

The Downside to Venture Investing (like Facebook?)

By Dan Richards

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Josh Lerner is a professor at the Harvard Business School, with a joint appointment in finance and entrepreneurial management. Much of his research focuses on the structure and role of venture capital and private equity organizations. He recently led an international team of scholars in a study of the economic impact of private equity for the World Economic Forum.

Dan Richards interviewed Professor Lerner at the American Economic Association conference in early January.

A video of this interview is available [here](#).

You've worked in the venture capital community for many years, and one of the first things that comes to mind was the Tech bubble of the late 1990s, which burst in the early part of 2000 because of stratospheric valuations and business models that made no sense. While I don't think anyone suggests that we have reached the same point now, there are some signs that we may be in bubble-like terrain in the social media space, with Facebook valued at \$50 billion and Groupon walking away from a \$6 billion offer from Google. What is your perspective on that?

It's a great question, and my perspective is colored a little bit by two things. First of all, it is clear that venture capital is an area which has had boom and bust cycles. You can look at periods like the early 1980s, with all the enthusiasm in investing in computer hardware, some of the frenzies around the Internet stuff in the late 1990s, or some of the wave in Biotech investment, and, with the benefit of hindsight, it's clear that the investor enthusiasm got ahead of where reality was and we are able to say this was clearly a case of overshooting. Everyone made decisions that ultimately ended up putting far too much money at far too high valuations.

On the other hand, I am also cautious at diagnosing this just simply because there has been so many examples in the past where the business press has been all over companies as being outrageously overvalued, and being prima face cases of bubbles in progress. The famous example from the early 1980s, when the Secretary of State of Massachusetts banned its residents from investing in Apple's IPO based on the sense that its valuation – I can't remember what it was, perhaps a couple hundred million dollars – was just outrageously overpriced, and the citizens just shouldn't be allowed to invest in such an overpriced company with such speculative prospects.



Similarly, if you go back and look at media coverage at the time of Microsoft's or Google's IPO, one finds lots of press coverage arguing that the valuations that were being assigned to those firms were absolutely outrageous, and didn't reflect the fundamentals, and were a sign of a market that was fundamentally out of alignment. So it is certainly an area where one has to tread cautiously in terms of saying a \$50 billion valuation is a proof that there is something fundamentally wrong about these prospects.

Venture capital has evolved dramatically. If you go back 20 years, it was very narrowly defined in terms of the type of investors who participated. Since then, we have seen venture capital enter the mainstream. We are seeing many university endowments and institutions get involved in it. What has been the history of returns in venture capital?

Certainly you see several things when it comes to venture returns. The first is that, by and large, if you look over the last 30 years you see reasonable numbers, not spectacular numbers in aggregate, but reasonable numbers akin to or perhaps slightly better than public market returns. What one also sees is that it has not been an even pattern, but one of feast and famine.

There are certain periods that have been extremely good, like the first half of the 1980s, the second half of the 1990s, and there were other periods that were quite mediocre, such as the second half of the 1980s, or most of the 2000s.

This seems to be a business where the Biblical seven lean years and seven years of feast very much characterizes the patterns. But that is in some sense the top-level picture. Once you dig into it, you see that it gets a lot more complicated. One complication is that there is an extreme unevenness of returns. The top 10% to 20% of funds by and large dominate the action in terms of returns. And if you were to basically invest in venture capital without investing in the top 15%, you were going to be condemned to pretty mediocre returns.

In the US, in Silicon Valley, Kleiner Perkins is the first name for many people.

Obviously there are other groups, such as Sequoia and so forth, that have had spectacular success over the years. But the challenge is that for many investors, particularly many of the newer investors, getting access to that top tier group is extremely hard. So when you look at the experience of venture investing, you see that the old-line investors, particularly some of the Ivy League endowments and some of the foundations that have been doing this for a long period of time and seem to have great access to these top-tier funds, have done far better than the typical pension fund that started doing this eight or 10 years ago.

In a way, this is very much an unfair game, where there seems to be a relatively small set of winning funds that tend to have success fund, after fund, after fund.



So is there predictability and persistence of returns?

Unlike in the world of mutual funds, this is a place where performance seems to be quite sticky, and the people who have the secret sauce seem to be able to do it again and again and again. Of course, not always, because there's turnover of people and so forth, but by and large you have a lot of persistence. And for many of the investors who can't get into that upper tier, it tends to be very tough.

The other unpleasant fact that is worth pointing out is that, when you look at where geographically that elite 15% of groups have been located, it's hard not to notice that they have been disproportionately in Silicon Valley or in the Route 128 area of Massachusetts. Obviously there are a scattering of funds in other places that have done well, but by and large venture funds in Silicon Valley have done far better than those in markets where it has been much less established.

So going forward, it sounds like if you are an institution that has those existing relationships with the winners, with the firms that historically have excelled, that it might make sense to continue to have a meaningful allocation to venture capital. But if you are not in that group, it sounds like a little bit of a red flag.

Certainly it is not the kind of area that one can come into as a tourist. And when I sit down and talk to sovereign wealth funds, as well as to other large pools of money, I often make the point of saying this is an area that you should only play in if you are willing to make a commitment on a period of decades to develop the kind of network of relationships, credibility, and gravitas to be a player in this area.

It's something that only is done with a very substantial effort of time and in human capital, and as a result is not something that rewards those who say, "Let's jump in, because Facebook and whoever else are about to go public soon, and venture is about to take off."

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