How the Chairman of Y Combinator Decides Which Startups to Invest In

Sam Altman

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Best Business Blogs

There isn’t a lot of advice out there about how to be a startup investor, so here is some

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There is a lot of advice about how to be a good startup founder. But there isn’t very much about how to be a good startup investor.

Before going any further, I should point out that this is a particularly hard time to invest in startups — it’s easier right now to be a capital-taker than a capital-giver. It seems that more people want to be investors than founders and that there’s an apparent never-ending flow of capital looking for access to startups.

The law of supply and demand has done its thing. Valuations have risen, and the best investment opportunities are flooded with interest. As a friend of mine recently observed, “it’s much easier to get LPs to give you money for your seed fund than it is to get a meaningful allocation in a ‘hot deal.’”

That said, to do well as an investor, you need to do three things: get access to good investment opportunities, make good decisions about what to invest in, and get the companies you want to invest in to choose you as an investor. That’s it! You can often help the companies you invest in become bigger than they otherwise would have been, but the sad reality is that your best investments will do quite well without you.

Getting access to investment opportunities is the easiest of the three categories: You can just work hard. It’s surprising that most investors don’t work hard, but it’s true and a bug that you can exploit.

Putting a lot of energy into networking actually works, as long as you aren’t just trying to touch base when people can find some time away from their crazy calendars to grab coffee. If you actually figure out how to help other investors you respect, and to really help good founders, then good investment opportunities will come your way.

If you’re starting out as a full-time investor, make it your full-time job to figure out how to help people who will become your future investment-sourcing network. Instead of just asking your contacts to tell you about investment opportunities, ask them if you can spend a day per week helping their best company. In general, early-stage investors can help a lot with closing candidates, future fundraising, customer introductions, and generic advice.

A brand is the other way to get access. There are a lot of ways to build one, but by the same principle of working hard, a good example is to write long-form content (hard, few people do a good job at it) instead of tweeting (easy, everyone does a pretty good job at it).

Great founders are the key to great startups. One way to do really well as a startup investor is to get good at predicting who is going to be great before they are — the market rewards finding great but inexperienced people. You can also do well by investing in people who are already proven, but the price of the shares you buy will reflect that.

So how do you identify future greatness?

It's easiest if you get to meet people in person several times. If you meet someone three times in three months and notice detectable improvement each time, pay attention to that. The rate of improvement is often more important than the current absolute ability (in particular, younger founders can sometimes improve extremely quickly).

The main question I ask myself when I meet a founder is if I'd work for that person. The second question I ask myself is if I can imagine them taking over their industry.

I look for founders who are scrappy and formidable at the same time (a rarer combination than it sounds); mission-oriented, obsessed with their companies, relentless, and determined; extremely smart (necessary but certainly not sufficient); decisive, fast-moving, and willful; courageous, high-conviction, and willing to be misunderstood; strong communicators and infectious evangelists; and capable of becoming tough and ambitious.

Some of these characteristics seem to be easier to change than others; for example, I have noticed that people can become much tougher and more ambitious rapidly, but people tend to be either slow movers or fast movers, and that seems harder to change. Being a fast mover is a big thing; a somewhat trivial example is that I have almost never made money investing in founders who do not respond quickly to important emails.

Also, it sounds obvious, but the successful founders I've funded believe they are eventually certain to be successful.

In addition to learning to predict who will become great founders, you have to be at least okay at predicting what markets will be good.

Startups are likely to happen in many more industries — startups can win wherever costs can be low and cycle time can be fast. Startups do particularly well in industries with rapid technological change because their fundamental advantages over large competitors are speed and focus. A higher rate of change gives startups more opportunities to be right and the large competitor more opportunities to stumble.

Like the founder, and like a company, what you should care about is the growth rate and eventual size of a market (I don't know why most investors are so obsessed with the current size of a market instead of how big they think it will be in 10 years, but it's an opportunity for you).

The best companies tend to have the courage to lead the market by a couple of years, but they know the secret for telling the difference between a real trend and a fake trend. For a real trend, even if there aren't many users, they use the new platform a lot and love it. For example, although the iPhone was derided for not having many users in its first year or two, most people who had an iPhone raved about it in a way that they never did about previous smartphones.

