

Why Power Law Portfolio Construction Will Always Be Dead on Arrival in the Venture Capital Industry

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Before I jump into this, let's start with a baseline truth: Statistics are subjective to the data sets used to generate the stats, and as such, stats can be skewed any way a person wants to skew them to make something seem factual, relevant or a source of truth simply by highlighting isolated data sets and obscuring others. You can smear lipstick on any pig with enough effort. I think this is a good place to start, because I want to save readers the time and energy of trying to justify what, in my opinion, is a failing/failed concept.

Building a portfolio using the "Power Law" model as a source of truth to do so in early-stage investing (i.e. venture capital) not only makes no sense, it's lazy, it ignores basic fundamental facts, and it is dangerous for investors who trust their money to GPs (General Partners) who "invest" using this portfolio construction logic. Let's dive in.

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How investing really works

Before I outline my points, let's first understand how investing, in ideal cases, works. In investing, the overall goal is to maximize capital appreciation while mitigating risk

to its lowest common denominator. Simply put: Make as much money as you can while taking the least amount of risk possible relative to the return you want to see annually. Generally, the way a person, company, fund, etc. seeks to accomplish this goal is through diversification.

Essentially, what you try to do is spread your investments across different linear and non-linear asset classes to create a mix of investments that will hit your targeted rate of return annually and protect you from taking huge losses when markets aren't performing well. Based on market conditions, if you've constructed your portfolio well, you can adjust your allocation percentages according to market conditions to further hedge against losses and still make some gains.

A good example would be the inverse relationship between equities and fixed-income investments. Typically, when the equities market is doing well, fixed income isn't – so, while you may still have fixed-income investments in your portfolio during a “bull market,” you would have a higher percentage of your investments in equities to capture better returns during a strong market. Conversely, in a down market, you would do the opposite.

What I have provided is a basic example for context to illustrate what most investors try to accomplish long term. The exciting thing about investing this way is that with the advent of mutual funds, ETFs and professional money management firms like Fidelity, Charles Schwab, etc. Most investors can passively invest, which means someone else does the portfolio construction and management for you (for a nominal fee, of course), so you can just sit back and enjoy the returns.

In venture capital, VC firms offer the same passive income-earning opportunities. The difference lies in the fact that what is being invested in is markedly different. Generally, when you invest in stocks through a mutual fund or ETF, you're investing in proven, mature companies that are publicly traded

and have, oftentimes, already stood the test of time. That isn't the case in venture capital. In venture capital, what you are investing in is startup businesses with little to no track record. This is vital to understand, because the dynamics between a startup and a mature business are as different as night and day. The challenge here is that the VC firms themselves are taking passive positions in early-stage companies using the Power Law as the core methodology for justification.

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The problem with the Power Law model

The Power Law from a venture capital standpoint, in basic terms, states that the odds of creating outsized returns for investors increase as you invest in more early-stage companies. The idea is that if a VC firm invests in a lot of early-stage companies (i.e. 35-50 per year) they have a higher probability of finding a company that will scale to the level of a unicorn (a company with a 1B+ valuation) or a decacorn (a company with a 10B+ valuation). The argument VCs make is that finding a unicorn or decacorn will allow them to create returns for their investors that will make up for the losses the VC firm has incurred along the search for a Unicorn and provide a nice profit for investors.

This sounds great in theory, and it even looks great when you put a lot of math behind it, because math always makes things seem smarter than they are. This is due (in large part) to the fact that most people aren't math savvy. However, when you really boil this "investing" style down to simpler terms, it's really just throwing sh*t against a wall in the hopes that something will stick. No matter how much math you put into this, no matter how many fancy models you build to make this approach look smart, the baseline premise is still the same.

In general, the masses of the VC community over time have essentially convinced people that this approach is somehow something far more savvy, smart and that they should be trusted to invest other people's capital this way, because it's the best way – so just “trust them on that.” In truth, when you look beyond the BS models and math formulas and keep it really simple, you see that VCs that invest this way have no better chance of finding a unicorn or decacorn than a blind man picking random companies out of a hat.

