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A Dollar And A Dream: Making The Case For Venture Capital

*Eric Savitz, Forbes Staff*

Guest post written by Chris Douvos

Chris Douvos is managing director at Venture Investment Associates, a fund of funds that invests in private equity, venture capital and other funds.


Chris Douvos

Here in Silicon Valley, we're all about using lottery slogans with Ivy League veneer. After all, isn't talking about "optionality" just a fancy way of saying "ya gotta be in it to win it?" And "asymmetric payoff" is just a spiffy way of saying, "hey, you never know," right?
That's why I was taken aback when I got invited to give a talk at the CFA Institute's Annual Financial Analyst's Seminar this summer. I mean, these are the cats that studied Greek during B-School so that they could do better in Advanced Derivatives class. Meanwhile, I've made a career of using ten-dollar words with my five-dollar brain; what could I possibly say about what is perhaps today's least-loved asset class: venture capital? After all, a witty intro, a hoodie and a bag of Silly Valley pixie dust can only get you so far with that crowd.

And then it hit me: the asset allocators, those exact folks who seem to be turning their backs on VC today, are the ones who bow at the altar of CAPM, the Capital Asset Pricing Model. And, as one might recall, the CAPM tells us that the portfolio that maximizes risk-adjusted return, the mythical Tangency Portfolio, is theoretically a value-weighted mix of all the assets in the world; the cool kids call this the World Wealth Portfolio (WWP).

Now here's where it gets interesting for those of us in innovation-land: the WWP isn't something like the S&P 500, or the MSCI All Country World Index. It literally is ALL the assets in the world, from the biggest publicly traded company to the smallest private one. On top of that, human capital is a vital component of the WWP. And, indeed, small companies and human capital *are specialties of the House of Venture.*

But here's the rub: notwithstanding some recent regulatory Band-Aids, the well-reported and deep-rooted dysfunction in public markets has created a great de-listing machine (thanks, Grant Thornton, for the catchy phrase), making private assets that incorporate a generous helping of human capital an even more absent (and vital) component of risk-optimized institutional investment portfolios. In fact, the entire category of "emerging growth" companies has become an endangered species, as only the most robust or most hyped companies get to pursue IPOs nowadays. Since it takes longer for companies to become the former, they are, by definition, further along their growth trajectory to the point where their growth curves are beginning to flatten while the latter kinds of companies are doomed to disappoint, fouling the waters for everyone. Some early-stage, start-up exposure might be just what the doctor ordered for return-starved, sub-optimized portfolios. After all, bonds are priced for some grim returns, equity markets gyrate Gangnam style, and mattresses aren't paying dividends the last time I checked.

And here's another thought that came out of the conference: someone asked me about the effects of the supercycle of de-levering now taking place, which served as a good opportunity to remind folks that venture-backed companies tend to have little, if any debt. Moreover, the technology companies that tend to acquire such start-ups are extremely cash-generative and relatively debt-free, making them pretty aggressive acquirers.

After all, for more than a decade, the number of start-ups acquired each year has averaged in the mid-300s, with a pretty tight standard deviation no matter the economic climate. But maybe I got too giddy in answering the question, because I said that these two factors "combined to make venture capital a good *hedge* against de-levering," engendering snickers from the audience. Well . . . using a word like "hedge" in a room of folks who spend their days trying to hedge out the most minute risks may have been ill-advised. So maybe VC isn't quite a hedge, but perhaps a diversifier? After all, exposure to growth octane is a pretty nifty complement to increasingly value-laden public market portfolios, no?

So maybe there is something to this crazy venture game. Of course, we feel it viscerally in the Valley; the gales of creative destruction blow continually here, except that they're gentle eucalyptus- and redwood-scented breezes. It's sometimes hard to explain that to the outside world, though. But walking around, one gets a palpable sense that every garage awaits its moment in the limelight. Prototypes are being assembled and software is being written; the next great fortune seems so close that one might hardly fail to grasp it . . . all you need is a dollar and a dream.