The very best companies tend to ride the wave of a new, important, and rapidly growing platform.

The spectral signatures of the best companies I've invested in are remarkably similar. They usually have most of the following characteristics: compelling founders, a mission that attracts talented people into the startup's orbit, a product so good that people spontaneously tell their friends about it, a rapidly growing market, a network effect and low marginal costs, the ability to grow fast, and a product that is either fundamentally new or 10x better than existing options.

You should try to limit yourself to opportunities that could be $10 billion companies if they work (which means they have, at least, a fast-growing market and some sort of pricing power). The power law is that powerful. This is easy to say and hard to do, and I've been guilty of violating the principle many times. But the data are clear — the failures don't matter much, the small successes don't matter much, and the giant returns are where everything happens.

The central learning of my career so far has been that you can and should scale up things that are working. The power of scale, and the emergent behavior that sometimes comes from it, is tremendous. I think about the potential energy of future scale for every investment I make. Most people seem terrible at this, so it's another bug you can exploit.

Although good ideas are understandably seductive, for early-stage investing, they are mostly valuable as a way to identify good founders. However, sometimes bad founders have good ideas too, and investing in them is the chronic investing mistake that has been hardest for me to correct. (My second biggest chronic mistake has been chasing investments primarily because other investors like them.)

The better the investment opportunity is (i.e., expected value relative to valuation), the harder it usually is to get the company to choose you as an investor.

Traditional sales tactics work pretty well here. Spend a lot of time with the founder, explain what you're willing to do to help them, ask founders you've worked with in the past to call them, etc.

A reputation for being above-and-beyond helpful and accessible is worth a lot here and rare among all but the best investors. A reputation for being founder-friendly helps too. What helps most of all is other founders you've previously invested in saying "that person was my best investor by far."

In addition to helping get access to investment opportunities, a strong brand also helps close them. It's a nice tailwind if you can get yourself to the place where simply taking your money helps a company get taken more seriously.

Decisiveness also helps — everyone wants to be wanted, and most investors wait for someone else to act first. If you decide quickly, and especially if you decide before others do, founders tend to appreciate that. The two most recent significant investments I made were 1) telling people I'd previously backed and had huge conviction in that I would do their Series A before they finished telling me what their idea was, and 2) offering to do the seed round of founders I'd never met before at the end of a one-hour meeting. I don't recommend doing that very often, but when your conviction is strong, let it show.

The best way to have a poor close rate is to not treat founders like peers. If you're picking well, you should be investing in founders who you think of as your peers at least. Founders have a sixth sense for who is going to treat them like a peer and who is going to treat them like a boss. And if they're good, they know you're failing an intelligence test if you act like their boss.

The most important way to help founders is to get them to be more ambitious — to think bigger and to have more self-belief. Help them set ambitious but achievable goals. Momentum is important and self-reinforcing — most people set goals that they expect to be just out of reach, which is usually demotivating. It's better to continuously set goals that you can just barely hit.

The second most important thing to do is to give them specific, tactical advice (instead of general strategy) about how to achieve their goals. Good tactical advice is something like "it seems like you've figured out yourself how to do sales for this company, so here is where to look and what to look for in your first sales hire, and here is the sales tool you should use."

There are a lot of specific things you can do to help — make introductions, help them hire, help them find other investors, help them find an office, etc. — but generally you should wait to do these until asked.

A big exception is that you should proactively let them know when you have very high conviction that they're about to make a big mistake, especially once things are working and they aren't setting themselves up to scale.

In theory, another big exception is actually helping founders come up with good new ideas. The first investor I ever watched in action was PG, and so I assumed this was something all investors were fantastic at. But it turns out he is a sui generis idea generator, and even most great investors are usually still bad at telling founders what to work on. It's worth trying to be self-aware.

Finally, I've found that most of the time when founders call asking for vague help, what they are really asking for is emotional support from a friend. Invite them over to your house, make them tea or pour them a drink, and start listening to their struggles.

An earlier version of this story incorrectly stated Steve Jennings' role. He is the former Chairman of Y Combinator.