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VENTURE META

What Venture Capitalists Don't Care if You Know

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Venture Meta:
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Before Facebook's act of cultural appropriation with the adoption of "meta" as their own, the term carried its own significance in popular culture. Rooted in the self-referential, for years **gamers have used "metagame" or "meta" for short to mean a generally agreed upon optimal winning strategy by the community**. To borrow from *What is a Meta* by Liam Ho of UNSW Sydney,

> *"Metas have shaped the way we look at traditional and contemporary online gaming and have had an insanely large impact on the industry, particularly in esports. Metas can include anything, from picking a specific character, to playing in a certain way. They guide and shape the way games are played."*

The term captures more than just in-game strategies or tactics. It's a holistic vision of how to win. It involves second- and third-order thinking both in and outside of the game and marries strategy, tactics, and intangible elements of gaming. Meta is a mash-up of every relevant aspect in a winning strategy.

Traditional portfolio management, balancing a portfolio across assets in order to lower risk and optimize returns, and the more quantitative Modern Portfolio Theory, are early metas of managing institutional pools of capital. Investors continuously refine specialized approaches to find the optimal recipe of metas across assets, sub-asset classes and strategies.

Is it time to rethink what models work in Venture?

It's not very often that there is an opportunity to fundamentally reconsider the approach to an asset class. The oil and gas industry's recent structural change is a great example. Our team has managed capital for endowments and institutions including Stanford University, The University of North Carolina, Duke University, Notre Dame, The Kauffman Foundation and Vulcan Capital. Based on decades of multi-asset class experience and focused commitment to backing innovation at these firms, we believe the venture ecosystem is experiencing an exciting transformation. For early-adopters and forward-thinking investors, it should serve them well to understand the dynamics at play.

As new entrants in venture and traditional VCs grew funds to $1+ billion in size, the general wisdom was that VCs could scale because the distribution of outcomes had changed; unicorns became decacorns and the potential for bigger outcomes increased. But, was this a new normal? The recent public market sell-off might suggest it wasn't. More likely, we were experiencing an unprecedented period of excess liquidity and unsustainable valuations fueled by a low-rate environment. If this "new distribution of

outcomes" was primarily driven by temporary multiple expansion, then we need to reconsider this novel approach to scaled venture investing.

The traditional "access" strategy of faithfully re-upping with a short A-list of LP-constrained venture funds has been hugely successful over past decades. However, with mega-funds, shifting landscape, and market uncertainty, there are important investor questions to think about, such as:

- Does the fund math work for vehicles of $1 billion, $2 billion, and beyond? Small checks in early-rounds don't move the needle, but is there sufficient upside from investing in growth rounds? And, does later stage come with lower risk vs a highly diversified early-stage portfolio?
- Is there an opportunity to win deals via paying higher entry valuations and offset the lost upside by increasing velocity of deployment? Or, was this strategy only feasible in an abnormal environment?
- Is there still potential for return asymmetry for this new generation of mega-funds? Venture is one of the few asset classes that can deliver outlier return potential for investors.
- It has to date, but will persistence of returns in venture persist for the new era of mega-funds? Following-on heavily into growth stage rounds may dilute return multiples for funds.
- Is there still strong alignment between the GP and LP for scaled, platform VCs? As venture firms become asset gatherers, is the GP in it for the carry or the management fee?
- With potentially significant challenges ahead for VCs' existing investments, what is the psychology, baggage, and mental time and energy required to support a large, languishing legacy portfolio? Will good money go after bad? Is the GP worried about career risk? What is quality of incremental investment decisions? This is particularly important during an uncertain operating and fundraise environment that awaits.
- How much can valuations reset for growth relative to early-stage?
- Who are the most relevant VCs for top founders going forward?

Now is the time to ask these questions of VC firms that have perhaps grown their fund size beyond their effective strategy, exceeding their maximum viable fund size. Most importantly, what is the meta for a family office, individual, institution, or any venture allocator going forward?

Venture isn't going away, now is the time to invest.

