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FAMILY WEALTH ADVISORS

TO	Signature Clients
FROM	Signature Investment Committee
DATE	June 30, 2017
RE	Second Quarter 2017

Commentary

David Jallits, Chief Investment Officer

Given Signature's culture of curiosity and the inquisitive clients we are fortunate to serve, I wanted to change things up a bit with this quarterly letter. First, I did not author it. That distinction belongs to Randy Castleman. Randy is a long-tenured venture capital investor and has been working with Signature for the past year as a consultant. We like to think of him as the first in a line of *Signature Scholars* – individuals who are current practitioners of their craft, from whose knowledge and insight we and our clients may benefit. In this capacity, he has been helping us identify, source and allocate to venture capital funds on your behalf inside our Opportunity funds.

Although not all of you access our Opportunity funds, the information contained within this asset class overview is well worth knowing.

Those of you who know me have heard me speak highly of venture capital in the past, not because it is "cheap," honestly no asset classes are "cheap" today, but rather because you never know when innovation will occur. We do know, however, that its occurrence will not be tied to economic growth in the same way bond yields or equity prices are. So, I thought it helpful if Randy spent a few pages walking you through the venture capital asset class and how it has changed over time.

As always, we remain grateful for your ongoing support and confidence in us. We will continue to work to deserve it. If you have any questions or concerns, please let us know.

Signature Scholar: Randy Castleman
Randy is an experienced venture investor and advisor to institutional investors on asset allocation, manager evaluation, selection, and monitoring for venture capital funds, and direct investments. He co-founded Court Square Ventures where he was involved in all aspects of the firm's operations, including fund conception and fundraising, deal sourcing and selection, portfolio development, investment liquidity, and relationships with LPs. Randy has a BA from Princeton, an MBA from UVA's Darden School and is a Visiting Scholar at the Wyss Institute at Harvard University. He is founder and chair of the Charlottesville Police Foundation.

Someone is sitting in the shade today because someone planted a tree a long time ago.
-- Warren Buffett

Over its 80-year history venture capital has enjoyed both favor and disfavor amongst investors. It has also undergone significant positive changes, with the net result being an asset class that can play an important role in a diversified portfolio.

The Basics of Venture Capital

Venture capital is a subset of private equity, focused on making direct investments in private companies. To take on greater illiquidity and risk, investors demand a return premium over more liquid options. The 10, 20, and 30 year returns from venture exceed returns from the S&P 500 by 2.4, 18.4, and 8.2 percent respectively.[i] Venture partnerships are managed by a general partner that controls the investment decisions of the fund, for which it earns management fees (typically 2% of assets under management) and a share of the profits (typically 20%, the "carried interest"). As long as funds (and management fees) don't grow too large, general partners ("GPs") work primarily for the carried interest, aligning their interests with the limited partners ("LPs").

Role in the Capital Markets

Venture capital offers an opportunity to earn excess returns, often with low correlations to, and time horizons different from, other asset classes. Venture helps drive the innovation economy -- which never takes a break, even in a slowing or turbulent economy -- so conceptually it is not tightly linked to economic cycles. Venture liquidity does depend, however, directly and indirectly on public markets for exits: companies can go public or be acquired by other companies, either public or private. It is important to keep in mind that venture operates on a long time scale. It can take five to ten years (or more) for a company to develop to the point where it can go public or become acquirable. Venture investors target opportunities where potentially powerful outcomes (e.g. 10 - 100x invested capital or more) can overwhelm the uncertainties introduced by a long time frame to maturity and the potential of a volatile economic environment.

Role in the Innovation Economy

There are many sources of alternative financing available to young companies, some quite a bit cheaper than venture funding, so management teams should strive to understand the high return requirements of their venture investors. That said, the strategic and operational expertise many venture managers bring to bear often makes venture financing an attractive option. It is the willingness of venture investors to embrace the myriad risks inherent in a startup that make it essential to the innovation economy and, by extension, to the greater economy.

A Diversified Venture Portfolio

There are many dimensions to consider in building an adequately diversified venture capital portfolio: vintage year, stage (seed to mature), sector (for example, technology or health care), business model, and geography. Investing in multiple venture partnerships over many funds as well as multiple sectors and strategies provides a full measure of diversification -- but only if those partnerships are carefully selected. A small number of venture managers produce the highest returns, and the best managers produce returns that far exceed the average. Though this dispersion of returns has begun to break down over the past decade and the investible pool of venture funds is larger than in the 1980s and 1990s[ii], it remains the principal challenge to creating a productive diversified venture portfolio. When manager

selection is done well, venture can be a powerful contributor: the Yale Endowment has enjoyed an average return in excess of 77% over the last 20 years from the VC component of its portfolio[iii].

