Some say that startups should raise smart money but not dumb money. Others say all the money is green, so there's no difference. The issue is more complex than that. And this complexity involves the capital sources that your investors use as well as the terms of their agreements with limited partners (LPs).

Angels invest their own money, VCs invest their LP's

Venture capital firms have limited partners. These limited partners come in all shapes and sizes from all over the world. And in turn these limited partners are frequently entities that are funnels for other sources of money.

Traditionally, angel investors were individuals that would use their own personal capital to make an investment. Recently, "seed stage" venture firms have emerged that have between one to three partners. These seed stage firms are usually backed by institutional limited partners or even by venture firms. They are really small venture firms that present more like angels because there are usually one or two partners running the seed stage firm.

To understand how these angel and VCs roles came to be, we need to look back in history.

1960's and 1970's: LPs realize they can seek alpha in VC

Let's go all the way back to the 1960's and 1970's — early days in technology angel and venture investing. There were very few venture firms at the time. Most of them were formed by former technology executives who had had enough of operating but wanted to stay involved in startups. So they took some of the cash they made during their operating careers and started investing in companies that were in their work or social domain. **And soon, corporate financial services and university endowments realized that these former execs-turned-angel investors had good instincts about which companies to invest in.**

Meanwhile, these corporate financial services and university endowments started to apply financial asset allocation theories to their portfolio. It's well known in financial theory that the allocation of capital in a fund across asset classes is the single most important decision that affects the fund's return and volatility. In addition to having investments in liquid public equities, they also had investments in oil & gas funds, real estate, commodities, and other asset classes. These endowments (the early limited partners) started looking for "alpha" so they could outperform other limited-partner managers. So they created a new asset class with the highly descriptive name of "Alternative Assets."

The LPs saw that angel investors and early venture firms made some spectacular returns. For example, MCI and Amgen came out of early small funds like Charles River Ventures and Genentech came out of Kleiner Perkins. **So the LPs got smart and said, "Aha, let's allocate some of our alternative investments to venture capital."** In a way, it became the asset they could invest in to differentiate their performance from their competition. And to also earn a healthy bonus for themselves for "winning."

These financial services companies and endowments would back these angel investors in a firm structure that usually took the form of a limited partnership — which, not incidentally, is totally different than an operating company. A limited partnership has limited partners and general partners; the limited partners are the major sources of capital. Historically, the limited partners would get 80% of the fund's returns and the general partners would get 20%. The funds were small — for example, Charles River Ventures was $5M in 1970 and Kleiner Perkins was $7M. Most of the capital came from the limited partners.

General partners would typically get a 2% annual management fee. At that time, venture firms had small headcounts and the 2% fee on the small fund was used to cover business expenses like rent, travel, administrative staff, and meals. The fees were not a way to earn a living. And through the 1970's, venture capital marginally outperformed the horrific public market.

Early 1980's: Weak public markets tighten VC money

In the early 1980s, the 15-year public equity disaster came to an end. The public market literally went sideways from 1966 to 1981. If you invested $1 in the public stock market in 1966, you would have $1 in 1981. Worse, if you accounted for inflation, you only had 70 cents!

Because of the weak public market, startup valuations were low and investment syndicates were a must. Founders looked for deep pockets, not just easy pockets. In short, money was tight, not a commodity.

Investors were concerned that there would be few exits and worried that, even if companies became cash flow-generating businesses, they wouldn't necessarily become high margin, high value companies. A whole host of terms became important in the term sheet like redemption rights, dividends, and participating preferred.

1982: Low interest rates and successful technology companies lead LPs to invest even more in VC

Starting in 1982, interest rates fell from 15%+ to 5%, paving the way for a lot of available capital as well as a lot of profit generation. These profits fed back to limited partners, who, in turn, pumped the profits back into venture capital through their "alternative assets" allocation, which was now 5% of their manageable funds. So the terms of limited partner's investments in venture firms loosened up a bit, which also permitted venture firms to loosen up the terms of their investments into startups.

At the same time, technology companies like Apple and Microsoft were printing money. It was in the air that technology companies would disrupt and create new industries. And our government was printing actual paper money and creating a lot of debt to fund the deficits spurred by high defense spending and other spending. So there was a lot of new liquid capital.

All this extra capital boosted the size of venture funds. There were serious and large limited partners that wanted to place a lot of capital into these well-performing venture funds. These limited partners were university endowments, insurance companies, charitable foundations, as well as “fund-of-funds,” which were channels that would pool the capital of small limited partners that didn’t have the capital base or reach to invest in these venture firms.

1982–2000: $120B goes into venture firms in 2000 alone

Meanwhile, the 1980s and 1990s marched on, with the public market taking off and seeing an annualized 18% return into 2000. Limited partners were also happy because they were getting good returns, and venture firms were growing and specializing by domain. By 1996, venture firms had total capital of $12B+ and the average venture fund was about $120M.

