

Ideas @ Edelweiss Multi Strategy Funds – The Mathematics of Venture Capital



I recently met two prominent angel investors with diametrically opposite strategies. The first gentleman - Mr. A has a very discerning approach to selecting portfolio companies. He prefers to spend a lot of time evaluating entrepreneurs and their ideas upfront and then holds a concentrated portfolio of 8-10 companies. The second gentleman - Mr. B casts a wide net at an early stage by writing small cheques to each company and then re-ups his stake in the emerging winners in future rounds of funding. The fascinating question is then, who is more likely to succeed?

From an entrepreneur's perspective, I would much rather be an investee company of Mr. A. Early stage startups require a lot of hand holding and guidance that this individual can provide in copious amounts. Furthermore, being an investee company of Mr. A signals to the broader ecosystem - potential employees, customers, suppliers and future financiers, that both horse and the jockey have passed a thorough vetting and are hence likely to scale up and succeed. When you think of buccaneer angel investors who can predict the future, you would think of Mr. A.

On the other hand, from an LPs perspective, I would much rather be an investor in Mr. B's fund. Angel investing is about taking highly asymmetric bets on unproven technologies and people and by its very nature is an endeavour from Extremistan. 7 out of 10 companies may go to zero, 2 may prove to be moderate successes and 1 may turn into the next Facebook making up for all the failures and much more. Angel investing is necessarily antifragile because you cannot lose more than you have invested in the duds but there is virtually no upper bound on the exponential growth of the winners. In this set-up, you simply cannot afford to not participate in every idea even if you cannot comprehend the business model.

This contrast between Mr. A and Mr. B's style is counter intuitive because it flies in the face of conventional investing logic and how many think of portfolio construction in a pure "stock pickers domain".