venturedesktop.substack.com /p/the-merits-of-bottoms-up-investing

The Merits of Bottoms Up Investing

Brett Bivens

16-20 minutes

"Throw that crystal ball out, you can't predict anything. What you can do is recognize when lightning strikes." — Peter Fenton, Benchmark

"The financial markets are far too complex to be incorporated into a formula." - Seth Klarman

For venture investors, a clearly articulated investment thesis is part and parcel to a good elevator pitch — the way that those you are doing business with quickly size you up.

LPs want to back VCs that possess a strong point of view on the future that they are deploying capital against. Founders, used to being led astray, want confidence that they fit within a VC's investment mandate and are therefore not wasting their time. And in building relationships with other VCs, a clearly articulated thesis becomes a way of developing influence, staying top of mind for co-investors or increasing the likelihood downstream investors will mark up your earlier bets.

Tell a better story, fundamentals be damned.

To be sure, a cogent investment thesis in the right hands is a powerful thing. As USV's Rebecca Kaden recently noted, the best thesis-driven firms often develop their perspective in a very organic fashion.

But the peril lies in the idea some investors have about their own skills in developing a fully explanatory, a priori investment thesis that neatly predicts the future. To paraphrase Ashby Monk from his exceptional essay on structural advantage in venture capital, "I'm willing to bet that the *gods of venture capital* are not nearly as divine as they themselves believe".

As Seth Klarman writes in *Margin of Safety* — his seminal (and out of print) book on value investing that I read for the first time a couple weeks ago — it is not clear whether this top down, thesis-driven approach to investing is best understood as a greater-fool or greater-genius game. But in either case, the odds of success are long and rest far outside of the investor's control.

As you continue reading through the post, I'd love to discuss with you here in this thread on Twitter — disagreements, other ideas this prompts for you, etc.

Discuss on Twitter >>

The Merits of Bottoms Up Investing

While I wouldn't classify myself as a dyed in the wool value investor, the fundamental driven approach that the discipline holds central has been influential in the way I think about investing and I've found that the core principles that originated with Graham and have been built upon (and popularized) by the likes Buffett and Munger are useful across asset classes — even venture capital — and can be applied more broadly to decision-making in almost any context.

Margin of Safety expands on these ideas even further and brings to light a number of other powerful investing concepts — most notably, in my opinion, the value of taking an entirely **bottoms up** approach to investing.

To understand what Klarman means by bottoms up investing, it is helpful to review his definition of the opposite approach and the inherent pitfalls in developing an investment strategy around a top down perspective.

> A great many professional investors employ a top down approach. This involves making a prediction about the future, ascertaining its investment implications, and then acting upon

> them. This approach is difficult and risky, being vulnerable to error at every step. Practitioners need to accurately forecast macroeconomic conditions and then correctly interpret their impact on various sectors of the overall economy on particular industries, and finally on specific companies. As if that were not complicated enough, it is also essential for top down investors to perform this exercise quickly as well as accurately, or others may get there first and, through their buying or selling, cause prices to reflect the forecast macroeconomic developments, thereby eliminating the profit potential for latecomers.
>
> The top down investor thus faces the daunting task of predicting the uncertain more accurately and faster than thousands of other bright people, all of them trying to do the same thing. It is not clear whether top-down investing is a greater-fool game, in which you win only when someone else overpays, or a greater-genius game, winnable at best only by those few who regularly possess superior insight. In either case, it is not an attractive game for risk-averse investors.

Sustainable investing success, then, is less a matter of being light years ahead of one's competition intellectually and, as Ashby Monk notes, owed to structural and behavioral advantages developed over time.

Benchmark and Bottoms Up Investing

Perhaps no VC firm embodies structural advantage — from the alignment of its organizational incentives to the brand edge it has built through a consistent approach applied over multiple decades — better than Benchmark.

It is also likely that no other firm is as allergic to the notion of a top down thesis.

You don't have to wait long in any interview featuring one of Benchmark's General Partners — and there have been a number of great ones lately — to gain insight into what seems to be the firm's organizing principle:

> **Our job is not to see the future, it's to see the present very clearly.**

This alignment shines through clearly across the partnership — whether it is Sarah Tavel talking about her investment in Chainalysis, Chetan Puttagunta explaining the logic behind his investment in Sketch, or Eric Vishria responding to a "request for startup" in the Open Source space:

> "We're not top down like that. It is so organic. When an entrepreneur pitches and tells a story that provides an insight that makes you think about the world differently, that's when I get really, really excited. And that's why it is really hard to be top-down and why we don't tend to be particularly thesis-driven."

