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The Social Subsidy of Angel Investing

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15-19 minutes

Alex Danco's Newsletter

Two Truths and a Take, Every Sunday

Michael Seibel of YC posted a short video the other day about a topic that's near and dear to my heart: Why Fundraising is Different in Silicon Valley.

This is an interesting and important question. If you're a startup founder looking for your first investment, the difference between fundraising in the Bay Area versus fundraising somewhere else isn't a difference of degree. It's just qualitatively a completely different exercise. Advice to founders on how to fundraise in San Francisco is, to put it bluntly, not applicable in other parts of the country. Your best bet is often just to move.

Why is it so different? It's not just a question of money being available to founders. If it were, then other cities would be able to compete with San Francisco's tech scene simply by throwing money at the problem, which has never worked and never will. It's something else.

Seibel's explanation is that there's more FOMO among Angel investors in the Bay Area than elsewhere, because there's been more success here. If you're an early stage investor in SF, you've probably passed on a bunch of companies that have gone on to become wildly successful. People in SF have more experience with upside regret. As Austen Allred put it, "The most important experience to have in Silicon Valley is to see someone incredibly smart start a company, think to yourself, 'That's the stupidest thing I've ever heard,' and watch them become wildly successful."

This is absolutely correct, by the way. But it's not the whole answer. The difference in angel investing between Silicon Valley and everywhere else isn't just a difference in perceived risk/reward or a difference in FOMO. It's that angel investing fulfils a completely different purpose in Silicon Valley than it does elsewhere. It's not just a financial activity; it's a social status exercise.

Angel Investors in the Bay Area aren't just in it for the financial returns; they're also in it for the social returns.

The Bay Area tech ecosystem has been so successful that startup-related news has become the principal determinant of social status in San Francisco. In other cities, you acquire and flex social status by joining exclusive neighbourhoods or country clubs, or through philanthropic gestures, or even something as simple as what car you drive. In San Francisco, it's angel investing. Other than founding a successful startup yourself, there's not much higher-status in the Bay Area than backing founders that go on to build Uber or Stripe.

From the outside, angel investing may look like it's motivated simply by money. But there's more to it than that. To insiders, it's more about your role and reputation within the community than it is about the money. The real motivator isn't greed, it's social standing - just like a century ago, with the original Angels who financed Broadway shows. Angel investing is how you stay relevant. It's how you keep getting invited to things. It's how you matter. Angel investing isn't about getting something, it's about being someone.

The inherent uncertainty and contrarian zeitgeist of the startup world plays an important part. It's famously like Hollywood: no one really knows what's going on. No one can really predict what startups will succeed or fail, no one can really predict what trends are real or illusions, to any genuine degree of confidence. But everyone has to get up every morning and put on a bit of a show: that *you* are perceptive, you are brilliant, you are contrarian, and you are right. The result is that everybody walks around all day in a perpetual state of anxiety, worrying that everyone else sees and understands what's going on, but not you.

In an environment like this, angel investments are the ultimate flex. They're the universally permissible bragging format: half "I saw this potential when none of you did" and half "I was invited to this deal and none of you were." I don't mean to say here that all angel investment is social posturing - some angel investors are among the kindest, most humble and helpful people I know. But the social returns to angel investment aren't just a happy side effect. They're often the main thing people are really after.

It's also convenient that the investment return profile of angel investing for social status is *way more attractive* than angel investing for financial return. Angel investors' money gets locked up for 5+ years (maybe even 10 years), so you face a significant illiquidity punishment relative to the S&P or even real estate. Second of all, your money gets massively diluted by follow-on capital. The more money a startup raises, the more you get washed out as a little guy who can't defend pro rata.

But from a social returns perspective, you face neither of these problems. Not only are the social returns immediate, they also get *reinforced* by follow-on capital raises. That $50 million Series B for your favourite portfolio company might have washed you right off the cap table, but it's an awesome achievement socially. As a bonus, even if the startup ultimately fails or you get recapped out of the picture, you still get a lot of the good will and recognition you were after. Even the downside scenario is pretty good, so long as you're a good citizen about it.

The end result is that the Bay Area has a critical density of people who are willing to offer founders a term sheet for enough investment, and at attractive enough valuations, that it makes sense for the founder to actually accept them. I honestly believe that without this social "subsidy", a lot of angel investing stops working. If investors were being purely rational, they could only offer something like a $2 million valuation for founders' first cheques. And if entrepreneurs are smart, they know they can't accept it; it makes them un-fundable from that day forward.