Astute investors never try to time the market but know when it's time to start sharpening pencils. Historically, some of the best vintages in venture are in/exiting a recession or market downturn. We would argue that this time is no different. The most severely impacted segment in venture to date has been growth and late stage; feedback loops are shortest for assets most closely linked to public markets. Early stage is least affected, so far, in terms of valuations. For further reading, Eric Newcomer provides a great summary of VC perspectives on the state of the market.

Venture is a relationship-driven, network-based asset class which makes it very challenging to tactically hop-in or out of the industry without sacrificing some degree of relationship capital, connectivity, and network intelligence. Venture is also fueled by innovation which happens through economic cycles.

Some of the best companies were founded during downturns (Paypal, Google, Uber, Salesforce, Airbnb, Stripe, Amazon, etc.). On the VC side, some of the highest returns are made by new entrants after downturns that are not burdened by the legacy of a bad portfolio that must be rehabilitated. A study by one established, scaled VC showed that over their life, 40% of capital deployed went into supporting companies and of that, they lost 50% of capital invested. The remainder of investments made a 3x return. Some other intuitive advantages / positives during downturns include:

- The market weeds out lesser quality operators, cash inefficient businesses, and weak unit economics.
- Fewer competitors get funding, meaning more access to talent.
- Companies are forced to make helpful, sometimes critical, pivots to survive.
- Management can focus on fundamentals.
- There is less noise and distractions for founders.

All in all, we believe experienced investors should be excited right now to invest in early-stage venture because: 1) there is a natural reset and entry point into a uniquely attractive asset class that we've not experienced in more than a decade, and 2) we're seeing arguably the greatest shake-up in the venture ecosystem architecture that we've ever seen, presenting a potentially huge opportunity for investors with the investment structure to play this change.

Venture is about odds; how you play the game is equally important as the character that you choose.

Rooted in observations from the Pareto Principle (80% of consequences come from 20% of causes), Peter Thiel of Founders Fund famously popularized the idea of the Power Law of Returns unique to venture:

> *"The biggest secret in venture capital is that the best investment in a successful fund equals or outperforms the entire rest of the fund combined. This implies two very strange rules for VCs. First, only invest in companies that have the potential to return the value of the entire fund. This is a scary rule, because it eliminates the vast majority of possible investments. (Even quite successful companies usually succeed on a more humble scale.) This leads to rule number two: because rule number one is so restrictive, there can't be any other rules."*

Venture is a unique asset class. Scaling constraints, expansive landscape (very few barriers to become a VC), limited capacity in early-stage rounds, feedback loops, noise, signals, reflexivity, and interconnectedness of key players and outcomes play into the big dispersion and asymmetric distribution of returns which define the asset class vs other asset classes. The shape of venture capital's returns requires more consideration than any other asset class where returns fall within a narrower band and are normally distributed. Apart from diversification considerations, each buyout manager, for example, can be independently evaluated through its own lens. Success of the portfolio only reflects the sum of the independent success of each fund.

Venture is different. Home runs define the asset class. With only ~2% hit rates in venture, investors must align their portfolio construction with the power law shape of returns. You must play the odds in venture, both at the fund level and portfolio level. It's not only about picking sound strategies; you must also optimize your chances of participating in the tiny number of outlier companies that deliver the bulk of venture returns.

Correlation Ventures did a fascinating study demonstrating the relation between the hit rate or home runs and the mean dollar-weighted realized multiple for venture investments in the U.S. since 1990. They found an incredibly high 0.98 correlation between invested dollars generating a 10x return (aka hit rate on home runs) and overall mean venture returns.

Given the influence of home runs on overall returns, the mean and median returns in venture can be quite different. Abe Othman, AngelList Head of Data Science, published a study and found there is an unbounded mean power law of returns found in venture. He contextualized the idea in an interview with Kauffman Fellows by assuming someone invests at random into an asset class.

