Why Angel Investors Don't Make Money … And Advice For People Who Are Going To Become Angels Anyway

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Everywhere I go in Silicon Valley I hear people discussing their angel investments. The conversations remind me of fish stories. People love recounting the one time they caught a big fish, not the many futile hours they spent waiting for a bite.

My skeptical perspective on angel investing is colored by my 25 years in the venture capital business and the data I use to teach my students at the Stanford Graduate School of Business.

I know that many of our clients at Wealthfront are tempted to become angel investors after they sell their company stock post-IPO. It's not that I think becoming an angel is a bad idea; it's just that most people who expect to make money as angel investors are fooling themselves.

To understand why I think this way, bear with me for a few paragraphs about what makes venture capital firms successful. There aren't many successful firms, as this Kauffman Foundation **research** makes clear. Cambridge Associates, an advisor to institutions that invest in venture capital, says that only about 20 firms – or about 3 percent of the universe of venture capital firms – generate 95 percent of the industry's returns, and the composition of the top 3 percent doesn't change very much over time.

Those premier venture firms succeed because they have proprietary knowledge of the characteristics of winning companies. Over the years, the knowledge of what it takes to succeed is passed down from partner to partner and becomes part of the firms' institutional memory. (In a professional setting, it's not the failures that teach people the most, but the successes. Failures teach us a lot personally, but that's a different story.)

The premier venture capital firms know the best investments have high technical risk and low market risk. Market risk causes companies to fail. In other words, you want companies that are highly likely to succeed if they can really deliver what they say they will. Unfortunately, consumer Internet companies don't follow that pattern. They usually have low technical risk and high market risk. There is very little chance they can't deliver their product. The big issue is whether the startup's product is of value to a large enough audience.

Most people see angels as taking market share from venture capitalists. I think that is the wrong perspective: The premier venture capital firms have consciously outsourced consumer Internet companies' bad market risk onto the angels, maintaining their returns as a result.

How low are returns for angels? I don't know of good statistics on returns for angels who invest in tech companies, but I can deduce returns from what I know about the venture capital business. As explained in the Kauffman Foundation research, the *overall* return for the venture capital industry has been quite poor (the average VC fund barely returned investor capital after fees). According to an annual seed financing survey by Fenwick & West, only 45 percent of companies that received seed financing in 2010 went on to raise venture financing in the next 18 months. Twelve percent were acquired, but likely in talent acquisitions that lost money for the angels.

If the average VC fund barely makes money, and seed investments represent even less compelling opportunities than the ones pursued by venture capital firms, then the typical return for

angels must be atrocious. Even Ron Conway's second angel fund, which had the good fortune to invest in Google (a 400x cost winner), only broke even (that means close to a 0 percent IRR)!

I know some of you are thinking you'll be the exception to the rule. Maybe, but if so, it won't be because you've been a great executive at a startup. My teaching partner at Stanford, Mark Leslie, the founding CEO of Veritas Software and a successful angel investor, tells me I would have been a better venture capitalist if I had been CEO of Wealthfront first, and a venture capitalist second, instead of the other way around. I tell him absolutely not. Running a company has not improved my investing skills, which are completely unrelated to being a good leader and strategist. Unfortunately, many entrepreneurs do not understand that being a good executive has nothing to do with being able to pick companies likely to succeed on the large scale needed to generate a good investment return.

My conclusion is that unless you are Andy Bechtolsheim, legendary founder of Sun Microsystems, Granite Systems and Arista Networks, and can have the pick of the best technical founders in the Valley, or you are a member of the Paypal Mafia, you should not be an angel investor. A few elites have a chance of making money. The rest of you are in for pretty dismal results.

I know that most of you are going to ignore my advice. If you do, and decide to make angel investments, here are a few tips:

1. Assume you are going to lose all your money. Treat success as a complete surprise. Successful venture capital firms generate approximately 80 percent of their returns from less than 20 percent of their investments. The chances are high your angel investments will be losing bets.
2. Don't do it unless you are worth at least $1 million or earn at least $200,000 per year. The SEC requires these minimums for angel investors because it is the minimum regulators believe is necessary for an individual to withstand the loss of the investment.
3. Take a portfolio approach. Whenever you invest in a risky asset class like startups, movies or new artists, you need to have a portfolio, because the law of small numbers will likely lead to a complete loss on your investments. Remember talent acquisitions, which represent the vast majority of successful angel investments, usually result in a loss for the investors. Try to build a portfolio of at least 15 companies.
4. Limit the size of your angel portfolio to 10 percent of your investible assets. Even sophisticated institutions that have the financial wherewithal to take significant risk and have access to the premier venture funds tend to allocate no more than 5 percent to 10 percent of their portfolios to venture capital. You don't have the staying power or the financial expertise of these endowments, so try to limit the size of your overall bet.

Perhaps the best angel investment you could make is choosing the right company to work for. The value of the options associated with a successful company will swamp the return on any angel investment you're likely to make, even if you do happen to have a success.

In case you're interested, I make one or two angel investments each year, but I don't do it to make money. If I wanted to make money on those investments then I would want the benefit of the counsel of my former partners at Benchmark Capital, because I know it is too hard to make such high-risk investments on my own.

I make those few angel investments because I want to help my best students achieve their goals, and because I like being involved in startups. That's the ultimate lesson from the fish stories in Silicon Valley. True fishermen cast their lines not because they want the fish, but because they like fishing. It's fine to be an angel investor – just don't do it for the money.