In a 2016 interview, Peter Fenton, who joined Benchmark in 2006 from Accel, spoke about the differences between the two iconic firms:

> "At Accel I was taught, 'we need to have a prepared mind' at really thinking about a segment, a category, and its coherence. So I came to Benchmark and I didn't know if I agreed with that. And my partner said, "don't you do that shit here." Throw that crystal ball out, you can't predict anything. What you can do is recognize when lightning strikes."

Fenton also talked about the bottoms up nature of his investments in this Quora Session. Twitter, Yelp, Elastic — all driven by investing in purpose and "tactile reality" than trends.

> I don't invest in trends. I know it sounds a bit too-cool-for-school but what I've found is that you get far more insight from purpose than from trends. So, for example, in the case of Docker I invested in Dotcloud (which became Docker), in the purpose of this radical, intense leader, Solomon, who wanted to give the world's programmers superpowers, tools of mass innovation. In the case of Yelp, it was Jeremy's purpose to allow for the truth of great (and bad) local businesses to be visible to all. Or when I met Jack in 2007, he had this unstoppable purpose for Twitter to "bring you closer". Sometimes that purpose is just this raw force, an energy, like it was in the case of Shay at Elastic in 2012. **When I feel like the trend, the space, the concepts vs the tactile reality of a purpose forms the narrative of the investment I lose all interest.**

Complexity Investing

The intertwining ideas of tactile reality, on the ground insight, and venture capital as a "field-based business" echo back to the early days of Benchmark and seem to be heavily influenced by Bill Gurley, the longest tenured GP at the firm today.

More directly, they point to a foundational belief in markets and companies as complex adaptive systems that cannot be, as Klarman notes in Margin of Safety, "incorporated into a formula."

Gurley, who sits on the Board of Trustees at the Santa Fe Institute, has on numerous occasions, remarked on the influence that the ideas of complexity science developed at SFI have had on his worldview and investing mindset.

The title of this section, *Complexity Investing*, is borrowed from the title of a paper by Brad Slingerlend and Brinton Johns of NZS Capital that, through its exploration of concepts like resilience and optionality, encapsulates the Benchmark approach quite well:

> We believe that the economy and the stock market are best understood as biological systems: specifically, complex adaptive systems. Complex systems have unpredictable outcomes; therefore, as investors, we focus on companies that are adaptable, long-term focused, innovative, possess long-duration growth, and maximize non-zero-sum outcomes.

Another way to think about Benchmark's approach to investing is through the lens of Gall's Law:

> A complex system that works is invariably found to have evolved from a simple system that worked. A complex system designed from scratch never works and cannot be patched up to make it work. You have to start over with a working simple system.

In sharing his own fundraising journey, Carta's Henry Ward noted that the most transformational companies create new markets that, by definition, seem small (or non-existent) at first. This is in line with the Peter Thiel / Facebook concept of monopolizing an initial niche before scaling into adjacent verticals.

It is also, as evidenced by the way Gurley has described some of the firm's early bets, an approach favored by Benchmark.

Investing in Venn Diagrams

It is worth pausing here for a second to marvel at the magnitude of success Benchmark has achieved throughout its history.

Successful exits in companies like Yelp ($2.5b market cap) and Stitch Fix ($2.7b) alone are more impressive feats than most firms can claim. But, as we know, the Benchmark story certainly doesn't begin or end with those two companies.

