How to Angel Invest, Part 2

34-43 minutes

We have another podcast called Spearhead, where we discuss startups and angel investing. This is a compilation of recent episodes. Also, see Part 1.

Everybody Thinks They Already Have Good Judgment

It takes years to know if you have good judgment

Nivi: For the past few episodes, we talked about why you should angel invest and how to get proprietary dealflow by building a brand. Now let's talk about judgment: how important it is and how to develop it.

Good entrepreneurs don't want to be associated with bad judgment

Naval: In the long-term, having good judgment is critical. Without it, you'll end up with a bad portfolio; other investors won't back you; you'll lose your money; and your brand will suffer. Good entrepreneurs don't want to be associated with bad judgment.

At the end of the day, judgment is the single most important thing. It's more important than access to deals and access to capital.

If you have poor judgment, you won't know it

The problem with judgment: Everybody thinks they already have it. That's because your ability to assess your own judgment is subject to your level of judgment.

If you have poor judgment, you won't know it. This cognitive bias is called the Dunning-Kruger effect after psychologists who popularized the idea. It's also common sense. People who are not that intelligent usually don't know it. It's partly an ego defense mechanism.

It takes five to 15 years to know if you have good judgment

Furthermore, you might have good judgment in certain areas and poor judgment in others. You might have good people judgment but lack market judgment. The only way to know is to look over a long period of time. Unfortunately, in early-stage investing it takes five to 15 years to figure out if you have good judgment.

The first thing to do is be honest with yourself about your own judgment. We'll walk through a plan to calibrate and improve your judgment over the long-term.

Judgment Gives You the Winning Lottery Numbers in Advance

But you still need a portfolio effect to be successful

Naval: At the seed stage, judgment is much more about people judgment, product potential and market potential than your ability to size up cashflows, customer acquisition costs or virality metrics—because you don't have much data.

Diversification is a hedge against lack of knowledge

When you have less data, you need a more diversified portfolio. In some sense, diversification is a hedge against the lack of knowledge.

Warren Buffett can examine in detail a company that's been around for 20 years. Judgment still applies, but he can pick one deal after doing diligence on many. With seed-stage startups, you have very little data. You might have to rely on other people's judgment, which is why social proof plays such a big role.

Nobody has enough data to have high conviction at the seed-stage

To be successful in early-stage investing, you're going to have to build a portfolio, because nobody has enough data to have high conviction or fool-proof judgment early on.

When he was posting as @StartupLJackson on Twitter, Parker Thompson wrote: "Everyone who invests after me is a spreadsheet jockey, and everyone who invests before me is a dart-throwing monkey." I thought that was very appropriate.

Later-stage investors look at seed investors as making wild guesses. And seed investors look at later-stage investors as spreadsheet jockeys.

But they're just applying different levels and types of judgment, because they have different data available to them. They're going to have different size portfolios and conviction because of the judgment they can apply.

Judgment gives you the winning lottery numbers in advance

Nivi: Given the amount of luck involved at the seed stage, how important is judgment?

Naval: Investing at the seed stage is like playing the lottery—except that you can use your access and judgment to get some of the winning numbers in advance. The better your judgment, the more numbers you know in advance. This increases your odds, but you still need a portfolio effect to be successful.

So it's crucial to cultivate and hone your judgment. This is a long-term game that will be played out over dozens—and eventually hundreds—of investments.

Judgment Is the Work You Do Before a Deal Arrives

Over time you'll need less data to assess a deal

Nivi: Given how quickly deals move, how much time do I really have to apply judgment? Won't I miss out if I take time to think things through?

Naval: Judgment isn't necessarily due diligence or even thinking. Judgment is the preparation you do before a deal arrives so that your subconscious can process it quickly.

Early-stage investing is more about gut feel than due diligence

Judgment for early-stage investing doesn't involve extensive due diligence. Yes, it's smart to check references, talk to other people and think it through. But that takes days, not weeks. Over time you will build up a gut instinct, and you will require less and less data to assess a deal.

