

Thoughts on VC From a (Wanna-be-a) Believer

Jack Gray

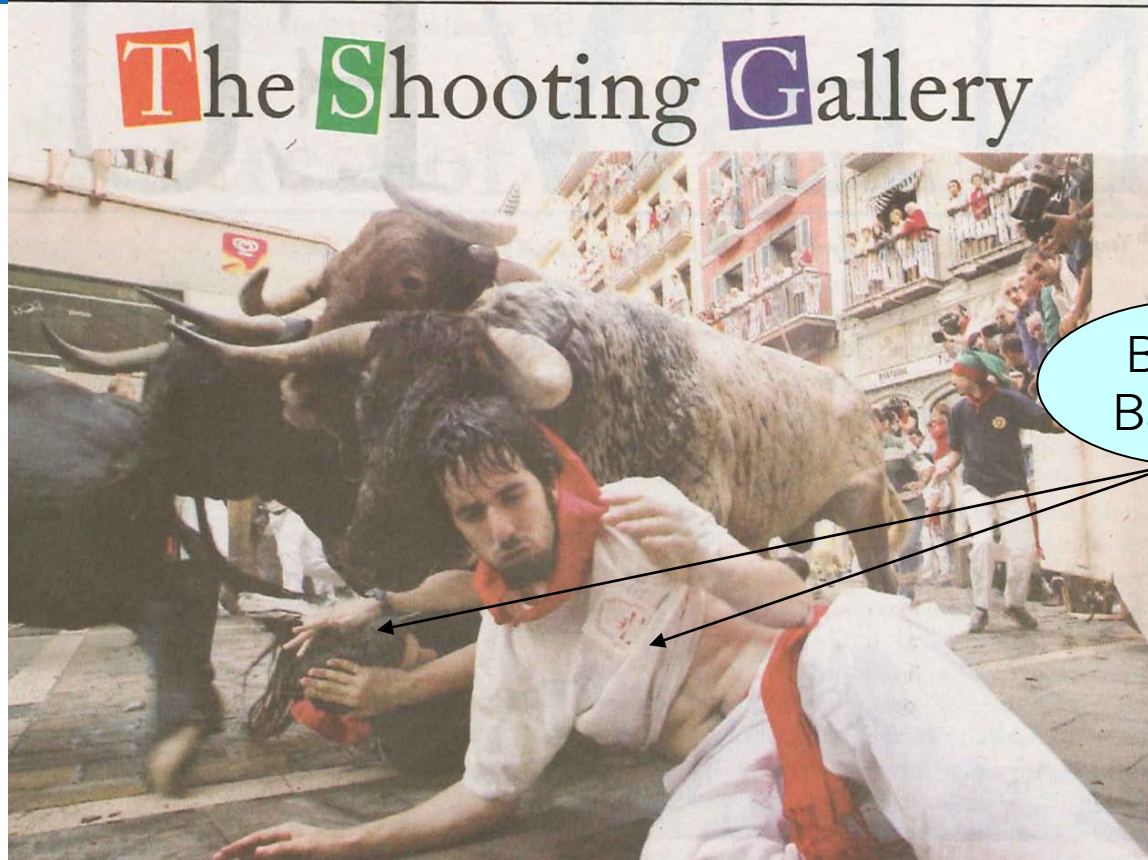
AVCAL Conference, 2010



Investment design & fund raising specialists

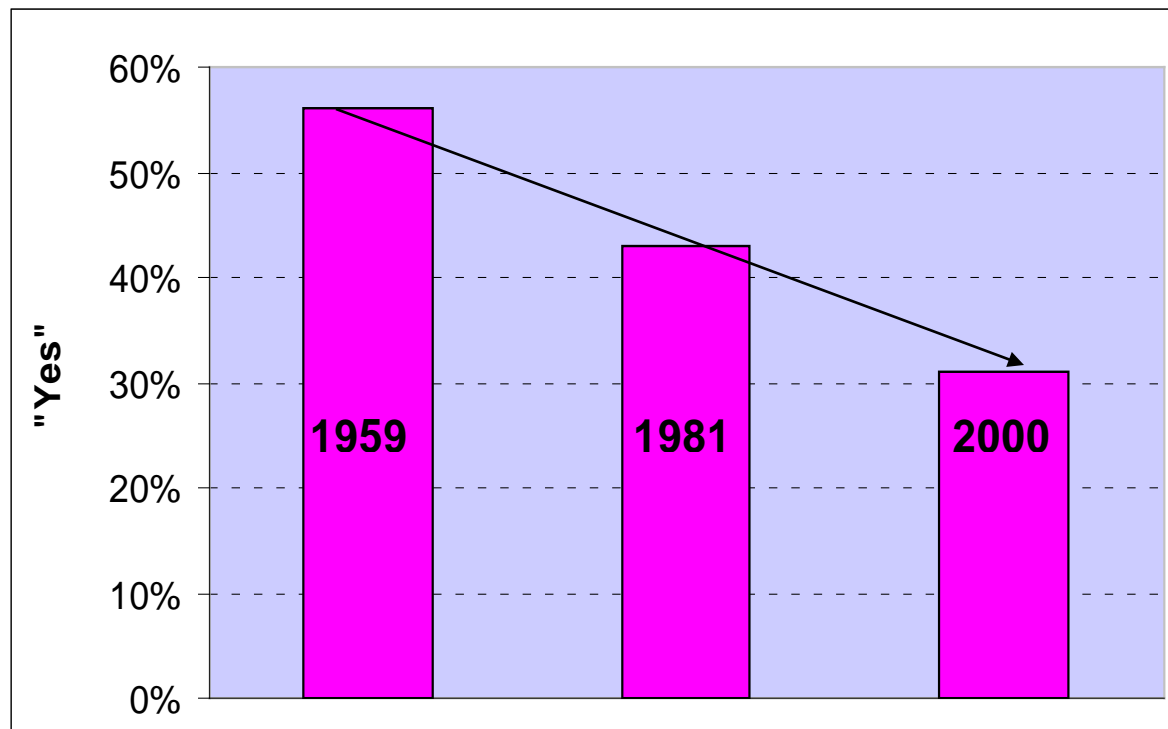






" Seeking to appease public anger, Spain made changes to the Pamplona running of the bulls. Entry is limited to those in banking and finance ... and entry is compulsory."
New Europe

“Can most people be trusted?” UK



