robust Nonconformist, Rules to Invest By

Adapted From
TIFF *Private Investments* Quarterly Report
1Q 2011

Fertile Valley. Several years ago, an auto company ran a series of advertisements in which swoopy retro-futuristic designs rotated gracefully at a mid-20th Century car show thick with beehive hairdos and proto-Mad Men. After a few moments, the Technicolor tableau faded to a dark background and a single question hung in the air before being replaced by the auto company's logo and a silhouette of their latest offering: "*Where are the cars we were promised?*" Of course, flying cars are still a way off, but at least we're pretty close to having our Dick Tracy multi-function communicator watches. The future is nearly impossible to predict since the meandering path of innovation is punctuated by orthogonal lurches into new areas. As venture capital investors, we've embraced the tension between the established order and the impending disruption. From our perch here in Silicon Valley, we've been eyeing several unfolding revolutions, from the rise of social media to the flourishing of smart mobile devices and the migration of computing into "the cloud." Each of these trends portends fundamental changes in the way we work, play, and live. Indeed, the institutionalization of disruption embedded in the business culture here can be exhilarating and the technologies spawned in – and inspired by – this fertile valley have already contributed to changes that would make our lives seem puzzling to our forebears.

Commitment Required. Yet, despite the wealth created by the endless blowing of the perennial gales of creative destruction, most investors have had unfulfilling experiences investing in start-ups. Fierce boom-bust cycles are marked by dizzying highs that attract lottery-playing institutions and dispiriting lows that can break the heart of even the most stalwart evangelists. Unlike investors in more-liquid public markets who can cut their losses if they find themselves having bought-in at high points in the market, venture investors are along for an extended, illiquid ride, which almost guarantees that these market participants will have to endure at least one faith-testing cycle during the life of a venture fund. As a result, investing in VC is probably inappropriate for all but the most committed institutions.

Lessons Learned. Indeed, commitment is forged in the hot fires of experience, and the most intense flames burn beneath the cauldron of downturns. Having started at Princeton's endowment in the immediate aftermath of the Tech Wreck of 2000, I was fortunate to get some battlefield advice that resonates today and has the added bonus of being generalizable across forms of investing. Below are a handful of the lessons learned during those days I've held most dear.

Any form of active investing works best when capital is expensive and time is cheap. Too often during good stretches, time becomes the investor's scarce commodity while cash is doled out more liberally, resulting in an inevitable slouching in expected return. When people are rushed, mistakes get made, difficult decisions are deferred, and available attention is lavished only on the best investments, while those lower on the totem pole struggle for notice. In the midst of good times, sloppiness can be temporarily overlooked – at least until more challenging times inevitably arise, at which time prior errors and inattention can compound in pernicious ways.

Pay attention to alignment of interests among all parties. While most investors in VC funds spend considerable time understanding the alignment between limited partners and the general partner, a much wider field of vision is required. As limited partners, we stand several steps removed from the portfolio companies that ultimately create wealth and, at each step, competing interests threaten our optimal return. Within the limited partner group, for instance, institutions may face differing constraints. During the period from 2001 to 2003 (and again in late 2008 and into 2009), LPs sometimes pushed GPs hard in conflicting directions on issues such as investment pace and fund reductions, resulting in some venture funds spending more time managing their investor base than aiding their portfolio companies and seeking out attractive investments amidst the target-rich environment of a downturn. Additionally, the investment syndicates that back start-ups may suffer from internal tension, as GPs may struggle with co-investors whose risk tolerance or time horizon may have changed due to their own fund dynamics. Many a cash-intensive growth opportunity has been forgone or exit has been sub-optimized by investors seeking to put points on an otherwise meager scoreboard. Even at the level of the portfolio company, members of the founding or management team may have visions that compete among themselves and with us. The history of good but not great exits is riddled with stories of founding teams that pushed their boards of directors into exits that created life-changing financial returns for the individuals at the companies but more modest outcomes for the funds that backed them.

Over-diversification can quickly become de-worse-ification. Most institutional investors are over-diversified, or said more glibly, de-worse-ified. Sloppy portfolios can be perfectly understandable: after all, the biggest source of underperformance in venture, with its disproportionate reliance on outsize winners, is the false negative. Missing perhaps one or two winners a decade can materially impact results. As a result, most investors demonstrate a tendency to make several smaller "placeholder" investments in lieu of fewer, larger, higher-conviction ones. An entire language of rationalization has evolved to justify such decisions. Like a lottery player who says, "you gotta be in it to win it," investors in VC funds invoke "asymmetric outcomes," or "optionality" to convince themselves that they need a bigger basket of funds, not a smaller one. After all, investors can only lose 1x their money, but the upside is unconstrained, and dreams of double-digit multiples dance in the head. Such a propensity is exacerbated by an entrenched deal-doing mentality that seeks the rush of the new, hot thing over the warm glow of a long and fruitful relationship with a manager. Investors who spend their lives clawing for allocation to the *en vogue* funds would be well-served in heeding Secretary of State Acheson's advice: "Don't just do something, stand there!"

Optimize discomfort. Investing is about getting appropriately compensated for risks taken. Most investors, however, are caution-seeking, career-risk minimizers who follow conventional paths and seek safety in numbers. In making investments that allow themselves to sleep well at night, such investors are consigning themselves to crowd-like results that don't generate adequate returns. The outcome of such a mentality can be particularly painful in venture capital, as middleof-road results have historically been weak, not only on an absolute basis but also on a risk-adjusted basis. Moreover, weak returns in an asset class prized for its return-enhancing characteristics suggest that meaningful opportunity costs were incurred.

Of course, following these rules doesn't guarantee success; hard work, a long horizon, and a stalwart presence can tilt the odds in one's favor. An old Silicon Valley adage reminds us that "the future takes a lot longer to happen than you think it will, but once it starts happening, it happens really fast." While, indeed, some profits from the unfolding of the future will accrue to those who happen to find themselves in the right place at the right time, the robust nonconformists with the courage of their convictions will enjoy the lion's share of the spoils. ■