You'll know if a founder is credible by listening to them. You'll know if they come from a credible network, which means you can spend less time checking references. You'll know how customers in the space think and you'll develop a gut feel for what founders can sell them.

The best investors are immune to FOMO

Startups are now trained to run a tight, fast fundraising process. This is especially true for startups coming out of accelerators. Some of them pressure you hard to make a decision.

The best investors are immune to the FOMO effect. If you push them to decide within 48 hours, they'll say, "Well, I don't decide within 48 hours, so it's not a fit for me." They won't look at it, even if it's a hot deal.

FOMO works on many investors—up to a point. I employ a 24-hour cooling off period for deals I consider. Even after I decide to invest, I force myself to wait 24 hours before moving forward.

Pivots Mean Your People Judgment Really Matters

Bets on seed-stage startups are bets on founders

Nivi: How is an investor supposed to know which companies to invest in, given how much they can pivot?

Naval: Since companies often pivot, your people judgment really matters. A pivot means keeping one leg in place and moving the other one around. It's not a jump or a leap into a completely different industry.

Oftentimes a company pivots into an adjacent space, so it's still operating within the broader market. In that case, you'll give more weight to evaluating the team and execution and give less weight to the exact product approach, assuming the market has enough room to pivot around.

The valuation should reflect that the company might go through pivots, and the company's cash burn and cash planning should, too.

Nivi: Here are some examples of soft and hard pivots: Twitter started off as Odeo; Instagram was Burbn; Slack was Glitch; and Lyft was Zimride. Uber started off with just black cars.

Naval: Uber's move from black cars to shared rides wasn't a pivot; it was an extension. Zimride's move from long-range shared rides to short-range shared rides also was an extension—and a brilliant innovation on their part.

Odeo to Twitter was a pivot, but it wasn't a jump. It was a pivot from podcasting to micro-blogging by the person who popularized blogging as we know it, Evan Williams. It was a bet on a great individual who was staying within his space.

Burbn to Instagram was barely a pivot; it was more of a step. Now, Geni to Yammer was a jump. David Sacks is one of the greatest product designers we've ever seen. He was early at PayPal, pivoted Geni into Yammer, and ran Zenefits. He was an early investor in some of the greatest hits out there. Geni was a David bet, similar to an Elon Musk bet. The people who bet on David would bet on him all day long.

Glitch to Slack was another jump. Glitch was a gaming company, but Stewart Butterfield had done something similar before. if I remember correctly. Even his first hit, Flickr, had also been a jump of sorts. People were investing in Stewart and hoping for the best—and he delivered.

But for every one of those, there's 10 failures.

Are Good Investors Piling in the Round with You?

It's a sign of good judgment when proven investors pile into the round

Naval: When you want to develop your judgment, the first step is to calibrate it: Do I have good judgment or not?

It would be great if you could look at the results of your investments and see if you were correct. But you won't know for 10 or 15 years, and the industry will have changed by then because it evolves and adapts quickly.

Look at markups in subsequent rounds

You can look at intermediate markups, noting when Sequoia, Andreessen or Benchmark invest in subsequent rounds and pay higher prices. That's an interesting metric, although it really indicates your taste in what other tastes makers like.

It's a Keynesian beauty contest where each judge is rewarded based on what the judge in the next round thinks. If your deals are marked up, it means you're becoming a good arbiter of future taste.

That kind of judgment is a *people proxy* mechanism; it's not really a way to build and calibrate your own judgment. Though it does have value: If you can predict what VCs will fund, your companies have a better chance of getting funded, which gives them a competitive advantage.

But being an arbiter of investor taste won't help you with a deal like Bitcoin, where it's incredibly strange, nobody understands it and there's no subsequent round of VC funding to bet on. You have to make the decision yourself.

Are good investors piling in the round with you?

You can also look at which investors follow you in the same round. If they commit before you, it's not a reflection of your judgement because you're probably keying off of them. But if good investors with proven judgment pile into the same round after you, that is a reasonable indication of good judgment.

Ask people about your weaknesses

Finally, you can ask people. Don't ask them if you have good judgment or not, because polite people will always tell you yes. Rather, ask them about your weaknesses. Of course, only ask people if they have good judgment themselves.