> *"Under virtually every other possible distribution of returns, picking more investments does not change expected returns. But with this kind of power law, picking more investments actually increases expected returns. This is very unintuitive!"*

Based on Othman's study, increasing your shots on goal with more early-stage investments gives a better chance of capturing the mean vs median return in early-stage venture, where the power law is strongest. Using data from Burgiss, Verdis, a single-family office, also made this important observation. They found that the mean return for early-stage was 50% vs a median of 7% from 1990-2015. From 2017 to Q1 2020, the mean vs median was 12% vs -10 bps, respectively.

Scale is key for early-stage venture, but it's extremely difficult for any single VC to do because there is a quality for quantity trade-off. Early-stage venture is a relationship game. Relationships are extremely difficult to scale. Building one-on-one connections with founders wins access. Very few venture firms can rely on the power of their corporate brand to transcend this human element.

We're likely entering a new venture era, meaning a new meta.

The evolution of venture capital never stops. For the past ~70 years, the most successful firms have transformed with the industry. Venture began as purely risk capital, then shifted to hands-on company building, and now provides seemingly endless resources and capital. The challenge for any VC, in addition to identifying the next big thing, is maintaining a relevant product offering to sell to founders (aka win the deal). A good product drives access for VCs which in turn drives returns. Venture has evolved from a cottage industry into consultant-like, full suite service platforms.

Today, there is another shift happening. There has been a discernable trend of the growing importance of the individual vs firm in venture (the rise of solo-GPs are an obvious example). However, while the

rise of the individual appears to be a new trend, it's actually not. Previously, intimate 1:1 relationships between investment partner and entrepreneur defined the modus operandi of tier-1 firms; partner names were synonymous with the venture firm brand and entrepreneur experience. As successful VCs grew their organizations and funds, investment partners became less accessible as both 1) the number of companies increased and 2) higher priority, more meaningfully sized investments in the portfolio demanded attention away from small first-checks. The desire of founders to partner with successful, highly helpful ***individuals*** never went away. The venture landscape just changed and so did where to find those individuals.

Now, the best one-on-one, close relationships for early-stage companies are found elsewhere: solo-GPs, micro-VCs, angels, operators turned investors, former founders etc. At the same time, there is record dry powder; there was more than $230 billion in dry powder at the end of 2021, and another $74 billion has been closed on by US venture funds since. There's been an explosion of new types of early-stage investor talent. There is a lot of noise among early-stage VCs, but there are also miniature flywheels forming around certain key-nodes. This fragmented, distributed network of nodes already serves as an informal scout network for the mega-funds, scaled-VCs, late stage and crossover funds. This new decentralized, organizing network of individuals / key-nodes is quickly defining the shape of the new venture ecosystem. First, let's look at the evolution of venture and how we got here:

1. **Cottage Industry (1950s – 1980):** High-touch, personal relationships, with boutique services feel. The individual venture partner was synonymous with the firm. VCs generally held the power given limited supply of capital.

2. **Industrialization (1980 – 2003):** Sequoia, KPCB, Bessemer, NEA, Menlo and several other top-tier venture firms were founded in the decade leading up to the venture boom in the 1980s and beyond. The asset class became more institutional. Many tier-1 VCs were minted. By the end of the era, founders began to gain influence, but VCs still took an active management style, fine-tuning startup management teams, influencing strategy, and replacing CEOs/founders. The industry's cottage industry origins characterized by 1:1 relationships persisted.

3. **Pro-Founder (2003 – present):** After the boom and dot com bust in early 2000s, the industry reset and shifted to become dramatically more pro-founder. From the ashes, new, future tier-1 VCs emerged during this period, unburdened by poor performance and the need to support legacy portfolio companies. Investment partner turnover at established VCs also contributed to the reshuffling of the venture world order. As capital flowed back into the asset class and the industry regained its footing in the early aughts, VCs looked to boost their founder-preference in the startup community by offering value-add services to entrepreneurs. In an increasingly competitive environment, the power dynamic began to shift in favor of founders.

4. **Pro-Founder + Services (present day):** Being pro-founder is largely table stakes in venture today. As the industry matures, tier-1 VCs have become multi-stage, scaled platforms, and the economics of large funds can now support incredibly robust value-add service offerings for founders.