World Values Survey

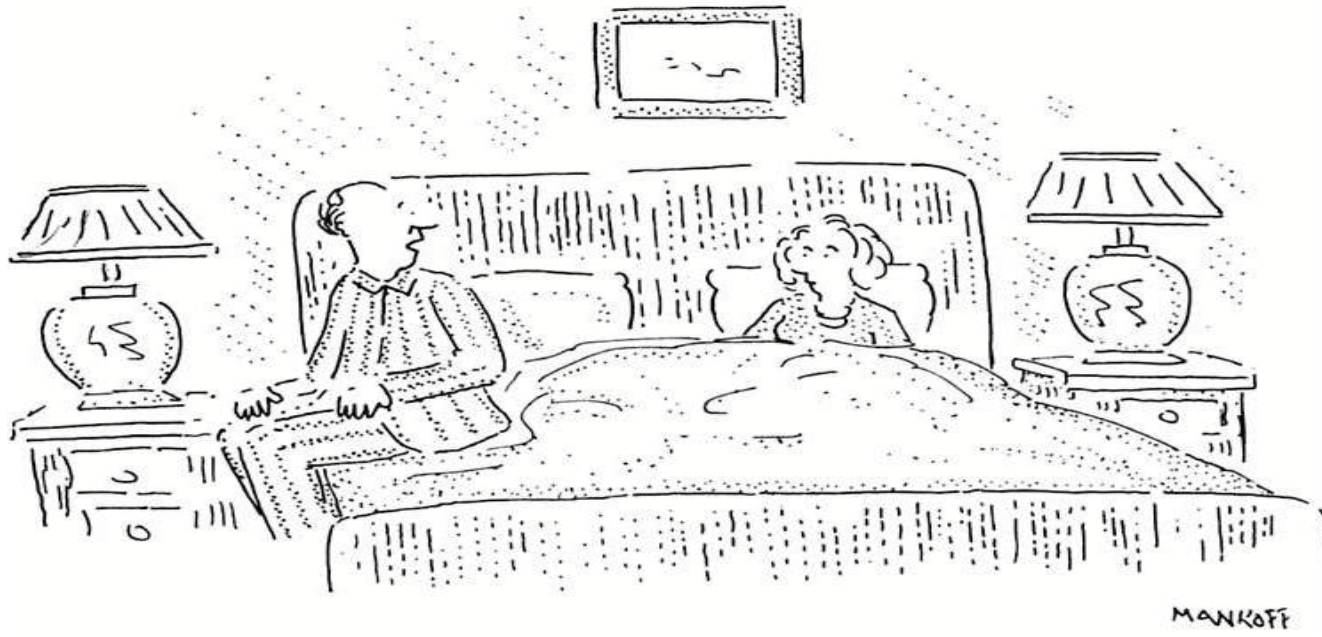
- Loss of confidence & trust in *asset classes*:
 - 1930s Equities
 - 1970s Bonds
 - 2010s Equities & Alternatives (including PE and VC)?

- Loss of confidence & trust in *institutions*:
 - DIY, retail & institutional

- DIY Drivers:
 - Control ... the illusion thereof
 - Lower agency costs?
 - *Fun-of-Funds* vs Fund-of-Funds

“Most firms that got money last year got it from angels.”

