What is Your Asset Allocation to Alternative Investments

In recent years, alternative investments have emerged as an effective and profitable asset class providing investors diversification beyond traditional public markets and fixed income products which present increased volatility over a shorter duration. The current trends in public markets have demonstrated that high growth companies are choosing to remain private for a longer period of time, thus enabling private investors to capture significantly more value than historically available. To profit from private market value creation, more investors are looking at alternative investment vehicles to provide access to these investment opportunities. One of the best alternative assets to invest in this strategy is venture capital funds. Now more than ever, it is becoming increasingly important for investors to look at the venture capital asset class as an important part of an overall strategic asset allocation.

What is Venture Capital

Venture capital is a unique institutional asset class that invests in equity and debt securities of early stage, private companies that do not have access to traditional capital markets. Venture capital firms provide money to startup companies or growing businesses that are perceived to have long-term growth potential and are developing a novel technology or business model. While this asset class typically entails high risk for the investor, it offers the potential to deliver outsized returns that are uncorrelated with other asset classes.

Venture Capital usually comes in progressive stages:

- Friends & Family Round: The first source of external funding for most early stage companies is sourced from friends, families, and angel investors. These investors normally invest somewhere between \$5,000 - \$50,000 with the Company raising a total of \$100,000 to \$500,000. This is often the first capital raise and the official starting point from where the founders build a prototype and attempt to prove their concept.

- Series Seed: The seed round of capital often signals the first formal round of funding and has historically ranged from \$500,000 to \$1.5MM, although the size of seed rounds has increased over the last few years due to an increase in demand and available seed capital. This round of financing is often the round where the first "institutional" money is invested in the Company (Institutional money is capital invested from a fund or corporation as opposed to an individual investor). In most cases, the institutional investor will "lead" the round, thereby setting the terms of the financing and often committing the largest amount of capital. Other investors will then adhere to the terms of the lead investors and write checks from \$25,000 to \$1MM.

- Series A: The Series A financing round typically ranges from $2.5MM to $15MM and represents the first major capital infusion into the business. In most cases, the Series A is led by an institutional investor who will set the terms and valuation while investing anywhere from $250,000 to $5MM.

- Additional Financing Rounds: If a company is fortunate enough to experience success in raising financing through the Series A, then they are often on a path to accelerate their growth through follow-on financings of growth equity in the Series B, C, D, etc. with the ultimate objective to register for an Initial Public Offering ("IPO").

While earlier investors assume increased risk and uncertainty, their potential returns are significantly higher than investors in later rounds of financing. For an investor to realize their profit, the Company will need to get acquired or IPO at a valuation in excess of their original investment. It is important to understand that the duration of these illiquid investments could be three to twelve years, during which time there are limited secondary markets, but often no viable market to liquidate venture investments.

Why Invest in Venture Capital

It's important for investors to understand why they should invest in venture capital since it is one of the riskiest asset classes. In exchange for the high risk and long duration, successful venture capital investments will deliver significantly higher returns than other asset classes. In fact, the top performing venture capital funds target annualized returns in excess of 30%, significantly higher than the single digit or low teens returns that investors expect to achieve investing in public markets and/or fixed income.

As mentioned earlier, the recent trend of companies staying private longer should also make investors think seriously about their venture allocation. A decade ago, companies like Yahoo!, Amazon, and eBay went public 2-3 years after they were founded. Today, companies like Facebook and Twitter are held private significantly longer, (7 years in the case of Facebook and Twitter) creating a large window to accrue value for private venture capital investors, not accessible through the public markets.

In addition, some of the recent IPO valuations limit the amount of value creation and growth a post-IPO stock can experience in public markets. For example, Alibaba become publically available with a market capitalization of nearly $230BN at its recent IPO. In order for Alibaba's stock to have the same post-IPO performance as companies like Cisco, Amazon, or Microsoft, Alibaba's market capitalization would have to rise to somewhere above $20 trillion. So how much room for appreciation is there today between a company's IPO and their ceiling? If you bought Google on the day of its IPO, your investment would be worth 10x today. If you bought Amazon on the day of IPO, your investment would be worth 176x your money today! Unfortunately, public market investors don't have access to opportunities like this anymore due to Sarbanes Oxley and other regulatory measures. Therefore venture capital funds provide investors the best access to earlier stage technology investment opportunities at low valuations.