5. **Rise of Key-Nodes (emerging):** Former and current operators, scouts, solo/duo-GPs, and angels are defining a new decentralized, network-based architecture in early-stage venture. Big exits have minted new angel investors with fresh, highly active networks that are recently and closely tied to founder community grassroots. Individuals appreciate the desire that founders have to partner with like-minded individuals over a more corporate-like venture firm; this has given rise to what Kyle Harrison terms Renegades of Venture where we see "…the unbundling happening in venture as the power of monolithic VC brands started giving way to more powerful influence of individuals. People who know the value of their own brand and reputation. They recognize the fundamental disruption going on in venture and are leaning into the opportunity it creates." These individuals and micro-VCs can often hit way above their weight relative to fund size.

   There are also multiplier effects available to the founders that strategically build their cap table to leverage diverse networks, not just a single large investor. With the added pressure and implications of raising too much too soon at big valuations, particularly in today's environment, founders are gravitating to the logical choice – highly engaged, highly connected, knowledgeable, 1:1 personal relationships that can deliver immense value. In aggregate, these individuals are creating a new network of early-stage key-nodes in venture.

Until now, the traditionally defined "venture access" strategy was the game-breaking meta.

Gamers refer to something that is "game-breaking" as a strategy, style, tactic, or character, that basically overrides any other meta. An approach, character, play-style, etc. is so superior to any alternative that there is no reason for a player to play in any other way if they want to win.

In the past decades, having "access" to invest in the tier-1 venture funds was "game-breaking." There was no reason to pursue anything else. If you couldn't play using the "venture access" meta, then arguably, you shouldn't play at all. Dispersion of returns was too great.

However, the rise of key-nodes and the timing of the current downturn are setting the stage for a new meta to emerge. We are strongly convicted that this new era will greatly diminish the effectiveness of the game-breaking, old school, member-only "venture access" meta.

What is the new metagame in venture?

Meta is a broad, comprehensive term. In gaming, inputs might manifest as overall strategy, tactics, character choice, character synergies, map / mode / route selection, item and ability load-out and usage depending on situation, reacting to opponent behavior, exploiting hardcoded game features, timing of certain actions, and equipment and levels that are meta in the highest skilled cases. Venture investing has many of the same opportunities for the "player" to optimize inputs for the proper meta.

Just like gaming, there are no guarantees or crystal balls for winning strategies in chaotic environments, but there is growing strong evidence of what the optimal venture meta might look like over the next decade.

Allocators have a strong structural advantage in venture.

Early-stage venture investing is the mechanism through which great talent is discovered and matched with capital. It can be an inefficient process, but the success cases have been incredible. Venture is about playing the odds but shouldn't be confused with buying equal chance lottery tickets. However, for funds that are too big or reaching beyond their magnetism for great founders, their portfolio can closely resemble a basket of lottery tickets. Founders don't want to be options. They understand their role in a mega-fund's portfolio and are increasingly savvy on which partners to choose. Giving up most of your round to a single investor that treats you as an option carries big alignment implications and cap table considerations for founders.

Lottery tickets don't yield access to the best founders. Quality matters, which is driven by quality of relationship between high quality founders and great venture partners. If the goal is to effectively play the odds in venture, and we know any single early-stage VC will likely face scaling challenges, then how do you align with the power-law of returns? A single early-stage VC fund sacrifices shots on goal. Spray and pray sacrifices on quality. Mega-funds sacrifice on upside. **The best way to optimize early-stage access to the best founders and ideas is to maintain quality of bets while also increasing number of bets.**

In a distributed ecosystem, potential breadth of partnerships uniquely affords LPs a structural advantage over any single early-stage fund. Allocators are set up to invest through multi-manager programs, and unlike incumbent VCs, they can do so non-competitively across the ecosystem. At a time when early-stage venture has experienced incredible evolution and fragmentation and mega-funds are losing their luster to founders and investors alike, allocators are in a unique position to play the game.