In the next four years, the public market went ballistic and became a huge bubble. This was partly a social phenomenon, but it was also because of the Fed, which provided easy money at low interest rates. Also, the Fed, fearing a market collapse caused by Y2K problems, was pumping the market with liquidity in 1999.

Valuations on the private market skyrocketed across all stages and private companies were raising capital at billion dollar valuations fairly early in their development. The time frame also accelerated: investments were made within days to weeks and diligence was measured in days.

By 2000, limited partner’s returns were turbocharged and top venture firms saw annualized returns of more than 200% — far in excess of the public market. In fact, from 1995 to 2000, a total of $180B was invested into venture capital and approximately $325B was returned to limited partners. And what did the limited partners do? They put in more money. In fact, they invested $120B into venture capital firms in 2000, a tenfold increase in five years.

Limited partners were very happy with their returns from venture firms and did whatever it took to place their capital into these firms. It was like a feeding frenzy to raise a fund. **My partners and I raised a $300M fund in three weeks during that period**. It was just really easy. Limited partner allowed select venture firms like CRV to have better carry (25%-30%) and terms between entrepreneurs and VCs loosened up again.

2002-2009: $205B goes into VC but only returns $220B to LPs

So far so good — until we hit the year 2000, when the public market cratered and limited partners and the broad populace scrambled to defend their portfolios. Cash liquidity decreased and limited partners got very concerned about how some venture firms were being run. They also began to worry about the ballooned size of most venture funds.

But that worry didn’t last long enough, as the Fed began pumping more money into the system to “save” the United States from a recession. The great housing bubble started to grow and the public market began a strong rise in 2003, a rise that buoyed the public market portion of the limiter partners’ funds. LPs began to feel and think more positively, resulting in more capital flowing back to venture capital with good terms intact. Limited partners also began to characterize the bubble as the result of macro forces that were then tamed by Alan Greenspan. As a result, the limited partners rationalized away their worry about venture firms and we soon found ourselves returning to $30B/year going into venture capital each year. This was more sane, but not totally sane.

As the public markets improved, limited partners (who are now both domestic and international capital sources) worried that too much of their portfolio was in the public market and started pumping more money into venture capital firms. From 2002 to 2009, a total of $205B was invested into venture capital, and approximately $220B was returned. You can do the math. That is not a good return for the whole asset class.

What happened? **A big part of the problem was that the public market never really responded like it did in the 1990s. The stock market blowout left collective scars across retail and institutional public market investors. There was no crazy bubble period, which was a problem because the amount of venture capital in total was still way too high given the total return.** And while venture capital returns did slightly outperform that public market over the decade ending in 2009, the public market returns and private venture capital returns diverged in terms of the median return per company.

LPs: "The fund I invest in better be investing in the next Google."

Along the way, something interesting happened to the shape of the return curve. In the 1980s and 1990s, venture capital returns were usually Gaussian with respect to their portfolios. Yes, there was Benchmark's investment in eBay and a couple of others that created 1000x returns. But most of the exits were shaped around $300M exits. A big exit was a 10x return.

In the 2000s, the middle of that curve got blown out, making a lot of portfolios look bipolar. Most portfolio companies returned less than the capital that was put in. And a few companies generated astronomical results: Google measured in the 1,000X to 10,000X multiple. Limited partner data showed that eight venture funded companies a year were generating the vast majority of venture firm profits, and that's out of a universe of three to four *thousand* companies funded every year.

Pretty soon this was common knowledge across the limited partner community, and the top limited partners — in terms of size and longevity — were looking for these "return the fund" opportunities when venture firms talked about their investments with them. If you couldn't speak about a potential "billion dollar opportunity," limited partners thought you really weren't in the game. **This data started a conversation across the limited partner community, which usually included the words "the fund I invest in better be investing in the next Google."** And limited partners liked to bring that up in their conversation with venture firm's partners, "Which one of these companies can return the whole fund?"

Additionally, a decade had passed since the 2000 blowout. The decade returns for venture capital in aggregate were weak and limited partners started to reassess how, who, and what venture firms to invest in. And then the savage bear market that started in late 2007 started to ravage the limited partners' portfolios again. This was the start of limited partners asking tough questions and looking for proof of how returns would get generated over the next decade.

2010: The balance of power shifts to limited partners?

Limited partners face the issue of diminishing returns because they also have shareholders. Likewise, the venture firms and seed stage firms that are down the pipeline from these limited partners are also subject to these hard questions.

Today, we're beginning to see a shift of money turning back into a commodity. But without the massive government bailouts, it turns out that money supplies like M2 are declining, indicating that the core economic environment is one of deflation. This means that cash is gathering more value than any asset, and this macro shift will shift the balance of valuation and terms in favor of the root sources of capital.

In the next post, I will review what this means for direct investors and what it means for portfolio companies. I'll also include a list of questions to ask your potential investors to ensure that they're the right investors for your company.