

VC investing requires \$10M, patience

How would you like to invest in future startups that may become the new Google, Yahoo, FedEx, Apple or Intel? Through venture capital partnerships you may be able to participate in such rewarding companies of the future.

According to the December 2007 National Venture Capital Association estimates, venture capital investing amounted to about \$30 billion in the United States last year, still a far cry from the \$90 billion invested in the late 1990s.

We define venture capital investing as providing capital to businesses as seed capital to test their ideas or to provide pre-revenue operating capital for not yet profitable businesses. These are very risky investments with very high rewards, if they succeed.



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A November 2007 study by the Angel Capital Association disclosed that on average angel groups had an impressive 27 percent internal rate of return. The worrisome part is that 7 percent of venture capital investments accounted for 75 percent of the total returns. About half of all ventures were losers.

Venture capital investing is



an illiquid investment that is expected to outperform stock market benchmarks and is often uncorrelated to stock market indexes (i.e. great for portfolio diversification and hedging). It is very much like growing grapes to make wine. They require years to mature, a substantial investment up front and have an uncertain outcome.

It is not surprising to learn that there are huge sums of money chasing a mere few true top-tier legendary venture capital firms. If you want in on these ventures you can expect to be going up against smart money coming from billionaire families

and university foundations, like Yale (print or read our article from Feb. 7, describing Yale Endowment's investment success and asset allocation through our Web site, www.pillaronline.com).

Venture capital partnerships raise pots of cash to infuse into 15 to 20 private businesses over what is typically a 10-year period. This approach reduces risk via diversification while keeping the returns in the 25 percent-plus area. Venture capital firms typically collect a 2 percent management fee plus about 20 percent of the realized profits. As a partner/investor you can expect capital calls over

a 5- to 6-year period to fund the enterprises the partnership has chosen.

The venture capital partnerships you invest in will typically have a 10-year lifespan. You should expect the bulk of your profits, if any, to be received in years 7-10. Profits are usually made after an initial public offering or the sale of the funded businesses.

When evaluating venture partnership returns we recommend caution. You can't just look at what one firm has done with its different partnership investments and assume that you'll end up with solid conclusions. One of the reasons you may end up with misleading conclusions is because of the different economic environments the different partnerships experience. This may reflect poor results in a recession, even though from a big perspective the actual results compared to other investment funds during the same time period were fantastic. When evaluating venture capital partnerships we should compare partnerships that commenced in the same year.

Since no one is perfect at predicting the economic, credit, world and terror type events, we would invest in different partnerships that commence on different years (time-averaging). One per year for five years would diversify away some of the risk in addition to exposing you to about 75-100 enterprises.

In our opinion you should have a minimum of \$10 million of liquid net worth before you consider investing in venture capital partnerships. If your liquid net worth is more than \$3

million but less than \$10 million then we would suggest you consider venture investing through a fund of funds.

Funds of funds, if they are well connected and established, may allow you an opportunity to have a seat at the table with the top-tier venture partnerships. Due diligence is critical when choosing your fund of funds. Here are due diligence areas we would start with:

- Evaluate the depth of the management team.
- Evaluate the track record.
- Evaluate their level of access to top-tier venture capital firms.
- Look at their limited partnership internal rate of return (which is net of fees and carry). Don't just look at the gross returns.
- We would heavily weigh what they are not willing to share or answer; these should be as strong a clue to you as any of their answers.

A mistake many make is to look at a partnership performance in years 2-6. As we mentioned earlier, the bulk of your profits will come in years 7-10. There are other considerations we highly recommend you consider: To learn more you can read our April 14, 2006, article titled "Hedge funds: Are the huge profits real or an illusion," (see our Web site).

If you have any questions or have other topics you'd like us to comment or write about don't hesitate to contact us through our Web site.

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