David Gill, St John’s Innovation Centre, Cambridge, UK

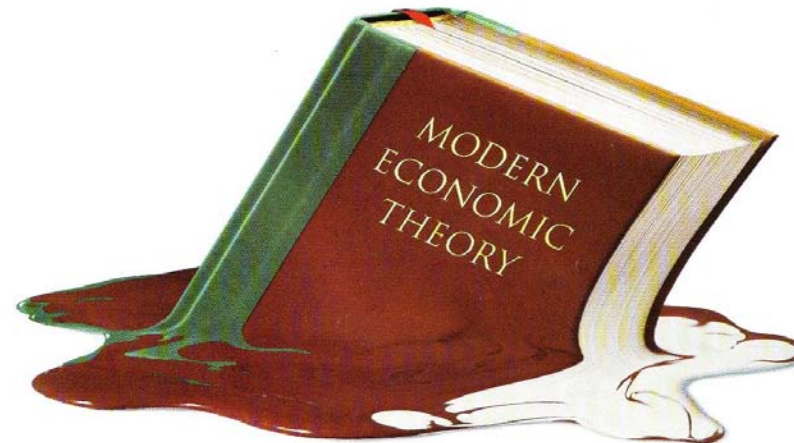


“I can’t sleep. I just got this incredible craving for capital.”

New Yorker

Vale Market Fundamentalism?

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Where it went wrong—and how the crisis is changing it



Australia...A\$10.50(Incl.GST)	Figi.....US\$6.00	Korea.....Won 5,500	Nepal.....NRs00	Singapore.....S\$12.00(Incl.GST)
Bangladesh.....Tk6.00	Hong Kong.....HK\$5.00	Malaysia.....RM20	New Zealand.....NZ\$11.00	Sri Lanka.....Rs150
Canada.....C\$15.00	India.....Rs 200	Philippines.....P\$20	Pakistan.....Rs60	Taiwan.....NT\$230
China.....RMB 75	Indonesia.....Rp 6,000	Poland.....zł1.50	Saudi Arabia.....SRs30	Thailand.....Baht 4.00
	Japan.....¥130 (Incl. GST)	Spain.....€1.50	Turkey.....TL1.50	Vietnam.....V\$36.00

“One by one the claims made by modern finance have been tested during this crisis and usually found wanting.”

“Smith’s invisible hand was invisible ... because it wasn’t there.”

Joseph Stiglitz, August 2010

“ Gone forever, one hopes, are the idiocies (*obscenities*) of Friedman-Hayek libertarian selfishness.”

Paul Samuelson, May 2009

Died, December 2009

- See Germany, China, and even (shock, horror) the IMF

New Ways

Effect on VC

Elinor Ostrom *	Co-operation	✓
Tim Jackson	Prosperity <i>sans</i> growth	✓
Joseph Stiglitz *	Sustainability	✓
Richard Layard	Happiness & fairness	✗
Amartya Sen *	Ethics & justice	✗
Danny Kahneman *	Behavioural finance	✓
Herbert Simon *	Bounded rationality	✓

* Nobel Prize in Economics

New Ways

Effect on VC

Andy Lo	Adaptive markets	?
Karen Ho	Ethnography	✓
George Soros	New Economic Thinking	?
FuturicT	Interdisciplinary economics	?

Non-Standard Utility?

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Players

- SWFs
- Corporates
- Pension funds; Endowments
- Govt innovation funds

Utility

ETI

Proximate industries;
Innovation

Prestige; R&D opps

Jobs; Green & clean

Universe

Effect on VC

- Open source
 - SITI; Linux; Wiki; ...
- Co-opetition
 - GM/Toyota; Alzheimers R&D; ...
- Industrial policy
 - Govt funding; ...

x

✓

✓

Welcome Back (Enlightened) Government

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6 Briefing The global revival of industrial policy The Economist August 7th 2010