Constructing the Venture Meta

- **Map Selection:** Focus on the **early-stage landscape** where the power law is strongest and there is greatest potential for true outlier returns. Avoid funds that dollar cost average into increasingly expensive rounds. Getting in early, at relatively low valuations provides the basis for potential outsized return upside on the winners.

- **Team Design:** Build a roster of **key-nodes** with complementary but not entirely overlapping networks. Lean into the power-law shape of venture by maximizing quality shots on goal. As an LP, foster an environment for synergies between both GPs and underlying companies. Key-nodes are often identified by their potential signaling power, track record of attracting both quality founders and top-tier follow-on investors and co-investors, and strong connectivity (newly formed or legacy) to the established venture community.

- **Character Choice:** Align with individuals that have **growing founder-preference** in the start-up ecosystem. Do founders want to partner with this person and if so, why? These individuals can be found in a growing number of places. Yes, early-stage is about playing odds, but given the network architecture of venture, skilled allocators have a strong opportunity to also add alpha through investing in key-nodes with greater chances of hitting home-runs.

- **Timing:** Venture is a long-term asset class, and innovation happens through cycles. Relationships drive access and can't be turned on and off. Some of the greatest outlier companies were started during downturns. Cycles often refine ideas, reduce talent costs, drive efficiency and lower entry points for investors. **Remain in the game.**

- **Game Design:** A key in venture investing is to optimize the probability of investing in outlier companies and, importantly, also participating as an LP in the outlier returns of said companies. Doing so requires early-stage exposure, quality bets, and a sufficiently large number of investments. **Align with the power-law of returns.**

- **Opponent Behavior:** Innovation isn't a sum zero game. However, access to early-stage funding opportunities can be. Ability for one VC to invest usually means another doesn't. In addition to distributing relationships across many key-node VCs, **look for VCs that are able to be collaborative vs competitive.** Often, this is determined by fund size. Bigger funds need to write bigger checks to move the needle on their fund. It's an advantage to not need sharp elbows to secure required big ownership in small, competitive financing rounds.

- **Class Selection:** Focus on funds that are **right-sized for their stage and strategy**. This often means focusing on funds of smaller class, micro-VCs, solo/duo-GPs, etc. Beyond the merits of aligning with individuals, there are four primary considerations within this "class" of VCs:

    - **Portfolio construction:** For a small fund to have a chance at capturing one or two home runs and deliver outsized fund returns, it needs to make a sufficient number of bets. One way to think about this is through the lens of the conversion rate from each round to the next and using these assumptions to back into an adequately sized growth stage portfolio. For example, a portfolio of only 10 seed stage companies with an assumed 60% graduation rate will yield only 2 active companies by Series C (60% graduate each round from Seed to A to B to C). This is an extreme example of a dramatically undersized portfolio. The other lens to consider is likelihood of investing in a fund returner. If this likelihood is 2%, then a portfolio with 50 companies gives an average VC a decent shot at hitting at least one home run at random. Any skill in selecting is upside.

    - **Position Size:** As an LP, if you want exposure to the upside of investing early, then the position size of an early-stage investment must be large enough to move the needle for the fund. A $500K successful seed stage investment could feasibly return the entire fund for a $20M fund. Whereas, the same investment is inconsequential for a $1B fund. In a famous example, Alex Graham shows how this can play out:

> *"Andreessen Horowitz invested $250,000 in Instagram in 2010. When Facebook bought Instagram just two years later for $1 billion, Andreessen netted $78 million—a 312x return in less than two years. That's a phenomenal return, befitting the firm's reputation as one of the Valley's best. But in a weird way it's not nearly enough, because Andreessen Horowitz has a $1.5 billion fund: if they only wrote $250,000 checks, they would need to find 19 Instagrams just to break even."*

  - **Fund Size:** The pool of capital being invested should match the investment partners' capabilities in sourcing, value-add, relationship building, etc.

  - **Solo GP vs a Team:** Done properly, both models can work equally well. There are pros and cons to both that must be considered. Evaluate case by case and know what to look for with each.