Judgment Requires a Willingness to Be Unpopular

Groupthink leads to poor judgment

Naval: People with good judgment tend to demonstrate it in all aspects of life.

They are well read, think critically and hold a broad range of ideas and opinions, including conflicting ones. People with good judgement are humble and have a relatively low ego, so they don't get too attached to earlier decisions. They constantly question themselves.

Often, they have scientific or other technical training and work in industries where they deal with real-world, consequential feedback and not just what people think of them.

Groupthink leads to poor judgement

People with good judgement are willing to be unpopular. The clearest thinkers work from the ground up and use first principles in their reasoning. They end up relying on their own authority.

Things that lead to poor judgment: groupthink, over-socialization of judgment and picking things because they are politically or socially popular. Lots of people lose money in this business chasing things they wish were true, as opposed to what actually turns out to be true.

The "PayPal mafia" is famous for being insular. They all have good judgment, they're all strange and politically incorrect—and they're all brilliant. They're not afraid to hold unpopular views, and they value each other's insights and judgment.

Whatever people say about Peter Thiel, no one wants to go head-to-head with him in a debate because he's brilliant and a contrary thinker. He's a first principles thinker from the ground up.

If you surround yourself with brilliant, contrary and first principles thinkers, you will develop extremely good judgment; however, you may not end up very popular.

The Best Deals Look Weird

You want to be right when everybody else is wrong

Naval: In investing, you want to be non-consensus right. You want to be right when everybody else is wrong. If you're right when everybody else is right, you won't make enough of a return. If you're wrong, you won't make any return.

The best deals have something broken, strange or different

The best deals are weird. They always have something broken, strange or different about them.

They're socially unacceptable, outside the norms of venture capital or too niche to be interesting. The founder doesn't fit the normal mold, or they're in the wrong city. Or they have a cap table problem. And so on.

That doesn't mean you should only invest in weird deals. It's like the old saying, "There's a fine line between genius and madness." The genius and madman both seem crazy until the genius is validated. One out of 100 turns out to be a genius; the other 99 turn out to be crazy.

You have to be iconoclastic enough to recognize genius founders without being so low in judgment that you let in all the crazy ones too.

Patri Friedman is making weird investments

The way portfolios are constructed, you may be better off investing in a lot of crazy deals than a lot of decent looking deals.

To give a recent example: Patri Friedman started a fund called Promonos Capital. He's investing in experiments in governance: new city states, towns and localities. These are places where people are taking local government into their own hands and doing experiments in governance.

This seems impossibly difficult to do. The history with seasteading in Honduras doesn't look great. But all you have to do is stumble into the next Singapore or Hong Kong—whether it's virtual or physical—and you have something that can create trillions of dollars in wealth and change the way people live.

Promons benefits from two things. First, they have a unique brand because nobody else is doing that. Everybody interested in this space knows to go to them. Second, the vast majority of their investments are going to look mad—but the few genius outliers should have huge returns because they're non-consensus investments.

Similarly, Founders Fund, Steve Jurvetson and a variety of other people built their brands by being willing to fund weird deals long before anybody else.

You Can Give Every Deal One Fatal Flaw

A startup that breaks all the rules won't get anywhere

Naval: You can give every deal one fatal flaw: the thing that traditional venture capitalists will use as their excuse to pass on the deal. If there's more than one flaw, you have to worry.

A startup that breaks all the rules won't get anywhere

Startups are rewarded for innovating on something new. If you invest in a startup that's trying to innovate on things that already work—such as team structure or founder mentality—you're just taking on additional risk.

You have to use your judgment to figure out when a startup can break the rules and when they can't. A startup that follows all the rules probably won't be interesting. A startup that breaks all the rules won't get anywhere, because they have to reinvent everything from scratch.

Uber was strange when it first came along, because investors considered it a taxi business and they didn't invest in offline industries back then.

To them it looked like the app was 5% of it and the other 95% was people driving cars—and they were correct. The question, though, is how much leverage accrues to the company that owns the app and how much can they expand the market with the app by introducing new products, attracting new customers and creating convenience.