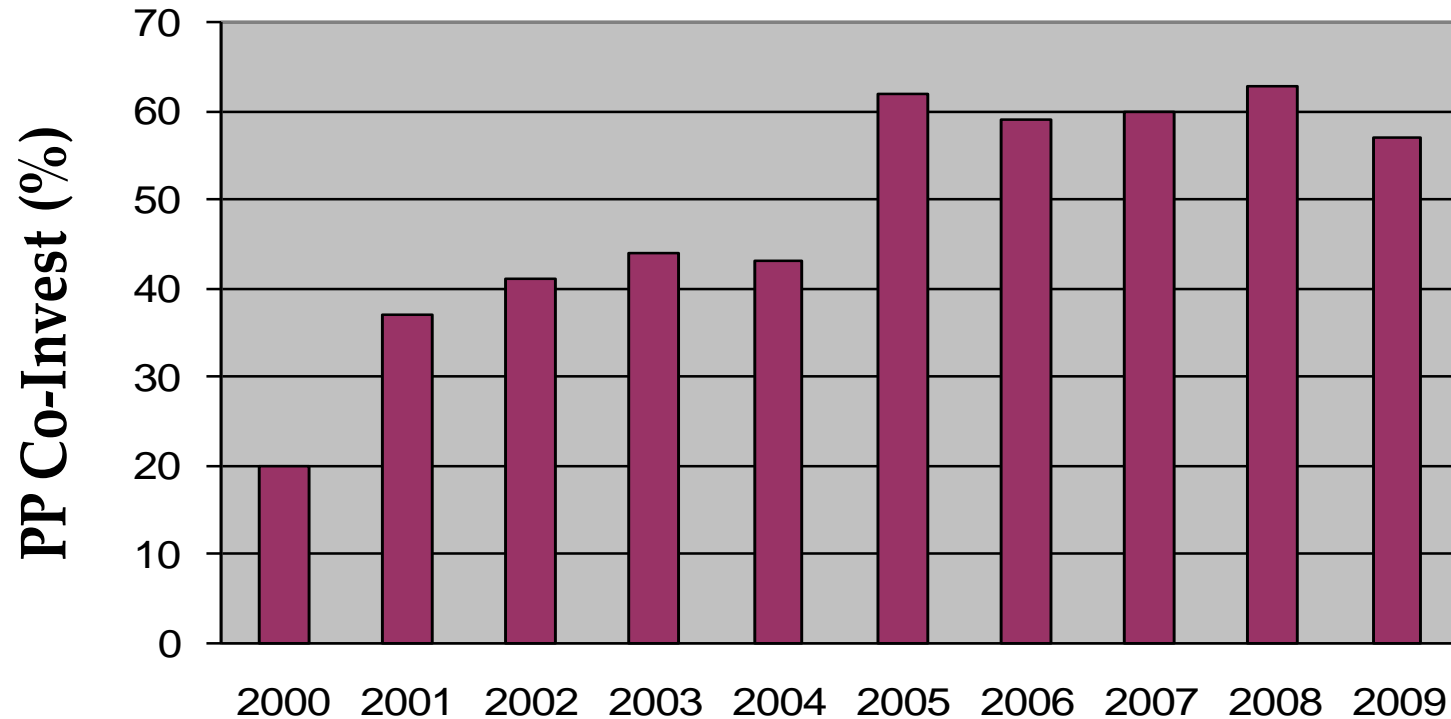
Picking winners, saving losers

PARIS
Industrial policy is back in fashion. Have governments learned from past failures?

government last year set up a Strategic Investment Fund to steer £750m (\$1.2 billion) of state money to particular industries and companies. The Conservative-led coalition has since rejected what it calls a "new interventionism" around the world. It has cancelled some loans, such as one to Sheffield Forgemasters, a northern steel firm. But much of Labour's plan remains.