- **Risk Strategy:** Sources of innovation can surprise us and many venture funds don't survive. Diversification across both sources of innovation (themes, technology, geographies) as well as diversification across key-node VCs **mitigates the risk of not participating in outlier returns or getting knocked out** of the game completely.

Executing the Strategy

The framework above is contrarian. Unsurprisingly, the most active supporters of the thesis are those closest to the situation, insiders – former entrepreneurs/operators and increasingly non-traditional LPs, namely mega-funds and partners from these funds. Large VCs are backing micro-VCs to act as a scout network to benefit their later stage efforts.

Why aren't more sophisticated investors pursuing the strategy?

- **Power of the Narrative:** Allocators look to VCs to understand the world of venture. VCs have a high degree of confidence in their abilities to select great companies. Most VCs, especially the successful platforms with significant LP-influence, are not served by promoting the ideas that you want to 1) concentrate stage exposure into early-stage companies, and 2) focus on playing the odds. Early stage doesn't scale for mega-funds and playing the odds diverts capital away from their fund.

- **Commitment to Thesis:** Given the number of GP relationships and capital required to play the odds in early-stage, allocators must be fully committed to the strategy which takes collective buy-in across teams, committees, and organizations.

- **Ability to Navigate a Vast Landscape:** Continuous relationship building and landscape mapping are required for this strategy. In addition to industry size, this is made more challenging by the

historically private, referral-based nature of the venture industry – not just among companies but discovering new VCs as well.

- **Career Risk:** There is more career risk to being independently wrong vs being wrong alongside the group. Conversely, some capital management organizations are not structured to properly align the investor with the upside for being independently right.

- **Following Returns:** Investors are drawn to past performance, particularly in venture where there is shown to be persistence of returns. The traditional venture access strategy has performed exceedingly well and justified re-ups (never mind if they're paper gains or internal up-rounds). However, investors able to anticipate effects of evolving landscapes and strategy drift, good or bad, stand to benefit.

There are a few advantages allocators might have or can develop to execute this strategy including: building a reputation for supporting the thesis by actively backing emerging and micro-VCs; leveraging existing relationships with traditional, scaled VCs for referrals to key-nodes; building data capabilities to assist with mapping venture networks to identify communities of focus; accumulate experience in underwriting emerging managers as well as co-investments from these relationships; and create a fully dedicated team to focus on the space.

Venture funds care about your commitment to their fund, not about your commitment to the meta.

Venture funds have two sets of customers: 1) entrepreneurs and 2) LPs. VC pitches to LPs can be very convincing (and accurate), but no single fund represents an adequate sampling of early-stage deals as to optimize the probability of participating in outlier returns. Buying into a single venture fund's pitch, as compelling and true as it might be, is a common mistake of missing the forest for the trees in venture.

As a new LP that is first investing in the asset class or as a long-time veteran that wants to position for the future of venture, it's vital for investors to leverage their advantages of being an allocator – the unique ability to non-competitively partner with several key-nodes across early-stage. We believe, this is the only true way to scale early-stage venture investing and effectively play the power law odds while not sacrificing quality for quantity.

The truth is that venture funds don't care if you've figured out any meta in venture, so long as it results in a commitment to their fund. They must win your business by pitching a highly differentiated, one-of-a-kind strategy. However, the secret is getting out; top-tier VCs and growth investors (sometimes one and the same nowadays) are already backing key-nodes in order to keep their seat at the table for later rounds.

Markets are offering venture investors a compelling entry-point right now, just as the base-layer of venture is reforming. Similar to early backers of tier-1 VCs, many of the early backers of key-nodes stand

to benefit. These investors will potentially better align themselves with the power law of returns and be disproportionately rewarded as their ecosystem connectivity and access grows exponentially.

Like gaming, venture is as much about game mechanics as it is skill. Key-node individuals intently want to partner with forward-thinking, like-minded investors championing this new era. We believe, a commitment to the thesis will go a very long way.

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