Black Swan Seed Rounds

I started seed investing in 2010 (and much more actively in 2012) before becoming a full-time YC partner. In this period, I invested in about 40 companies. So far, five of them are in the “really good” category—a current value of ~100x or more, based on the valuation of the last round or last offer.

I’ve been thinking a lot about what these investments have in common, and what about them was different from other investments. The most striking observation is that, in my experience, the “hot seed rounds” that everyone is fighting to get in are anti-correlated with very successful investments. (It’s probably different for A and B rounds because the best companies often have exponential growth at that point.) The hotly-competed seed investments I’ve made have underperformed.

For all of the really good seed investments I’ve made, other investors I respected thought they were bad ideas. Stripe started before it was cool for very young founders to take on very established industries, and the prevailing thoughts from people I asked about were that it was never going to work (the initial plan was to be a bank) because Patrick knew nothing about the industry. Teespring got passed on by most investors, saying “It’s just a t-shirt company.”

Right before I invested in Zenefits, a prominent investor told me I didn’t understand the health insurance market at all and that the company was unlikely to survive another 3 months. When I made this investment, the company was worried about imminently running out of cash. I almost got talked out of investing by the other investor.

The one major exception is Optimizely—the prevailing sentiment was that Optimizely was going to be great, and it was a competitive seed round. It was the only high-return company where I had to fight for an allocation—in the other four, I could have put more money in.

There is a general exception to this observation when the founders are already well-known and have impressive track records. Those seed rounds are almost always competitive.

Note that other investors thinking an investment is bad does not guarantee success. For the total write-offs I've had so far, other investors also told me they were going to be terrible. Being contrarian and wrong is still bad—you have to be contrarian and right. I think the only takeaway about what other investors think is that you should ignore it.

Great companies often look like bad ideas at the beginning—at a minimum, if it looks great, the seed round is likely to be overpriced, and there are likely to be a lot of other people starting similar companies. But even when I attempt to adjust for price, the hot-round investments still have underperformed.

I asked a few other investors about their experiences, and most are roughly similar. Most of the really big hits never had TechCrunch writing about their super competitive seed round everyone was trying to get in.

I think there are a lot of reasons for this. A big one is that being good at fundraising has very little to do with running a good company. Another is that most investors are actually very risk-averse despite what they say, and the great companies look really risky at the seed stage. And a major third is that it's just very hard to pick well at the seed stage, and most companies don't have hot seed rounds, so most successful companies don't either (though I don't think this random distribution fully explains the phenomenon). But in any case, founders shouldn't worry if their seed round isn't massively oversubscribed.