[Perspectives]

When history isn't the best guide

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By Bob Pavey

Having lived and worked through two previous venture industry collapses, what are my expectations for the third? While I'm preparing for times that are at least as bad as the post-1969 and post-1983 eras, I actually think the current difficulties may prove more short-lived.

Despite the much publicized discontent of some limited partners with instances of high venture capital firm fees and carries, the more global trend is a greater recognition by limited partners that venture capital is a "must have" asset class for any fund that hopes to perform well over the long term. The vast majority of potential limited partners still want in, not out, thus assuring a continued strong flow of capital to venture investing.

Also, the technological underpinnings for a small-cap stock rebound are far broader and deeper than they were after both 1969 and 1983.

The excesses of 1969's technology stock run-up followed a long period of prosperity in which investors--as in the late 1990s--forgot about risk. Exciting venture-backed technology companies were though relatively few in number, but they generated outsized enthusiasm.

Digital Equipment had repaid its venture investors 1,000 times their original investments. Other investors tried to emulate that by pouring more money into minicomputer, laser and semiconductor ventures. It was a clear case of great innovation, excessive optimism and too much money.

The prime source of capital for the emerging venture capital industry was, believe it or not, the insurance industry. The largest venture

fund of the period drew heavily on Chicago's State Street insurance money and reached the then-astronomical sum of $81 million. The other significant source of venture investment was the fortunes of America's elite industrial families--the Whitneys, Rockefellers and Phipps (Bessemer), et al.

When the crash came, neither proved sufficient to keep the flow of funds coming to struggling companies. IPOs dried up in the mid-1970s to zero (a painful memory, indeed!). The conventional wisdom at the time was that small companies would never amount to anything in the financial markets again. Rather, large institutional investors would only be able to effectively manage their sizable investments in the "Nifty Fifty," the big cap growth stocks that included such names as Avon and Xerox.

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Groundwork for the turnaround

Two major changes turned the venture-backed technology industry around. The first came in the mid-1970s when venture capital firms persuaded Washington to remove legal barriers to venture investing--specifically, the confiscatory 49 percent capital gains taxes, taxes on stock options, and "prudent man" rules that kept managers at pension and other funds from investing in venture capital.

The second change was the emergence of a PC industry that took computing out of data centers and onto office desks. Not only was the venture capital industry able to more easily draw on funds, but it was also able to tap into exciting new technologies surrounding the emergence of personal computers, peripherals and semiconductors.

When that wave peaked in 1983, we saw excesses similar to those of 1969. However, this second venture industry crash proved less severe than the first. By then, venture capital had begun the process of institutionalization. Along with more professional management at the venture capital firms, the early pension funds and university endowments viewed venture capital as a strategically important -- if still small (about 2%) - part of their total portfolio.

As a whole, the industry stayed the course. IPOs never entirely disappeared. But the best "exit strategy" often proved to be the sale to larger corporate acquirers who, increasingly, saw the purchase of venture-backed companies as a pathway to innovation.

The period still required its own painful adjustments. In the face of sinking portfolio values, limited partner investors---then, as now--grumbled about paying hefty VC fees. A number of institutions decided they did not know how to manage this asset class, and they hired professional "gatekeepers" to negotiate better terms. Overall, venture returns stayed relatively low as risk-averse investors kept their money in big-cap stocks.

What do these experiences teach us about our predicament today?

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To begin with, the old concept that financial markets ultimately revert to the mean looks more valid than ever. The crazier things get on one side, the crazier they get on the other. In fact, most limited partners, who now tend to be somewhat more experienced as a group than venture capitalists, expected a cycle like this, and they're not panicking.

They are, however, annoyed.

Our reading of their mood is that they see an industry that raised too much money too fast and that frequently acted as if another downturn would never happen. They also see some firms attempting to hold on to high fees and carries they appeared to deserve during boom times, but probably don't today.

And, partly as a result of limited partner pressure, we are already seeing adjustments. A handful of venture funds has returned money to their limited partners, and there will no doubt be a quiet reduction in fees and carries--not for most firms but where appropriate.

That annoyance on the part of limited partners is unlikely to turn into outright abandonment (or anything close). In fact, limited partners retain a strong commitment to private equity investing in general and venture capital investing in particular. Whereas the thinking today is that big-cap stocks are most profitably managed via index funds, most limited partners believe that quality venture capital funds are the only way to improve overall equity returns above common stock indices.

Noting that historic venture capital returns are highest after a crash, many see this period as a great opportunity to expand their allocation to venture capital. We continue to get many serious inquiries from potential limited partners about investment and, by the look of it, so do our peers. The current $3 billion to $5 billion quarterly rate of investment in venture capital is only low when compared with the levels of the last three years. Our industry as a whole is assured of adequate liquidity for the foreseeable future for future investments (but not for rescuing all current portfolio companies).

The outlook is just as positive when we look at the technology side of the equation. Despite the hype, the Internet revolution appears significantly broader than the preceding PC revolution. Its potential encompasses everything from radical new improvements in supply chain management for corporations to self-service for consumers to even the communications industry with voice-over-IP services. And growth of data transmission in the backbone continues to expand at

an annual 100 percent clip.

Our past cycles certainly teach the need for caution at all times, but they also teach us the ultimate wisdom of investing countercyclically. After as much of as a year of small cap gloom, I would not be at all surprised to see a strong, very sustainable, upturn-in fact, I know it will happen. The only question is when.

biography
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