Significant Changes

So, venture capital is an idiosyncratic but potentially powerful producer of returns that can be less correlated to economic growth but operates over a long time scale. An awareness of the significant changes venture has undergone in the last 20 years is important for understanding the asset class and selecting the best managers within it.

The Dot-com Bubble

The run-up to the dot-com bubble in the late 1990s saw the largest influx of capital into venture ever, reaching a peak of more than $100B in 2000, up 10x from 1995[iv]. Investors of all kinds were mesmerized by vanity metrics (e.g. eyeballs, click-through rates) and ignored fundamentals. The bubble burst in 2000 and things have returned to a new normal (in 2016 venture funds raised $44 billion[v]) but the disruption ultimately produced significant positive changes to the asset class.

A New Focus on Profitability

Investors learned the hard way that even superficial metrics of traction or growth must ultimately translate into revenue and profit. VCs still look for companies that break new ground in new ways, but since the bubble (and reinforced by the economic crisis of 2008), startups must demonstrate credible paths to profitability. Soft metrics have given way to a relentless focus on unit economics and what it takes to reach each next stage of financing, from seed to exit.

Plummeting Startup Costs

In 1997, a startup's first fund raising round was typically $5 million and would be used for hardware, office space, and people. By 2010, $500k and five months could accomplish what might have taken $20 million and five years. Today, startup teams can test a new business idea for $50k or less. These reductions in costs -- and, importantly, in the risks investors must assume along the way -- are due to resources such as on-demand computing and storage, shared workspaces, and even operational labs for life sciences; and they have changed the basic math of startup investing.

New Business Models

New technologies also enable new business models. The most impactful example is Software as a Service ("SAAS"), where software is delivered online for a monthly fee instead of one-time purchase. Enabled by cheap bandwidth, SAAS has changed the economics and structure of the software industry, eliminating intermediaries and making software more accessible and relevant, with online updates providing new features as needed.

Angel Investors and the Stratification of Early Stage

As startup costs dropped, many successful tech entrepreneurs became angel investors. Familiar with technology and not wanting to manage a formal fund, they began to finance the earliest stages with the highest risks. With this new source of first capital, some began to question the ongoing relevance of institutional venture capital. However, it has become clear that, while the costs of starting a business have indeed plummeted, the costs of *scaling* a business remain significant, and this has assured a place for traditional VC. In fact, traditional Series A investors now arguably enjoy inbound deal flow that has been much more vetted, developed and de-risked (thanks to angel investment) than the raw opportunities of the past.

Old Boys Club to Founder Friendly Platform

Traditional venture capital has also reevaluated its business structure and paternalistic relationship with founders. As funding from peers became an option, old-school VCs seemed increasingly out of touch. And as supply of capital grew relative to demand, the power balance shifted. Financial terms became more company-favorable and the investors began to position themselves as "founder friendly" to win deals. In 2009 Andreessen Horowitz pioneered a new model, featuring dozens of partners on a "platform" that provides operational expertise, not just investment dollars. Today, their platform boasts over 100 professionals across a half dozen operational groups and the model has been widely adopted by other firms.

Influx of Capital

Since the economic meltdown of 2008, a gaggle of new investors have begun investing in startups. Often, but not always participating in the later stages, hedge funds, mutual funds, sovereign wealth funds, and corporate venture capital units have become increasingly active. From 2011 to 2016, the number of corporate VC groups increased from 35 to 107, with dollars invested growing from $8.6 to $24.9 billion[vi], doubling its percentage of total venture investing from 12 to 24 percent[vii]. This influx has pushed up prices at times but also provided new sources of capital and liquidity.

Factoring in the Changes

Venture capital has changed significantly in 20 years, growing past the speculative lunacy of the dot-com boom/bust to a more rational, but no less exciting, period where innovation continues undiminished. The venture capital business is still in flux as it matures from its stodgy roots to dynamic firms that can work more collaboratively with entrepreneurs. Selecting venture managers isn't easy, and constructing a diversified portfolio of funds even less so, but the benefits in terms of time horizon, correlation, and returns can be powerful.

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[i] Cambridge Assoc. *US Venture Capital Index and Selected Benchmark Statistics, 12/31/ 2016*
[ii] Cambridge Assoc. *Venture Capital Disrupts Itself: Breaking the Concentration Curse*, 2015
[iii] http://investments.yale.edu/endowment-update/
[iv] Source: National Venture Capital Association *Yearbook 2016*
[v] Truebridge Capital Partners *State of the Venture Capital Industry 2017*
[vi] https://www.cbinsights.com/blog/corporate-venture-capital-history/#unicorn
[vii] https://www.cbinsights.com/blog/corporate-venture-capital-institutional-venture-capital/