Google was strange because everyone thought the search wars had already been won by the time they showed up.

Breaking the rules is easier when you understand technology

To know which rules to break, it helps to understand technology. As an investor, the best position is this: Others pass on a deal because they don't understand the technology, and you have enough technical insight to know it's feasible. Then, you have to make sure you can get it funded to the point where it's obvious to everybody.

The value comes in breaking the "rule" that you know isn't a rule, while everyone else thinks it is.

You'll Get Less Money in Your Winners

Always try to get your standard bite-size in a deal

Naval: It's easy to overestimate your own judgment. It's perfectly OK to say, "I don't know." That should be your answer most of the time.

There's only a few deals where you should say, "I have conviction." And, even then, be careful how much conviction you have.

At the seed stage, if you put a lot of money into one company and very little into another, that begs the question: "Do you really have conviction, or do you simply have better access to one deal?"

Generally, the better the deal, the less access you'll have.

Always try to get your standard bite-size

If you put a lot of money into a few deals and little money into many others, you'll find that your winners tend to come disproportionately out of the deals with little money invested. And that will hurt your portfolio return.

Once you have conviction, always try to get your standard bite into that deal. If a deal has too much space for you, that means: Either you should invest more in other deals or less in this one, or you should get rewarded with a lower valuation because you're creating the signal that the company will use to raise the bulk of the money.

Anyone chasing hot markets gets killed

Anyone in this business who's chasing hot markets gets killed.

If you started seed investing when the consumer social market was hot, the market was done by the time your investments matured.

If you invested in the masses of food delivery companies that showed up once it became obvious Uber was winning—if you invested in companies five through 50—you lost your money.

If you invested in crypto in 2017, you hit the tail end of the market; the early side was 2009 to 2015.

Today, SaaS is hot. It's a proven moneymaker. Let's see how it plays out. When current seed-stage SaaS investments mature in five to 10 years, you may find the returns are a lot lower than they are today. It's good to be at the beginning of a market—not at the tail end. By the time you see conferences about it and read *TechCrunch* articles about it, it's probably too late.

Don't Fantasize About What You Would Do If You Were the Founder

You're not running the company—you're betting on the founder

Naval: A common trap for investors—especially if you're an entrepreneur—is to fantasize about the things you could do with the company if *you* were the founder. You'll learn the painful lesson that it's actually the entrepreneur who's running the company.

It's important to listen carefully and take the founder at their word about what they plan to do. Don't get caught up in the idea that somebody else is going to run the company.

Angel investing is the opposite of value investing. Warren Buffett says, "Buy into a business that's doing so well an idiot could run it, because sooner or later, one will." That's not the case with startups.

With most startups, almost all the value creation happens while the founder is intimately involved. So you're betting on the founder.

If you bet on a founder you're not excited about even though you're excited about the market or product, often the founder will fumble the company or a competitor will come along with a much better founder. When that happens, either you'll be conflicted from investing in the new company or the new founder won't want to talk to you because you invested in a competitor.

Invest in the Smartest Scientists in a New Field

You're not going to become a great tech investor by reading TechCrunch

Naval: There are many ways to build good judgment. The timeless kind of judgment—good decision-making and the ability to size people up—comes with experience. You can develop it by reading great works at the intersection of science, business and philosophy. Read books that cover how smart people think. Build so-called "mental models" and develop an understanding of microeconomics, mathematics and game theory.

You're not going to become a great investor by reading TechCrunch

You can build timely specific knowledge in a field by diving in and learning everything you can about it, as quickly as possible.

You won't become a great tech investor by reading about technology on *TechCrunch* or *Bloomberg News*. You have to go to the source. You shouldn't hesitate to read scientific papers and journals. You should brush up on your mathematics. You should genuinely enjoy the act of learning science and technology. After all, technology is applied science.

Invest in the smartest scientists in a new field

You can also develop good judgment by investing in the smartest scientists and technologists in the space. Even if they don't make you money, they can perform due diligence for you on deals. They can validate and calibrate deals for you, and they can send other great scientists your way. Perhaps you'll make them advisors to your fund, give them a piece of your carry, or let them invest with you.

