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The truth about venture capitalists, Part 3

9-11 minutes

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Bonus chapter!

(This will be the last post on venture capital for a while, if I can help it.)

The current venture capital environment in the United States is characterized by a very large number of venture firms (866, according to the National Venture Capital Association), investing an extraordinarily large amount of capital (over $7 billion in the first quarter of 2007 alone, according to Price Waterhouse).

Traditionally the venture capital industry was said to experience a "seven fat years, seven lean years" model -- seven years of boom, followed by seven years of bust.

Following that pattern, the late 60's/early 70's were great (the "-tronics" boom -- this is when Intel was funded by Arthur Rock), the mid-70's were terrible, 1978-1985 was great (the PC!), '86-92 was terrible, '93-99 was fantastic, and '00-06 was not so good.

As you'd expect, inflows of capital to venture firms during the lean years typically shrank dramatically -- venture capital returns are terrible during the lean years, and who in their right mind wants to put more money into an investment vehicle with terrible returns?

This capital inflow shrinkage would then lead to a significant percentage of venture firms closing their doors (technically, not raising new funds -- the venture capital firm equivalent of going under) -- especially the newer, less proven ones.

Ultimately, capital inflows would shrink to the point where the remaining venture firms were managing a much smaller base of cash, which primed the pump for dramatic investment returns over the next seven fat years: less capital + a new wave of high-growth startups = explosive investment returns.

That is the cycle that has played out every time -- except this time.

Let's examine that $7 billion invested by venture firms in the first quarter of 2007.

Annualized, that is an annual investment rate of about $28 billion per year.

Pulling the data on venture capital investing by year over the last 10 years, we see that this is, as you might expect, substantially lower than 1999's $54 billion and 2000's $105 billion (what a year!)...

...but, *higher* than 1997's $15 billion and 1998's $21 billion.

And that rate of investment has been broadly consistent for the last several years -- in fact, it's been trending up.

Even when you adjust for inflation, venture capital funding is flowing *into* venture firms and *out* to startups at a *higher* rate in 2007 than in 1997 and 1998.

Those of you remember 1997 and 1998 will remember that those were true boom times for venture capital. The returns on funds from '93-95 were extraordinary -- some of the best ever -- and limited partners were shoveling money into venture firms, leading VCs to fund new companies as fast as they possibly could.

Yet, despite disastrous venture returns on average from 2000-2006, the cash spigot from investors in venture capital firms continues to be wide open to a level where VCs can be *more* active in 2007 than they were in 1998.

While some older, stale venture firms have recently shut down -- Sevin Rosen and Yankee come to mind -- the rate of venture firm death has not been *anywhere* close to what you'd expect, and in fact many new funds have been formed and raised money in the last few years.

And the cash just keeps on coming.

Somehow we've ended up in a paradox: venture capital returns, on average, have been terrible, but contrary to historical precedent, the money keeps flooding in, venture firms keep going, and you have more money chasing deals than you did in the middle of the dot com boom.

How can we explain this?

In a nutshell:

Institutional investors who invest in venture funds -- large university endowments, philanthropic foundations, and pension funds -- began radically shifting their investment strategies in the early to mid 1990's, and that shift has led to private equity generally, and venture capital specifically, becoming a permanent "asset class" for those investors.

I call this the "asset-classization" of venture capital.

Here's how it works:

A large institutional investor like a university endowment runs its investment strategy with a top-down approach that says, we'll put *x*% in stocks, *y*% in bonds, and so on -- this is called asset allocation.

The actual details of which stocks, which bonds, etc. are less important -- the big decision is what percentage of the total capital to put in which asset classes, because when you run a huge pool of capital, that's what mathematically drives your returns. (You can't put enough money into any single investment to really move the needle, at least not without being irresponsible, so you have to think in broad strokes -- in terms of asset classes.)

Traditionally, such large institutional investors were quite conservative. An asset allocation that was perhaps 60% US equities, 30% US bonds, and 10% cash would not have been unreasonable.

Really daring institutional investors might have allocated some percentage to non-US equities, or (gasp) high-yield "junk" bonds.

This all started to change in the late 80's and early 90's when a group of advanced thinkers, such as David Swensen, then and now head of the Yale University endowment, crunched the numbers and realized that if they had a long-term time horizon (which they did -- Yale and its peers are expected to be around for some time), they could generate higher returns by allocating more of their capital to so-called "alternative asset classes" -- basically, anything other than public stocks, bonds, and cash.

This meant hedge funds, real estate partnerships, commodities, timber, leveraged buyout firms -- and venture capital.

To read about this new strategy -- and it is a fascinating strategy -- pick up a copy of David Swensen's excellent book Pioneering Portfolio Management, which describes his approach in detail. (Be sure to also pick up a copy of his book for individual investors -- Unconventional Success -- which explains why *you* can't pursue this strategy without getting your clock cleaned.)

The institutions such as Yale and its peers that adopted a Swensen-style strategy did *fantastically* well in the 1990's, and outperformed (technically, "kicked the ass of") any institution that had an older, more conservative investment policy.

This predictably led a significant number of institutions to shift massively into alternative investments and venture capital in the late 90's, just in time to get hammered by the crash of 2000-2002.

Here's the interesting part: that hammering -- by people who, say, only started investing in venture funds in 1999 -- has **not** resulted in a significant pullback on the part of institutional investors from venture capital.

Instead, venture capital has become an apparently permanent asset class of many large institutional investors -- and increasingly, smaller institutional investors.

Those institutional investors are managing *so much money* -- literally trillions of dollars -- that even a very small asset allocation to venture capital represents an enormous amount of cash -- tens of billions of dollars per year.

An organization called NACUBO (don't ask) tracks asset allocation behavior of university endowments, and tells us that the average large ($1+ billion) university endowment had a 3.5% asset allocation to venture capital in 2006.

3.5% of a ginormous amount of money is a *lot* of money.

But it's a small percentage of the total base, so apparently what's been happening is that although returns on venture capital have been poor (technically, "sucking") for the last several years, institutions that invest in venture capital are not taking that much actual pain on their overall asset bases, and they don't see that many better alternatives, and so they're sticking with their overall asset allocations and therefore sticking with venture capital.

You can argue that this is smart -- that such institutions are very well set up for the next venture capital boom, and that they will do very well over the next 10-20 years with this strategy -- versus the old approach of pulling out just before the sector was set to boom again.

You can also argue that this is not smart -- that this is leading to more venture dollars chasing few good deals and long-run terrible returns for everyone. Particularly since historically, most of the positive returns for venture capital have gone to the top 10% of venture firms -- or maybe even the *top 10* venture firms -- and most of the money going into venture capital as an asset class by definition is going into the other 90% of venture firms.

But regardless, it does seem to be the case.

And that's why, from where I sit in Silicon Valley, there are probably 200 venture capital firms within 20 miles with likely over $20 billion of capital at their disposal chasing a very small number of good potential investments, despite terrible average returns for the asset class over the last seven years.

I love this country.