□

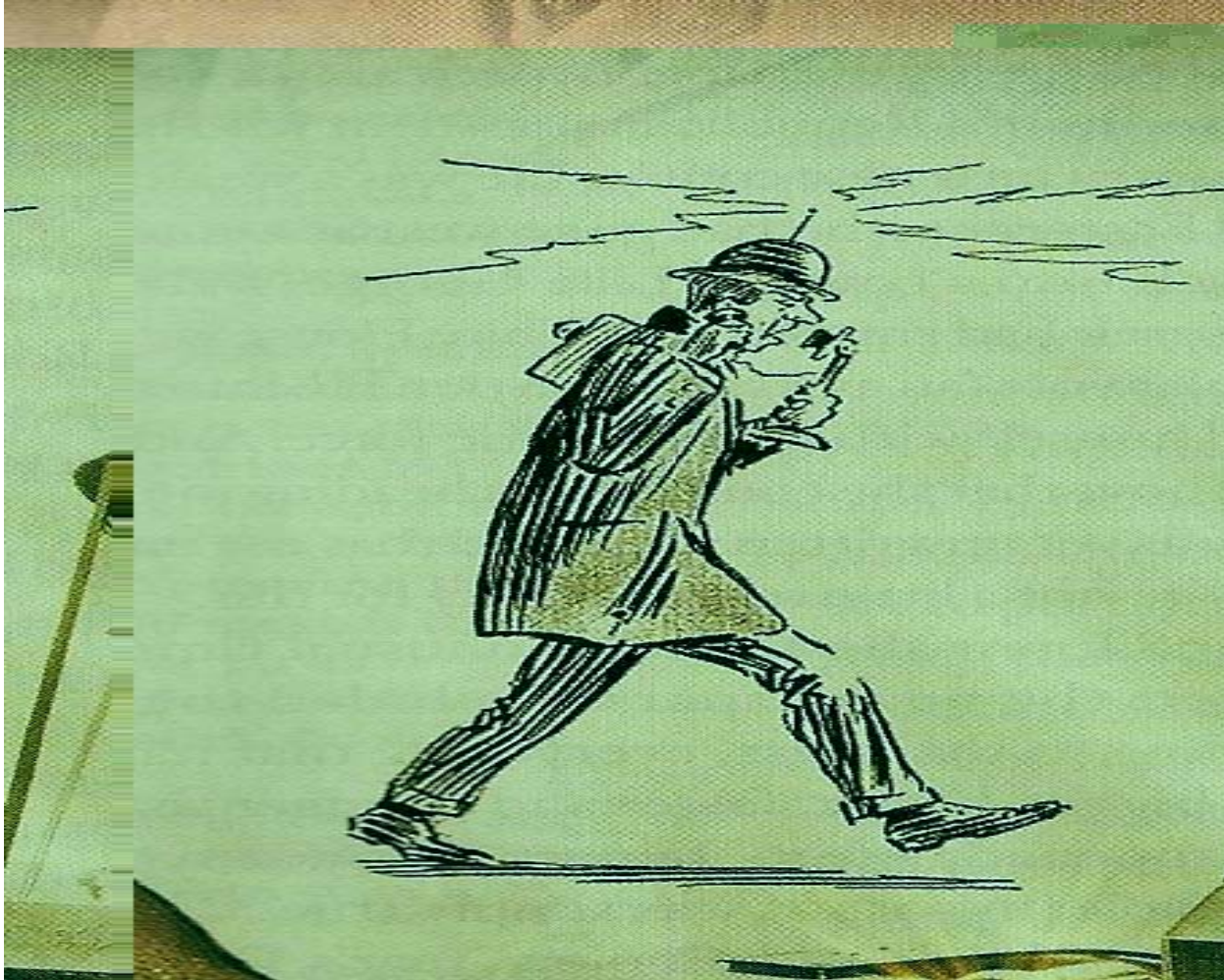
UK Early-stage VC

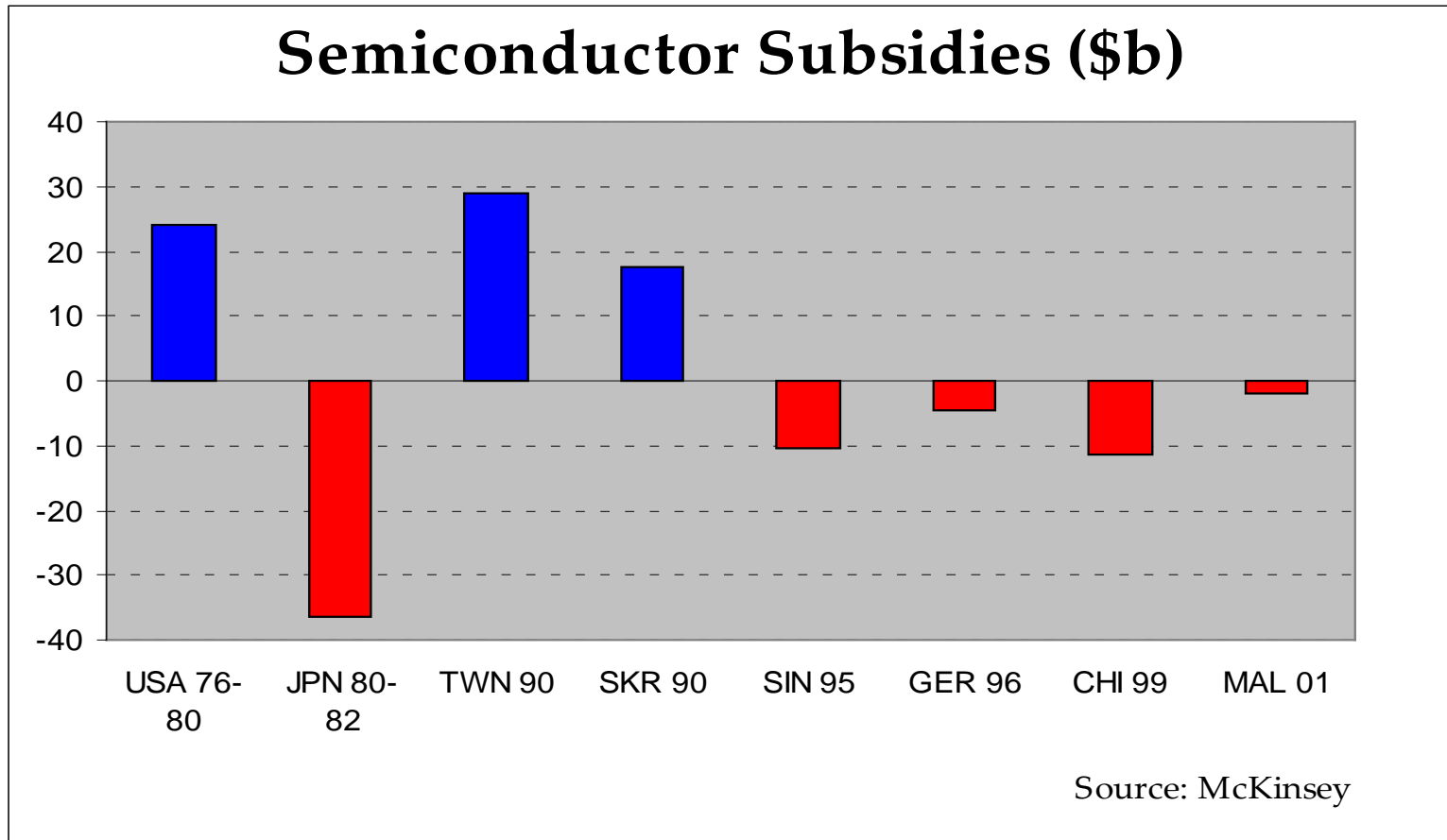


The Economist

Picking Winners c.1900

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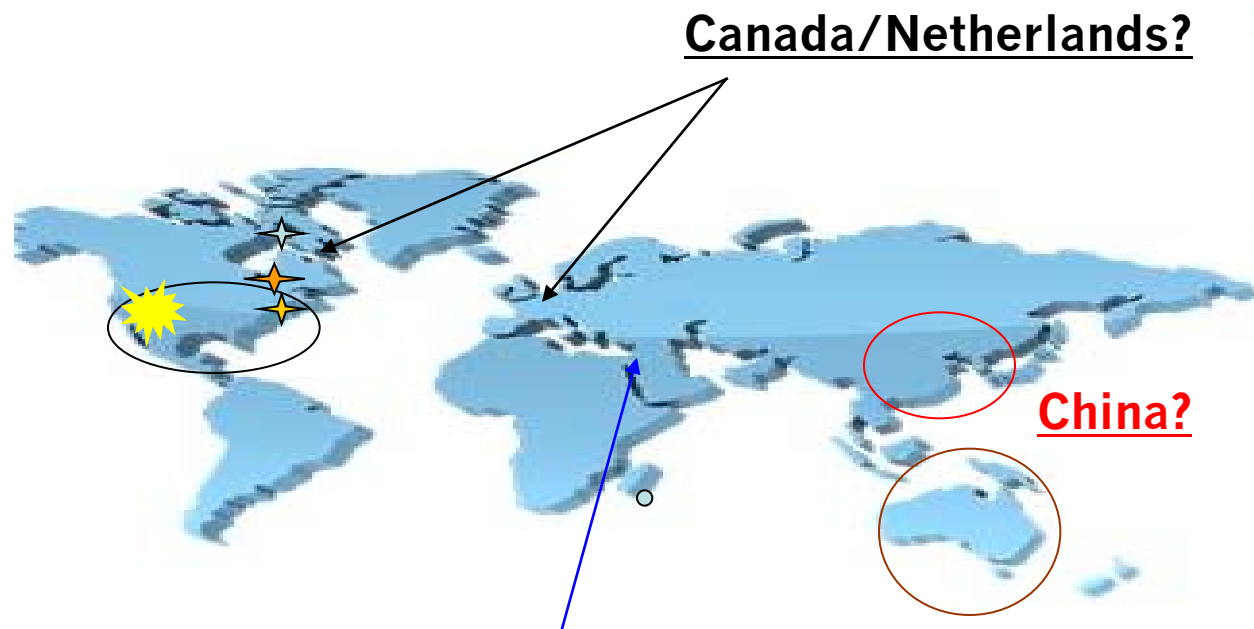




Does 'industrial policy' help or hinder VC?

As Citizens We *Want* to Believe

- A vibrant VC market is *necessary* for a growing developed economy ... probably *false* for countries & companies
- R&D is *necessary* for a vibrant VC market ... *true*
- Government should fund intellectual infrastructure & not pick winners ... probably *true*, but is R&D productivity falling (diminishing returns)?
- VC can *create* wealth ... *true*. Unlike most finance, VC scores highly on 'financial innovation'
- My country *can* develop a vibrant VC industry ... *maybe*