I did this early on, when I invested in cryptocurrency companies. I became friends with Zooko Wilcox-O'Hearn, who started Zcash; Juan Benet, who started Filecoin; Ryan Shea and Muneeb Ali, who started Blockstack together; Bram Cohen, who started BitTorrent; Eli Ben-Sasson; and Andrew Miller. They became my go-to people for vetting and validating deals. They told me which technologies were real and which ones weren't; and which scientists were credible and which ones weren't.

Scientists and technologists are a secret weapon

If you surround yourself with top scientists and technologists, they will become your secret weapon. They tend to be no bullshit—they'll tell you exactly what they think of a new technology. And they'll refer you to their networks.

You'll need to use your own judgment to decide when they're being unnecessarily negative or jealous, because that's human nature. Overall, very technical people tend to be extremely objective. They're used to corresponding with the real world and scientific results, rather than people who are influenced by subjectivity.

If you can find a group of painfully honest and distinguished scientists and technologists, that will be a secret weapon throughout your investing career.

Invest Only in Technical Teams

If there's no technical team, you're not investing in technology

Nivi: Let's discuss how judgment applies to evaluating teams, product and market, traction, and social proof.

Every great founding team has a great technologist

Naval: This is the *technology* business; you want to invest in *technology* teams. Every great tech startup is highly likely to have a great technologist on its founding team. If they aren't the most important member of the team, the technologist must be sufficiently compensated and motivated. Their name and accountability must be critical to the project.

If there's no strong technical person on the founding team, either it's not a technology business or the company has outsourced that function—which is not just a yellow flag; it's a red flag. For example, I don't consider Dollar Shave Club a technology business.

Of course, you can make money investing in non-technology businesses like Dollar Shave Club or Chipotle, but that's not what we're talking about here.

If you're not building, you're selling

Anyone on the founding team who's not highly technical should be great at selling: to end users of the product; to investors while raising money; and to potential employees to recruit talent.

A *community builder* is another character that can be incredibly useful, though good ones are rare. They sell, too. Only, they're good at mass sales instead of one-on-one sales. Like growth hackers, they're a unique combination of building and selling.

Great community builders are high leverage, but they're also extremely difficult to find. They're probably the rarest thing right now. Everyone claims they're good at community building, but you need to see the results.

You're Not Investing in Nice People

Invest in people with high energy, intelligence and integrity

Naval: I use Warren Buffett's three-part test for qualities you want in a partner: high energy, high intelligence and high integrity.

Startups are the Olympics of business

High energy is obvious. You have to work hard, because startups are the Olympics of business and you're competing against the best in the world. To paraphrase "Glengarry Glen Ross": first prize gets a Cadillac Eldorado; second prize gets a set of steak knives; and third place gets fired. If you're going to win, you need people who put in everything.

There's a meme on Twitter that you should work 9 to 5 all the time, and that's work-life balance. That's fine; not everybody should kill themselves at work. But then I'd argue that you shouldn't be an Olympic athlete or a founder of a winner-take-all technology startup.

If you're doing a startup, you and the rest of the core team will have to work your tails off.

Be a snob about intelligence

High intelligence is important, because you need good decision-makers. Intelligence isn't just about broad judgment; it's also about moment-to-moment judgment.

If you invest in people who aren't of the same intellectual caliber as you, then you're essentially investing down, talking down and thinking down. You're picking the wrong people.

Integrity gets tested when the stakes are high

High integrity is critical. If you don't have that, you end up with a smart and hardworking crook who can easily cheat you—and there's so many ways to get cheated in this business.

Integrity takes a long time to figure out. It's hard to assess someone's integrity if you haven't worked with them for a long time, which will be the case with most founders. You can observe how they treat people around them, including prospective investors, co-founders and employees. Someone who self-deals with others eventually will cross you.