Benchmark (San Francisco) Following

#	Company Name	Market Cap	Last Known Valuation	Last Financing Valuation	Revenue	Year Founded
1	Instagram		521.00	521.00	20,000.00	2010
2	Uber (NYS: UBER)	70,847.42	75,713.49		14,147.00	2009
3	eBay (NAS: EBAY)	29,005.20	715.30		10,800.00	1995
4	Equinix (NAS: EQIX)	52,324.55	885.28		5,455.09	1998
5	Juniper Networks (NYS: JNPR)	8,221.92	1,661.34	1,661.34	4,445.40	1996
6	Red Hat		34,000.00	34,000.00	3,482.65	1993
7	Twitter (NYS: TWTR)	27,677.12	30,000.00		3,459.33	2006
8	Zillow Group (NAS: ZG)	10,477.68	3,510.64	3,510.64	2,164.23	2005
9	Snap (NYS: SNAP)	25,009.57	10,000.00	10,000.00	1,715.53	2010
10	Stitch Fix (NAS: SFIX)	2,527.91	1,431.18	1,431.18	1,656.14	2011
11	Dropbox (NAS: DBX)	7,725.01	8,229.96	8,229.96	1,591.20	2007
12	Grubhub (NYS: GRUB)	4,738.91	3,223.29		1,312.15	2004
13	1-800-Flowers.com (NAS: FLWS)	1,033.89			1,300.72	1976
14	Infinera (NAS: INFN)	1,424.72	1,080.78		1,246.36	2000
15	Yelp (NYS: YELP)	2,440.21	3,500.00		989.11	2004
16	Proofpoint (NAS: PFPT)	7,250.18	385.55		888.19	2002
17	Zendesk (NYS: ZEN)	9,932.00	631.67		816.42	2007
18	Wix.com (NAS: WIX)	7,382.25	924.00		720.70	2006
19	New Relic (NYS: NEWR)	3,567.03	1,059.05		571.95	2008
20	Elasticsearch (NYS: ESTC)	5,782.05	2,501.74		342.25	2012
21	Upwork Global (NAS: UPWK)	1,009.31	1,561.19	1,561.19	289.31	2014
22	Zuora (NYS: ZUO)	1,761.39	1,449.12		269.21	2006
23	One Medical (NAS: ONEM)	3,024.78	1,713.76	1,713.76	256.91	2007
24	Rambus (NAS: RMBS)	1,842.99			224.03	
25	ServiceSource (NAS: SREV)	177.65	1,194.03		222.74	1999
26	Ambarella (NAS: AMBA)	2,262.60	155.46		222.59	2004
27	Domo (NAS: DOMO)	690.52	524.03	524.03	166.63	2010

The best way I've thought of to explain Benchmark's "see the present clearly" approach — and the way their investment process differs from others — is that while most VCs believe their job is to invest in circles that will eventually form a Venn diagram, Benchmark invests when they find valuable Venn diagrams that already exist.

As Klarman writes in Margin of Safety, a top-down investor must make several accurate predictions in a row to be right. In the VC context, an investor aiming to be right about both the convergence of a technology with a new high value user behavior AND the timing with which that convergence will occur faces extremely long odds.

Better to stay out of the prediction business altogether and instead focus in the early days on companies that have established what Gurley calls "**Liquidity Quality**". He discussed this idea in the context of Yelp on a recent episode of the *Invest Like the Best* podcast:

> I've come up with this phrase I use internally that I made up — so I one day, I'll have to write a definition of it — called Liquidity Quality. And I tell entrepreneurs, I care way more about Liquidity Quality than I do how broad you are. We can use venture dollars and growth playbooks to go broad if the fire's burning bright. So how do you get this liquidity quality high? Jeremy (Stoppelman from Yelp) doing things that don't scale at those nightclubs in San Francisco, and people being super passionate in their reviews, frequency being high, the quality of the experience, even though is in a very small area? And so I very frequently run into entrepreneurs who think they need to expand to 10 cities really quickly to raise their A or B or whatever. And I'm like, no. If you have like incredible unit economics and growth metrics in a single city, where it's obvious that your playbook is working and things are spinning and things are getting better, you basically have network effects. That's way more interesting.

Writing in 2013 at the time of Benchmark's Series A investment in Stitch Fix, Gurley observed that the company possessed similarly strong liquidity quality — word of mouth growth from passionate users who consistently came back to the product fed a flywheel that "simultaneously better served the individual desires of the customer and also contributed to higher inventory turns, fewer write-downs, higher capital efficiency and higher ROIC."

This wasn't an investment in a DTC brand that could eventually layer on technology or an AI company that could eventually apply their approach to retail and personalization. It was and continues to be a company that, as Gurley recounted in a wide ranging interview (that I highly recommend reading) has aligned the Venn diagram of technology and adoption in a way that competitors could not easily replicate.

Of course, simply investing in valuable existing Venn diagrams — even ones with defensible moats — doesn't drive fund-returning outcomes.

