

Upside risk

Everyone claims that they understand the power law in angel investing, but very few people practice it. I think this is because it's hard to conceptualize the difference between a 3x and a 300x (or 3000x) return.

It's common to make more money from your single best angel investment than all the rest put together. The consequence of this is that the real risk is missing out on that outstanding investment, and not failing to get your money back (or, as some people ask for, a guaranteed 2x) on all of your other companies.

And yet angel investors continue to ask for onerous terms to mitigate their "downside risk". All this does is piss founders off, misalign incentives, and harm the investors' chance of getting to invest in the best deals, because those are usually hotly pursued and good founders check references. An angel investor is much better off focusing on investing at a reasonable price [1] and not trying to "win" on any other terms.

Instead of downside risk [2], more investors should think about upside risk—not getting to invest in the company that will provide the return everyone is looking for.

[1] Speaking of price, the mistake that founders make (corresponding to investors focusing too much on downside terms) is focusing too much on getting a high price. I have seen many founders price out good investors and put the company in a bad situation facing a down round a year later, all because they were obsessed with getting a high sticker price for their company. I think it's because it gives founders something quantitative to compete on.

[2] As a side note, I think most people have terrible intuition about investment risk/reward tradeoffs in general—this is not limited to private companies. It feels like every time I turn on CNBC (which is thankfully very infrequently) they're talking about an impending total collapse. The end of the world only happens once; it's very unlikely to be Monday morning. But we seem hardwired to focus on downside risk. The CNBC watchers would be better off keeping a cushion in cash and not selling their stocks after every panic.