When working well, this little setup functions almost like a wealth tax: it taxes the people whose most productive years are behind them, and redistributes the money to young entrepreneurs who are trying to build something, in a sort of merit-based but sort of random way. The downside to all this, of course, is that it excludes a lot of founders who don't look or talk quite the right way, or know how to ask the magic words that unlock social FOMO in the right way.

The social rewards of angel investing solve an important chicken-and-egg problem in early stage fundraising that financial rewards does not.

One of the biggest frustrations you face as a founder out fundraising is the refrain: "This sounds really interesting. I love it. Let me know when there are a bunch of other people investing, and then I'll invest too." From far away, it's easy to label this behaviour as cowardly investing. But it happens for a reason. If I'm in this for the money, and I can get in at the same price later but with more validation from fellow investors and more confidence in the founder's ability to get things done, then of course I'll want to do that. This poses a chicken/egg problem that can hold up or block fundraising entirely.

But when you consider the *social* returns to angel investing, the equation flips. When you're pursuing the status, credibility and social capital of being able to say "I gave this entrepreneur their first term sheet, when no one else would", then you can't afford to wait. It's in your interest to get to conviction as quickly as possible, and then genuinely act like the well-connected, contrarian luminary you'd like to be seen as. (Even if you pass, founders can hit you up for introductions and you face social pressure to make good on them. If you don't, it's like admitting "my network actually isn't that big.")

The social returns to angel investing resolve our chicken/egg problem: they turn angel investing into a kind of "race to be first" that is much more aligned with the founder, and more conducive to breaking inertia and completing deals. The founder wants you to move first, and so do you. David Perell pointed out to me the other day that this social arrangement is a little bit like the advertised promise of ICOs, in the sense that your premium for buying in early acts as an active catalyst to get the building & fundraising flywheel moving in the right direction. (Although, unlike ICOs, angel investing for social status is legal.)

There's another important way in which the social returns to angel investing are more entrepreneur-aligned than the financial returns are: they force the investor to remain on good behaviour.

This is another big difference between the Bay Area versus other cities - let's use Boston as an example. Boston has a long heritage of startups, an entrepreneurial mindset, and a legitimate angel investing community. But Boston angels are different from SF angels in an important way. For the most part, Boston Angels are not *peers* with founders in the way they are in the Bay Area. The two groups aren't friends. There's an age gap, a culture gap, and they don't hang out at the same parties.

In SF, on the other hand, founders and angel investors are all part of the same social group, so there is real social pressure to not behave like an asshole. Institutions like YC explicitly codify this behaviour. If you act like a jerk, you get blacklisted and banned from demo day. This isn't a financial penalty; it's a social banishment.

More than that, there's pressure to not be annoying. You see frequently in other cities that angel investors in your cap table can be an enormous drain on the founder's energy. They want constant updates in a format *they* want: not one that necessarily makes sense for the startup at its current stage. They demand a lot of the founder's time, and most of all they want their unsolicited suggestions taken seriously. Angels do this because their peer set is other angels, who probably also demand these things. But if you do this too often in SF, where angels and founders are part of the same social group, word will get around that you're a headache and your money isn't worth it.

The social returns to angel investing have a strong geographical network effect, because they require a threshold density in order to kick in.

It's probably not unreasonable, at least at Blog-Post-level-precision, to think of social returns as following Metcalfe's Law: the social returns to angel investing as a collective will be proportional to the square of the number of people who locally care about angel investing. If you invest in the next Stripe, the social returns to that investment will be proportional to the number of people who could theoretically congratulate you about it. There's a strong network effect at work.

If you can assemble enough early stage investors together, it should conceptually become self-sustaining. Once you have that sufficient density of people who care about the social return to angel investing, and you establish a genuine "early stage capital market" that is subsidized in part by the social and emotional job that it's doing for its angel members, you create something really special. You get the rare conditions where capital is available for founders at high enough valuations, with no strings attached, and by investors who are evaluating them "the right way", that you actually sustain a scene that produces startups in sufficient numbers to generate those few unlikely mega-winners that replenish angels' bank accounts and keep the cycle going.

To reiterate: if you're a founder looking for your first cheque, you need to find something that, economically speaking, shouldn't be available. You need to find someone who'll write you a cheque for a real amount of money, but that doesn't take too high an ownership stake. The social element of angel investing is absolutely crucial here, because it contributes to both the speed and the valuations at which angels will make commitments to founders. It's an innovation subsidy that works in the best possible way, but it only works in places where those social returns are actually valuable.

