Increasing Returns and Reducing Risk within a Private Equity Portfolio

VenCap®

Venture capital has matured and many investors are missing out on the upside potential and increased diversification it can offer

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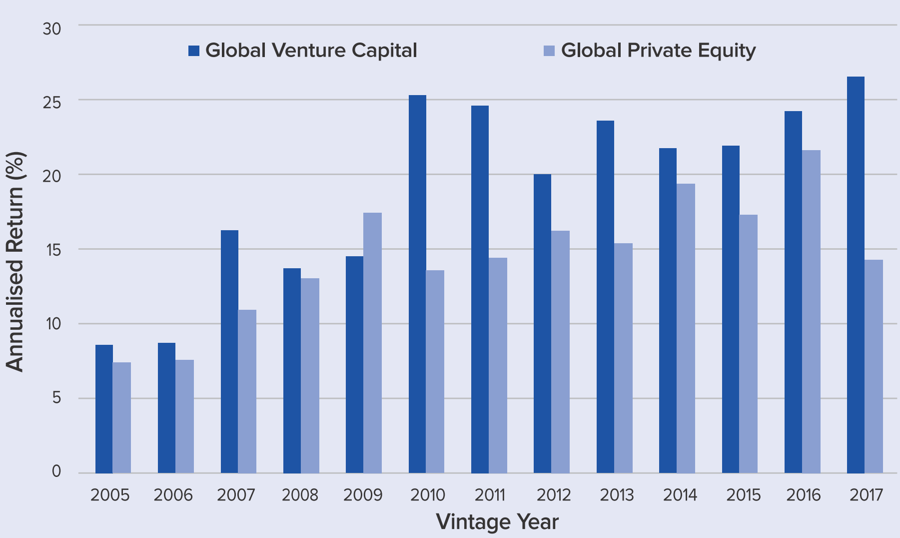
Venture capital has changed dramatically over the last 20 years. From a small, cottage industry, primarily based in Silicon Valley, VC has now become a global, multi-stage asset class that has consistently outperformed private equity since 2005. Why then, are so many investors still missing out on the returns and diversification that VC can offer?

The increased maturity and global scale of the VC industry has driven a dramatic change in the relative performance of venture vs private equity. According to Cambridge Associates, from 2005 to 2017, VC has outperformed private equity in all but one vintage year.

VC-backed companies are now staying private for longer, with more of the value they create going to their private round investors. And when these companies do exit it is at valuations that are materially larger than their predecessors. In the last 12 months alone we have seen companies such as UiPath, Snowflake, Roblox, Doordash, Crowdstrike and Coinbase complete successful public listings and trade at valuations in excess of $30 billion. Many of these companies have become "fund returners" for their early-stage backers. Looking forward, expect to see VC-backed companies increasingly disrupt large parts of the traditional economy by providing "full stack" solutions that allow them to capture a larger share of economic value.

In addition to providing strong returns relative to private equity, venture capital can also help to reduce overall risk by adding diversification to an investor's portfolio. Over the last 30 years, venture capital has consistently shown a lower correlation to public markets. While the correlation of both private equity and venture to the S&P 500 has increased in recent years, venture capital has continued to provide investors greater overall portfolio diversification than private equity.

VC CONSISTENTLY OUTPERFORMING SINCE 2005



Source: Cambridge Associates Investment Benchmarks as of 30 September 2020

HIGH CONSISTENCY AND CONCENTRATION OF PERFORMANCE

An allocation to venture capital, however, is not without its risks. The strong overall performance generated by the industry is not enjoyed uniformly, with the majority of the value created by entire VC industry coming from a small number of companies each year. In turn, there is a concentrated group of VC firms that have proven able to back these companies vintage after vintage. And unlike private equity, academic studies have shown that venture capital firms show a relatively high degree of performance persistence. In other words, there is a much higher likelihood that a VC firm whose previous fund was top quartile will maintain this performance with their current fund.

This concentration of returns together with the persistence of performance provides a strong argument as to why investors should focus most of their efforts on VC managers with a proven and consistent track record, rather than gambling on inexperienced or second-tier firms. VenCap has been implementing such a strategy for more than a decade, with the vast majority of its commitments since 2010 focused on just 14 "core" managers. Investments in these core manager funds have outperformed the median VC return in every vintage year since 1995 and have exceeded the upper quartile benchmark in 73% of vintage years. They have also consistently outperformed the public markets.

By continuing to ignore venture capital, many investors are missing out on the increased performance and reduced risk that VC can provide. However, any investor considering a VC allocation will do well to understand the unique characteristics of the venture industry and construct their portfolio accordingly.