That is not investing, that is speculating. It's gambling, and it's no different than taking all of your money to the casino and hitting the roulette table. 94 percent of venture capital-backed companies go on to fail! They either fail outright, and the investors are unable to recoup the capital they've invested, or the company is able to return the principal investment but can't provide any returns above the initial investment. Investing is about getting back more money than you originally invested. If a company can only give you back what you invested in the end, you might as well have just put your money under your mattress, saved yourself the stress and come back to get it from under the mattress at a later date. It doesn't take a math genius to understand that a 6% success rate under any standard of evaluation is a failing grade.

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Why do investors still use this model?

How is it that VC firms get away with investing like this, and why do investors who invest in these funds keep believing in this process? A better question is, why do VC firm GPs, in general, adamantly stand by this “investing” approach? Here is what I've observed: First, studies show that it takes the average venture capital-backed company a minimum of three

years to mature into failure. It's easy for a company to appear a lot more healthy and viable when it is flush with investor capital and deploying a lot of money into PR to paint a narrative that is far rosier than the reality actually is. VC firms use the narrative created by their portfolio companies' PR campaigns to demonstrate to their investors that they are making good investment decisions. LP investors (who generally don't know much about how things really work or what it takes to build a viable business at scale) are duped into believing the narrative and end up investing more money with the VC firm.

Regarding GPs, here is what I've observed: To raise capital, they often tout their "Ivy League" education and limited experience as a way to demonstrate their bona fides. It's not uncommon to see things like "Harvard educated," "Ex-Gogler," "Goldman Sachs alum," etc. At first blush, and to the unsophisticated, it would seem like the person (or people) who will be managing the fund are extremely qualified to do so. Here is the reality: A college degree has next to no relevance when it comes to building a business. College can't teach you how to build a business. You learn that concept through trial and error. It is a grueling process of failing over and over, learning the lessons from those failures and applying the lessons learned until you've gained enough knowledge and experience to get it right! You can't read your way to experience, you actually have to operate in a real-world environment, so, the college degree means little.

The truth

You have no idea how many times I've found out, upon deeper digging, that the "Ex-Gogler" was an intern or had a title that sounded great, but in reality, wasn't more than the most junior person on the team. The same can be said for a lot of these so-called "Goldman Sachs alums" who are touting these credentials in the VC space. A lot of GPs in the VC space

spend approximately one to three years on Wall Street, and that is not nearly enough time to gain subject matter expertise in anything! *Outliers* by Malcolm Gladwell lays out the fact that it takes approximately 10 years to become a subject matter expert in anything.

This is why so many VC firms stand by the “gambling” approach to investing in early-stage companies. They lack the sufficient command of subject matter and experience to do anything more than give someone else’s money to a founder they “feel” good about and hope for the best. Investing in early-stage companies isn’t something that should be done passively. It must be done actively. VC firms should take a hands-on approach to investing in early-stage companies and bring their knowledge and real-world experience to the table to help founders (who are often inexperienced) produce a viable company and product that can lead to scale and viability. I call this “accretive value proposition,” and accretive value is the only way you can de-risk early-stage investing and increase the number of companies that go on to exit.

It’s not about the number of companies you invest in, it’s about the time you spend helping founders develop the companies you’ve invested in into something great, and that can only be done if you’ve got the right mix of real-world experience (i.e. IPO, LBO, M&A, structured finance and relevant business development experience) to do so. If you’ve never seen the end, how can you add value in the beginning? Companies that successfully exit all share common themes, and the only way you can identify that is if you’ve actually participated in exits yourself. When you understand the common themes from experience, you can help founders build their companies for exit from the beginning. This is what I call bringing the end to the beginning. When you approach it that way, the company has a much greater probability of going on to achieve an exit, which is how we all make money in the venture capital space.

Investing is not about trying to hit a home run every time you come to bat, which is the mentality a lot of VC firms have. The goal is to achieve base hits, because consistent base hits lead to runs, and the aggregate of runs scored is what wins the game. My honest advice (and this comes from almost 16 years of experience in the requisite areas above) to all investors in this space is not to place capital with a VC firm filled with GPs who have never experienced a business failure, overcome the failure and gone on to find success as an operator.

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