Founders don't necessarily need to be nice people. Niceness is a signal that's easily faked. It's not enough of a filter. Technical people tend to know that, so they don't overemphasize niceness. It may be important to you, because you've decided it's more enjoyable to work with someone who's nice. But there are plenty of successful business people who are not nice.

Seek integrity over niceness. Integrity means living up to an internal moral code of ethics. It's being reliable and honest. Niceness often is just politeness or someone sending off signals that they have integrity when the stakes are low. Integrity gets tested when the stakes are high.

Coachability Is Overrated

Great founders listen to lots of advice and follow little of it

Naval: There's a meme among venture capitalists—especially inexperienced ones—that a good founder should be coachable. These investors rely too much on their own abilities, thinking they're right and founders are wrong.

Inexperienced investors also rely too much on the idea that you can change people in the short-term. Experienced investors know this isn't the case.

In fact, great founders aren't that coachable. They listen to lots of advice, but they follow very little of it. They develop their own internal compass. So I believe that coachability is an overrated metric.

Your Reputation Is Built by the Companies That Are Doing Poorly

Don't invest so much that you'll behave badly when things get rough

Naval: Angel investors tend to be on the tough side when they get started, especially when investing a lot of their own money.

Generally, you don't want to invest money that you're not OK losing. If you have too much at risk in any deal, you'll engage in bad behavior when things get rough. When the company performs poorly, you'll behave poorly. Emotionally, you won't be able to help it, and it'll damage your reputation.

Your reputation is built by the companies that are doing poorly

Your reputation gets built in those moments. Your *returns* get built by the companies that are doing well. Your *reputation* gets built by the companies that are doing poorly.

In the long term, your returns also depend on your access. And your access depends on how you behaved with founders when companies were doing poorly.

As a consequence, you never want to have too much at risk. So don't put down so much that you care.

Founders Almost Can't Be Referenced

A founder who's great for one business may be terrible for another

Naval: Some angels insist on checking references of founders. This can work if you know what you're doing, but reference checking is an art that most people haven't mastered.

Founding a startup is an act of creativity. If you think of the great writers, philosophers and artists throughout history, honest references would tell you they're all crazy.

Founders are non-fungible; they're irreplaceable. A founder who's great for one business may be terrible for another. The founder who can build Craigslist—community-oriented, extremely patient and almost anti-capitalistic—won't work for a financial startup that's racing to raise and deploy lots of capital while pitching banks and regulators. So, it's the right founder for the right job.

References tend to be generic. They don't work as well for assessing founders as they do for hiring employees, where you're looking for someone to scale processes that already work.

I passed on Twilio because of a reference

I passed on Twilio in the seed round because of a reference—big mistake. The reference came from somebody I trusted who had good intentions. It was probably even accurate, but that was beside the point. I should have gone with my gut feeling that Jeff Lawson was the right founder for the job.

I also passed on Ethereum very early because of a reference from a VC who was active in the space. The reference dissuaded me in a way that it shouldn't have—though I clued into that one later.

References can devolve into checklists

References from VCs are among the worst type. For every deal a VC does, other VCs passed on that very same deal. Sequoia does a lot of deals that Andreessen has passed on, and vice versa. This goes up and down the chain.

The best deals aren't always chased by the best VCs. In this market, everyone has their own unique point of view, and the good players have *very* independent points of view.

References can devolve into checklists: "I better check the box that I've done all these references." Or, if you do listen, your point of view becomes a smeared average, diluted by what other people think.

Avoid Teams That Would Sell Early

Venture capital is a grand slam business

Naval: Angel investing is a game of exceptional outcomes; it's not a game of averages. You're better off with a portfolio in which nine out of 10 investments go to zero and the 10th one goes 1,000x, than a portfolio where all of them are 2x or 3x.

If a founding team hints, signals or even just *appears* likely to sell the company early, it's a strong negative indicator. Teams that are overly financially motivated often will sell a company for $100M or $200M. That's a life-changing outcome for them; but it doesn't matter much to you because you own so little. It's not going to move the needle on your net worth.

As Bill Gurley famously said, "Venture capital is not even a home run business. It's a grand slam business." The smart VCs look for extreme outliers.