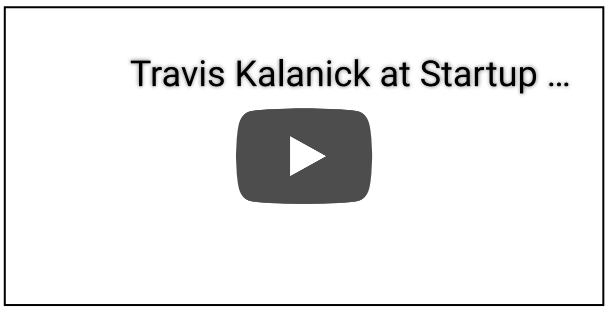
As Benchmark founder Andy Rachleff is fond of saying, simply being right is not enough. To truly participate in differential outcomes, one must also make decisions that are non-consensus. In other words, Benchmark's incredible track record is a result of seeing Venn diagrams where others didn't.

Yelp and Stitch Fix are two great examples, but perhaps the strongest evidence of Benchmark's bottoms up strategy in action is the company that may have sent the team on their recent PR blitz (and me down a rabbit hole of Benchmark content) in the first place — Uber.

Missing by a Mile

> When we got this company started (in 2009) we were pitching the seed round and we pulled a bunch of research from this report that showed that San Francisco total spend on taxi and limo was like 120 million bucks. But we're a very healthy multiple bigger than that right now, just Uber in SF. So it's not about the market that exists, it's about the market we're creating. - Travis Kalanick in 2014

Both in culture and in go to market, Uber is the ultimate bottoms up company — and a perfect example of the plethora of growth opportunities that unfold when early liquidity quality is achieved. This video, from about a year and a half after Benchmark's Series A investment in the company provides a great look at just how impressive the early growth and engagement numbers were and hints at a few of the growth paths ahead.



Uber's story also provides a great case study in how common it is to undervalue early liquidity quality — the Venn diagram of engagement and technology — by taking a falsely precise top down view of how large a market may end up being.

Two years after this video — with Uber having just raised over $1b at a $17b valuation — NYU Professor Aswath Damodaran published a widely-read analysis with the point of view, based on what turned out to be an overly rigid top down perspective of Uber's market size, that the company was worth only about a third of what investors had pegged it at.

To be fair to Damodaran, even the Uber founders may have underestimated the scale of the opportunity to ladder up over time off of a base of early liquidity quality. From the company's seed deck:

UberCab

Overall Market

- $4.2B annually and growing
- Top 4 players combined only 22% of revenues

7.25 THE UNITED STATES

Taxi and Limousine Service (US $ mln): The United States 2004 - 2014

Year	The United States	% of Region	% of Globe
2004	3,858.07	89.89%	22.70%
2005	3,942.95	89.85%	22.42%
2006	4,029.70	89.82%	22.13%
2007	4,118.35	89.78%	21.85%
2008	4,208.95	89.74%	21.56%
2009	4,301.55	89.71%	21.29%
2010	4,396.19	89.68%	21.03%
2011	4,492.90	89.64%	20.76%
2012	4,591.75	89.61%	20.49%
2013	4,692.76	89.57%	20.22%
2014	4,796.00	89.53%	19.95%