USA

- Large diverse economy
- Risk-taking culture
- Military (Govt) funding

Israel

- Scientific culture
- Military (Govt) funding

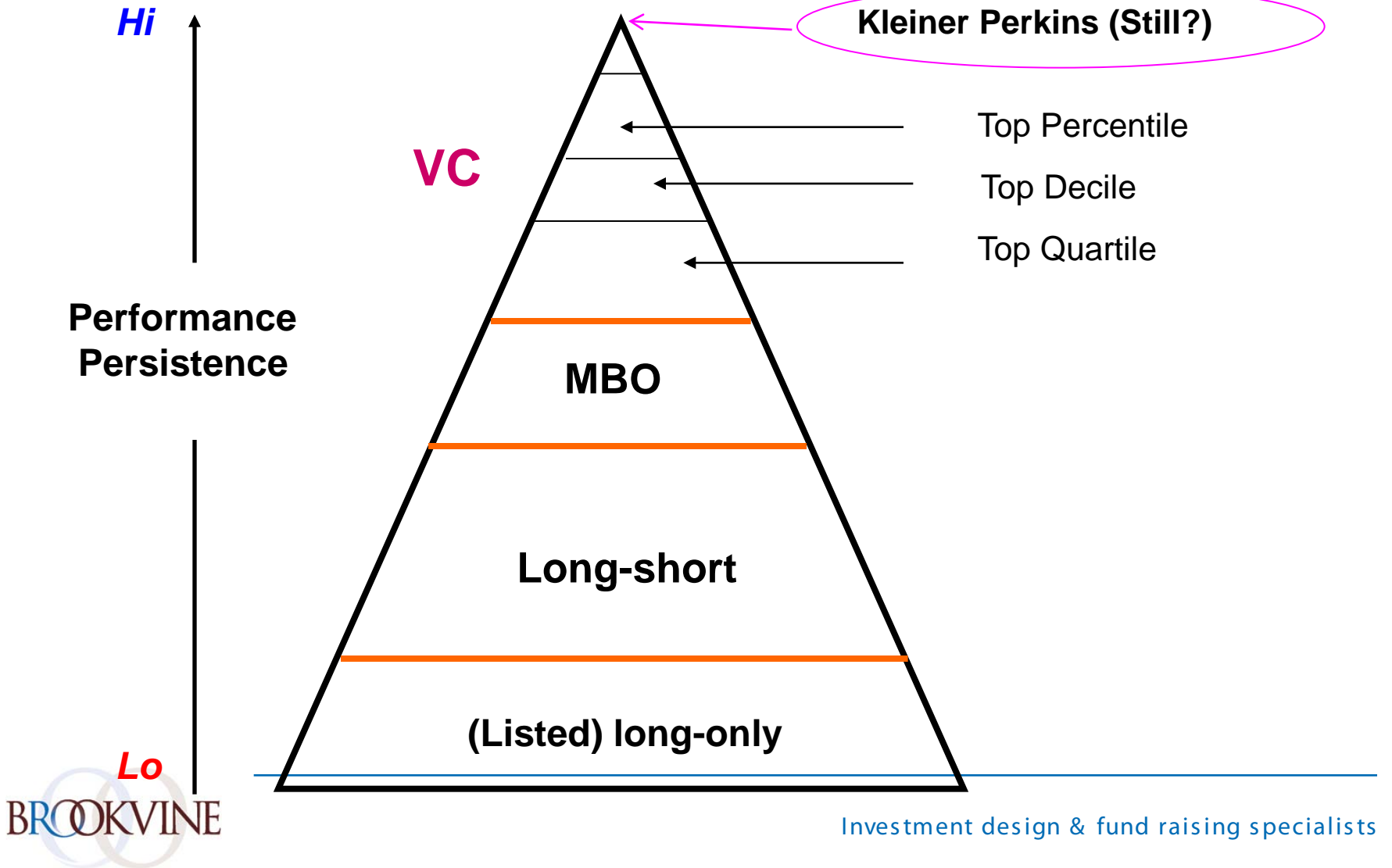
A Sunburnt Country?

As Investors We *Want* to Believe

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- VC *can* increase institutional risk-adjusted returns, but ...
- Only top-decile managers ‘succeed’, but ...
 - ‘Success’ follows a power law, so
 - VC is an *access class* not an *asset class*

The Persistence Pyramid



As Investors We *Want* to Believe

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- VC *can* increase institutional risk-adjusted returns, but ...
- Only top-decile managers ‘succeed’, but ...
 - ‘Success’ follows a power law, so
 - VC is an *access class* not an *asset class*

and

- Large survivorship/backfill biases?
- Will vintage 06/07 spoil (soil?) persistence?

Always With the 'Buts'

The Ten 'Toos' of VC:

1. Too small (~ 2% of portfolio; rats & mice)
2. Too interesting (20% of board time)
3. Too complex (early stage; growth; ...,)
4. Too illiquid (crisis-induced?)
5. Too expensive (increases MER)
6. Too poorly aligned (let's both lose *together*)
7. Too informationally asymmetric (eternal)
8. Too (career) risky (*total* loss; headline risk)
9. Too long (average time to IPO 8 years & *increasing*)

And Just Like That, You're a Speculator, Not an Investor

And just like that, you're out of China.