You cannot substitute it with other sources of "free" money. Plenty of cities and regions have tried this and they've all failed. You cannot simply add money and create a tech scene. If you do, then either that money will be *too* freely available and attract the wrong kind of opportunists, or it'll be like grant money that takes up so much of the founder's time and energy that it distracts them from actually starting and running the business in the first place.

Outside of San Francisco, the social returns to angel investing largely evaporate. LA and NYC are okay, but aside from that, angel investing in other cities is not going to give you the same kind of social lift or relevancy that you're used to in the Bay Area. Being able to say you were the first investor in Stripe only works if people have heard of Stripe. If an insufficient number of people in your social scene and in your community care about startups, then not only does your motivation to angel invest go down, but your motivation to go pursue *other* forms of status that are more locally suitable will probably go up concurrently. You may find yourself playing more golf, or maybe doing more philanthropy.

For the most part, out of the people I know who are successfully angel investing outside the Bay Area, almost all of them "caught the bug" in San Francisco. Here in Toronto, for instance, there's a funny coherence to the smaller group of people who all either worked in the Bay Area and came back here, or otherwise got a sufficient degree of exposure to the "real" tech scene in some way. It's really funny, but there's no good substitute for physically spending time there.

The good news is that this export of "angel investing as social status subsidy" is happening naturally, as people move way from the Bay Area and seed their local tech communities with that particularly useful kind of FOMO and status anxiety. San Francisco may have given us all brain damage, but it's undeniably been useful - and, in the long run, may turn out to be one of the Bay Area's most valuable exports.

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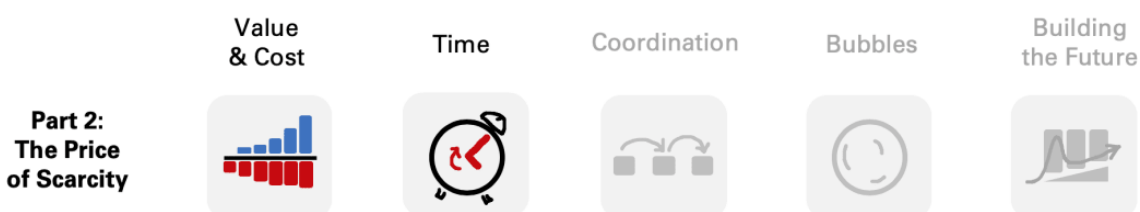
This Thanksgiving, one group of people that I'm sincerely grateful for is everyone who's signed on as a subscriber to my current book project, Scarcity in the Software Century. If you're one of those people, thank you so much! I'm really lucky to have you as a reader, supporter, critic, editor, et cetera.

If you're not a subscriber, or perhaps you don't know about this project yet: Scarcity in the Software Century is a book that I've always wanted to write, and that I'm now putting together chapter by chapter, week by week. It's been an interesting but fun challenge to write, and hopefully it's going to be a valuable resource for people when it's done. The book tackles two important questions: **How does software help us conquer scarcity?** And **How does software create new scarcity?**

Part one, which now has a written first draft across several sections, is all about "The Arc of Scarcity." It's about scarcity, and about how the world is organized around it; how we conquer scarcity with technology, and reach a virtuous cycle of abundance; how new scarcity and new business models inevitably emerges out of abundance, and how the entire cycle fits together as a phenomenon we can understand.

Section two, which I'm working through now, is all about scarcity and innovative businesses as a financial phenomenon. The innovation economy can be a paradox: it simultaneously destroys old scarcity and also creates new scarcity, and must figure out how to pay for this ahead of time. How do we pay for and build the future if we don't know what it looks like yet?



If you're not already a subscriber, you can sign up here. We'd love to have you on board!

Some other good reading for this week:

Startups and Uncertainty | Jerry Neumann ** This is really excellent.

Redefining Margin of Safety | Brad Slingerlend

Some more reflections on Silicon Valley | Sar Harabhakti

Adam Sandler's Everlasting Schtick | Jamie Lauren Keiles, NYT Magazine

Werner Herzog cannot stop talking about Wrestlemania | Gabriella Paiella, GQ

How Texas Instruments monopolized math class | Maya Kosoff

Have a happy Thanksgiving weekend, a lucrative Black Friday, and a great start to the holidays,

Alex