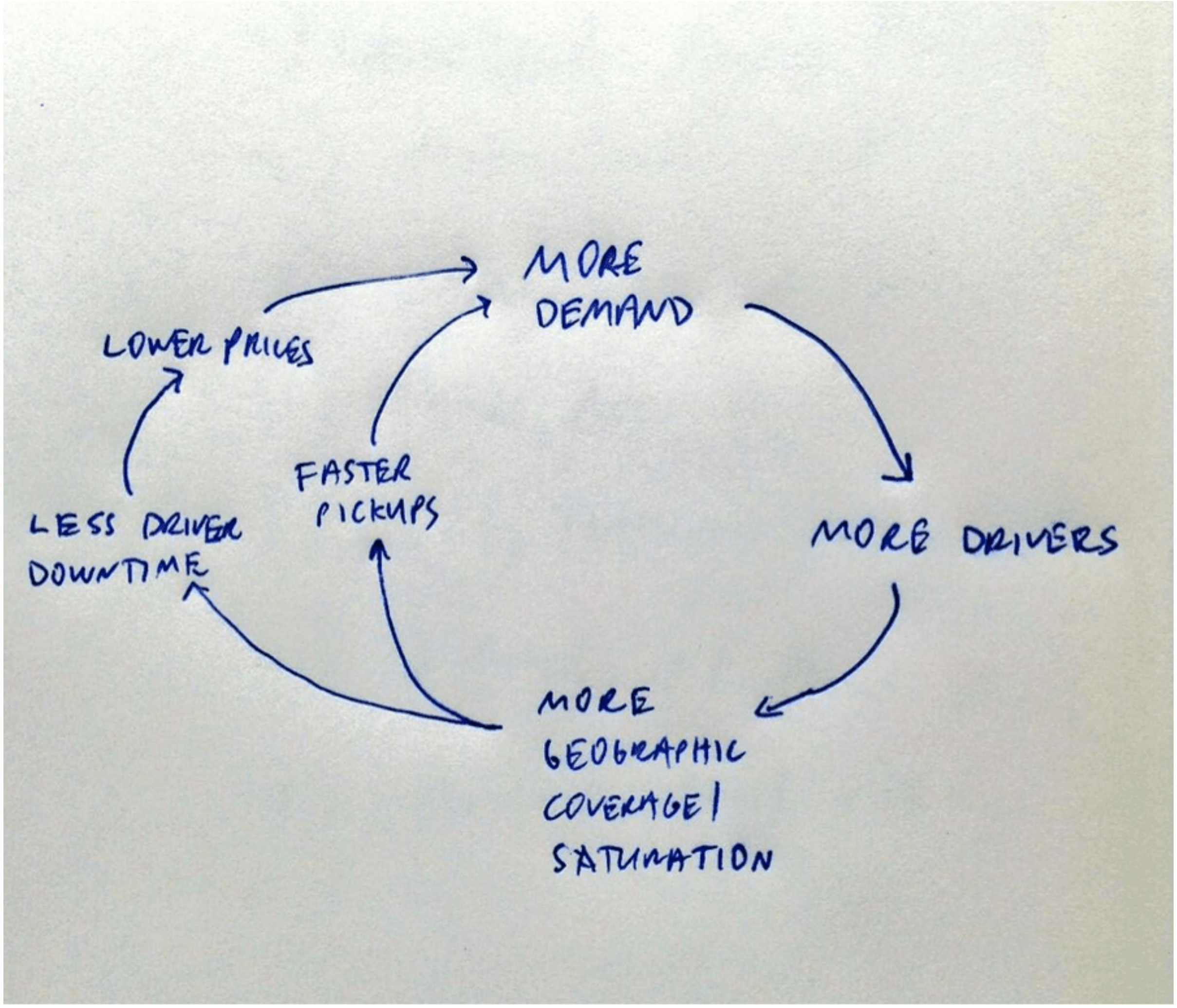
Source: Philip M. Parker, INSEAD, copyright 2008, www.icongrouponline.com

17

But as it turned out, and as Gurley argued in his masterclass of a response, the past can be a poor guide for the future if the future offering is materially different than the past.

> Let's first dive into the TAM assumption. In choosing to use the historical size of the taxi and limousine market, Damodaran is making an implicit assumption that the future will look quite like the past. In other words, the arrival of a product or service like Uber will have zero impact on the overall market size of the car-for-hire transportation market. There are multiple reasons why this is a flawed assumption. When you materially improve an offering, and create new features, functions, experiences, price points, and even enable new use cases, you can materially expand the market in the process.

He goes on to cite factors like faster pick up times, seamless payments, and civility as driving forces that increase liquidity and send the Uber flywheel spinning towards new opportunities.



In each successful step in Uber's ladder, high liquidity quality in a geography or product extension led to opportunities to push towards the next opportunity — Black Cars led to UberX led to UberPool.

When the company strayed from this strategy and allocated resources too aggressively to potential Venn diagrams where the circles hadn't yet intersected (expansion into certain emerging markets, for example), it struggled.

We increasingly live in a world of increasing returns. Success compounds and leads to more success. As a result, the ability to grasp the ground truth for a given industry or within a given company is more important than ever before.

Businesses, as Gurley writes are complex adaptive systems that cannot be modeled with certainty. In the early days of a company, the challenges of quantitatively modeling the future are even more magnified.

Some — Klarman's "Greater Geniuses" — may be capable of envisioning the long term future state of a company, betting on it early, and willing it into existence. For the rest of us, a bottoms up approach to investing in the future represents the best — perhaps the only — path to repeatable, sustainable success.

Thank you for reading! I'd love to discuss with you here in this thread on Twitter — disagreements, other ideas this prompts for you, etc.

Discuss on Twitter >>