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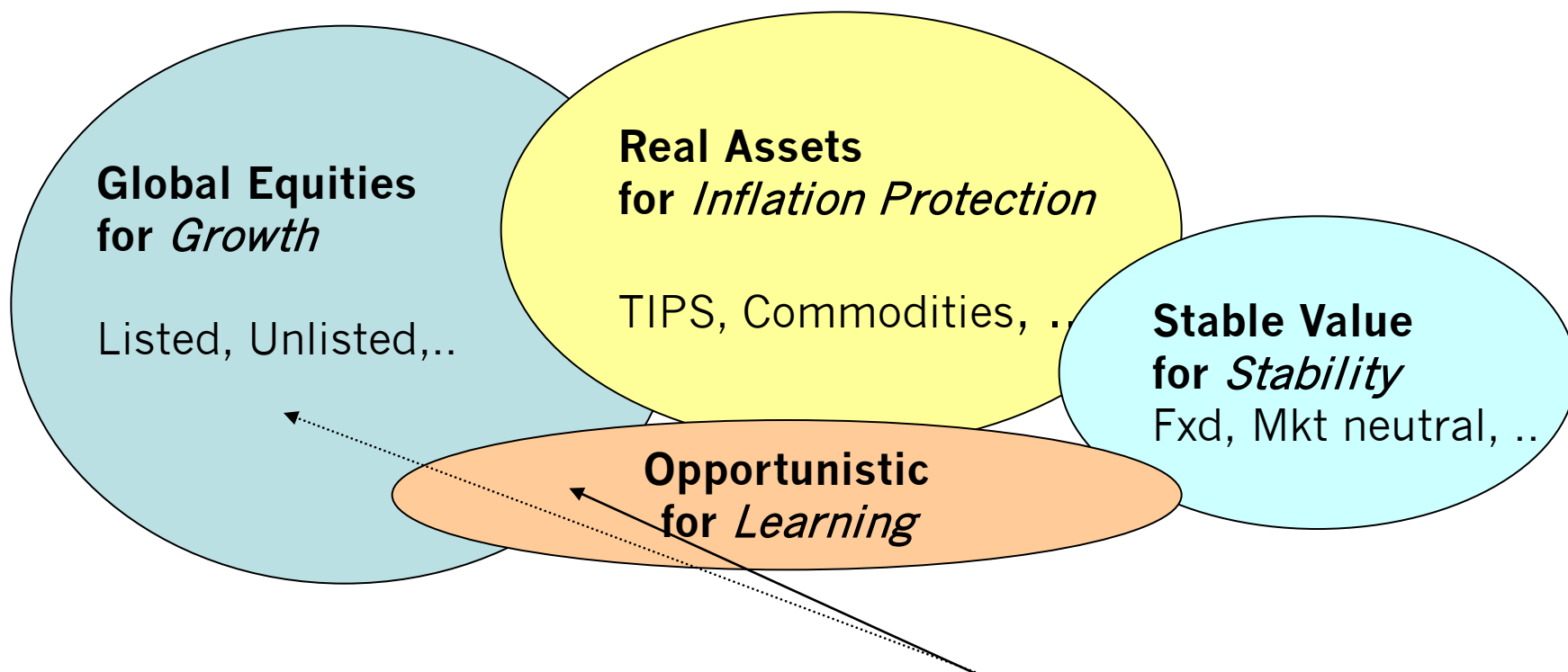


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'Too Different'?

Buckets **x** ... Purpose **✓**



Venture Capital

The Ten 'Toos' aka System Justification

“Like other practices with deep cultural roots, eg, religion, management structures (of pension funds) are *accepted uncritically* and are *very resistant to change*.”

“We were repeatedly struck by the *lack of interest in questioning* ... there was surprisingly *little interest in considering alternatives*.”

W. O'Barr & J. Conley
*Fortune & Folly: The Wealth & Power of
Institutional Investing, 1992*

Critical But Not Measurable

- Effective investing demands ... people, organisations, committees, structures with the “*right stuff*”:
 - Culture
 - Cognitive style
 - Character
 - Temperament
- “IQ and investing are not well correlated ... Temperament is the key ...”
Warren Buffett
- What’s the “right stuff” for VC managers & investors?

Who Has It?

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Managers and investors:

“Ultimately value investing needs to fit your *character*. If you're predisposed to be patient ... appreciate the idea of buying bargains, you're likely to be good at it.

If you have a need for action, if you want to be involved in new and exciting technological breakthroughs ... you're not a value investor, and *you shouldn't be one.*”

Seth Klarman
Baupost

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