This is why smart VCs let founders sell secondaries early on. They take some money off the table in exchange for going for the gold.

When you invest in a company that is going to sell early, you miss out on compounding interest. Also, VCs downstream will read that signal and pass on that deal, and the startup won't be able to raise the cash they need to become a big company.

It's difficult to pull this signal out of founders, although sometimes they offer it.

'First-Time Founders' Often Have Been Tinkering for Quite a While

Their 'first' startup isn't always their first startup

Naval: There's a running debate among investors about which is best: first-time founders or repeat founders. There's no hard and fast answer.

I'd argue that most of the value in the industry is probably created by first-time founders. Think of Jeff Bezos, Bill Gates, Larry Page and Sergey Brin, and Mark Zuckerberg: Lightning strikes, things catch fire and the company takes off.

'First-time founder' can be misleading

Though, the label "first-time founder" doesn't really apply to some of these. Zuckerberg had other projects before Facebook took off. Gates founded Traf-O-Data with Paul Allen long before they did Microsoft. They measured traffic and sold the data to cities.

Often, a so-called "first-time founder" has been tinkering for quite a while.

Repeat founders tend to be better at execution

Repeat founders also can be extremely successful. Look at Uber, WhatsApp and Zoom.

Repeat founders tend to be much better at execution. They're good at recruiting teams and generally more careful about what markets they enter. Repeat founders also have better connections, which makes fundraising easier.

Because repeat founders have been around, they're more likely to have established long-term relationships with people you know, making it easier to check their reputation and whether they have integrity.

Repeat founders tend to be less passionate

On the other hand, repeat founders tend to be less passionate. They surveyed the market and picked what they think is going to work—not necessarily what they're super excited about.

They tend to have less specific knowledge about the field because they haven't been buried in it for the last 20 years; although you sometimes get that specific knowledge with founders coming from bigger companies who incubated a technology they really like.

Deals with repeat founders tend to be more expensive, so your returns are lower. There are tradeoffs. I don't have a hard and fast rule like "don't back repeat founders" or "don't back first-time founders." I find both can work, and both can *not* work.

Repeat Founders Don't Really Want to Start Over From Scratch

Test repeat founders for passion

Naval: With first-time founders, you must test their ability to learn. Are they fast learners? Will they learn how to run a company? Will they adapt and grow?

This is different than asking: "Are they coachable?" I believe coachability is overrated.

Test repeat founders for passion

With repeat founders, you should test for passion. When the going gets tough, will they see the company all the way through—or will they go start the next thing? Do they have conviction? Do they have the humility to go through it again, starting from scratch?

Repeat founders often don't want to start over with four or five people crammed into a tiny space behind wooden desks. They want to start with a lot of money, a big bang, a big office and a big team.

That can work when there's mostly *execution* risk, which is often the case in enterprise sales and software. It doesn't work as well when there's *invention* risk, which is the case with consumer, social networks and deep technology development.

First-time founders take on market risk

Nivi: So, first-time founders take on market risk, which explains why they tend to have the biggest outcomes. It also explains why most of them fail. While repeat founders take on execution risk, which explains why they deliver more consistent results. It also explains why the returns aren't huge: They're not betting on a market insight.

Naval: That's a deep way of summarizing it. First-time founders take on market risk and create new markets as a result—or own entire markets—and repeat founders take on execution risk.

There are also some blends. For example, when you're developing a new technology, it can create a new market. That requires deep expertise, which favors a first-time founder. But it also requires raising lots of money and addressing things like manufacturability and distribution of something new, which might require a repeat founder's resources.

Sometimes a sweet spot emerges: a repeat founder with previous success that wasn't so big that they lost their first-time founder mentality.

Let's say you have a team of people that builds robots. They failed because they were too early and the market wasn't quite ready. But they made a good attempt, and they did it with little money.

The team comes back later and still wants to build robots. They tell you the timing is finally right and they've brought on a few younger people with access to new technology. Now they're in a position to raise more money—and they've got a big chip on their shoulder, determined to prove this space can work. Those kinds of bets can be very interesting.