Increasingly, money managers and RIAs are using public markets as tools for income and wealth preservation, but investors must look to private markets and venture capital when their objective is wealth generation. In light of these recent trends, venture capital should be looked at as part of an overall strategic asset allocation; how much allocation depends on an investor's risk tolerance, time horizon, liquidity needs and other factors.

How to Invest in Venture Capital

There are two main ways to make venture capital investments: direct and indirect through a venture capital fund. Direct investments involve making an investment directly into a company in return for equity or debt. With direct investments, the individual investor assumes the responsibility of finding a company to invest in, conducting all the due diligence on the company and its founders, undergoing market and product research in order to understand the opportunity, and finally negotiating the terms and structure of the investment. A direct investment will concentrate an investor's risk into one company and one opportunity. In order to diversify risk with direct investments, an investor will need to make numerous direct investments, sourcing opportunities and going through the due diligence process with every investment. It is very challenging for individuals to generate positive returns through direct investments.

The other way to invest in venture capital is indirectly through a venture capital fund. These are investment vehicles where a number of investors (known as limited partners or "LPs") pool money which is invested directly in a number of companies through a manager (known as the general partner or "GP"). In the traditional VC fund structure, it is the responsibility of the GP to find companies to invest in, conduct due diligence on those companies, negotiate terms of the investment, and build a portfolio of complementary companies aimed at maximizing the portfolio return for their investors. Funds invest in numerous companies in order to diversify and reduce risk. In exchange for sourcing companies, conducting due diligence, negotiating deal terms, and managing the fund, GPs are compensated through a management fee (usually between 2-3%) and carried interest ("the carry"), which is a percentage of the net return to an investor (usually 20%). The carry is the incentive for the manager to perform - the larger the return delivered to investors, the larger the carried interested paid to the GP, ensuring alignment of incentives between the LP and the GP. In most cases, the GP is also required to make a participating investment as an LP alongside the other investors.

How Scout Ventures works with Limited Partners

Through three funds and over 50 investments, Scout Ventures has helped its LPs build a venture capital strategy that works best for them. Scout's investments and strong performance have given its LPs a diversified entry into the venture capital market with exposure to a broad range of technology-enabled companies located throughout the United States.

Scout considers its LPs their greatest assets; they are far more valuable than the capital they invest. Scout's network of LPs and advisors includes experts and executives in a wide variety of industries. The collective knowledge of Scout's investor base makes the fund smarter, which in turn, leads to better hands on execution and stronger performance. Scout will also vet any company that is sourced directly from an LP. If an LP is thinking about investing in a specific company, Scout will review the company and provide investment commentary leveraging the context of the hundreds of companies the firm sees each month.

In addition, all of Scout's LPs are eligible to invest their own capital directly into any company that Scout is investing in (provided there is capacity). This allows LPs to invest additional capital directly into companies or entrepreneurs that they believe in, thereby increasing their capital concentration into companies that have been vetted by a professional manager. Scout acts as a venture advisor for LPs, identifying investment opportunities for LPs that suit their specific interests whether its a certain industry, geographic location, or emerging technology; Scout helps tailor a venture capital allocation that is consistent with each LP's individual goals.

Over the past five years, markets have shifted tremendously, altering what can be accomplished in public markets. However, many investors are still using investment strategies geared towards the markets of 5 or 10 years ago. In light of the new realities of public markets, the continuing role out of government regulations, and opportunities in private markets, it makes sense to ask - what is my venture allocation?

Scout Ventures is a "Series Seed" technology investor with offices in New York City and Miami.

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