Seed Funds and the Concentration Question

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As I've settled into my role at Haystack, I've thought about shedding light on what I'm seeing around me and to poke at strategy, tactics, and a little bit of inside baseball. On Twitter and in offline conversation, people discuss portfolio construction and the merits of heavy diversification or concentration, along with investment models throughout that spectrum. On a more personal level, I see how hard a concentrated strategy can be, so I've gained an increasing appreciation for the work.

The argument for concentration. Some investors are heavily in favor of concentrated portfolios. The theory focuses on diminishing returns on investment once an optimal mix of uncorrelated assets is assembled. Another way to look at it is through the practical lens -- as an investment manager, you can only look out for so many companies at a time, so concentration is a marker of disciplined management. Many LPs also favor managers who invest through a concentrated approach, as they tend to own more of a business and avoid dilution when a company scales.

Realities of the market. Regardless, many early-stage funds don't really concentrate. Y Combinator is the most extreme example of this given the number of companies they fund a year. They have their own model that's proven, that works; but I think it's up for debate whether YC counts as a traditional venture capital firm. In other pockets of the market, there's a flood of seed funds and first time managers entering the market. Many of these funds don't concentrate because they're optimizing for shots on goal. It's better to prove to LPs that you can win allocations in competitive rounds and co-invest with some of the best investors in the Valley early on, which helps one fundraise down the road. The incentive structure inhibits newer managers from building concentrated portfolios.

Which funds concentrate? The funds who have been in the game for a long time, who I've started to look up to, are seed funds who take concentrated positions early on in a company's lifecycle, demonstrating conviction in the founders they work with and discipline in portfolio construction on behalf of limited partners. Firms who stay out of the spotlight and let the work speak for itself, such as but not limited to IA Ventures, Steve Anderson's Baseline, and PivotNorth. For these funds, it's about disciplined investment management, willingness to take risks Series A / B venture firms won't take on with a lens into venture as the craft business that it is. If you want to see how precise these folks are, read this post from Roger Ehrenberg or this one from Brad Gillespie, both of IA Ventures.

What makes a fund concentrated? There is a clear pattern to how these funds build up their portfolios. If you were to think about the number of investments per General Partner *per year*, concentrated funds invest in 1-4 new startups. These funds maintain a small partnership of investors (sometimes even a single GP) with the belief that an investment partnership doesn't scale. Extending beyond the small group turns the investor into a manager or an operator. Concentrated seed funds show discipline when it comes to ownership and pricing. Venture capital is a grand slam business, but sensitivity to price mitigates the risks involved with seed investing. Finally, if you look at the portfolios of IA, Baseline, and PivotNorth, there is consistency in the pursuit of capital efficient, software or networks-driven businesses. They didn't stray away when others got interested in funding capital-intensive or services-heavy businesses.

The principles behind concentrated seed investing resonate with me. *Investing that leans on art over science, analysis that comes to the table with a point of view, a bias towards long-term relationship building, and appreciation for venture as craft.* But, concentrated investing presents its own set of challenges, especially for junior investors. Concentration magnifies upside gains as well as downside losses -- you need the stomach to handle that. Couple that with long feedback loops, and tough situations can emerge a few years into the role. Furthermore, investors earlier in their career are incentivized to invest at a higher clip in order to build out a track record ("your portfolio is your path"). This motivation tends to reveal some partiality during deal decisions. It can be tough to sit on the sidelines for months and understand which moments are right to seize. But I do believe the patience would pay long-term dividends.