The separation of advice and money

One of the most interesting changes in venture capital going on right now is the separation of advice and money. For a very long time, these have been a package deal.

Great advice is really important; some founders don’t appreciate this initially (I was guilty of it) but always learn to. But great advice does not have to come from venture capitalists; it often comes from people like former founders.

There have been a few small indications of the advice/money separation over the past few years, but crowdfunding is now really making it happen. Some companies can raise money on very good terms from investors that don’t know much about startups, and then give equity to the advisors they want to work with.

There are probably going to be big advantages and big disadvantages to this. On the positive side, founders may end up with less total dilution and get to choose whatever advisors they want—not just the people that happen to manage institutional money. Another big positive is that more competition (and more transparency) makes investors behave better. On the negative side, advisors probably won’t work quite as hard for a company that they don’t have a lot of capital invested in. Also in the negative column, this will probably further worsen founders’ disrespect for capital. And perhaps worst of all, I expect a lot of people to lose a lot of money—startup investing is both hard and appeals to gambler’s instincts, and it’s easy to imagine it becoming the new daytrading. At some point, of course, the pendulum will swing back.

Advisors will probably still put in some capital, but probably at a better effective price than people who just invest. The hard part is that everyone thinks they are a great advisor and wants the special treatment.

The bigger force at work is the long-term trend towards founders having more leverage than investors. This change in leverage has happened for a lot of reasons, but specifically, crowdfunding probably would not have been possible if companies needed as much capital to start as they did ten years ago. Also, startups are cool now, so more people want to invest.

Quick and painless fundraising, without advice necessarily being part of the package, is what many founders want. In a sense, VCs sell advice, but founders want to buy money.

Crowdfuding is an answer to this (also, the crowd is willing to fund things VCs are not, pay higher prices and on very clear terms, etc.) Fundraising has not been an efficient market—VCs and angels have been able to corner it with laws, access, and it being the only source of advice. But the Internet continues its never-ending march.

The best VCs are great, and they will probably continue to do well. In fact, they’re so good that they could probably get away with only selling advice—they understand how to build big companies in a way that few other people in the world do. They may have to adapt their strategy somewhat—for example, in response to being able to buy less ownership in earlier rounds, I suspect some firms will shift to writing much larger checks to the obvious winners in later rounds.

The mediocre and bad VCs will have to adapt or die.