

## Are you an Angel investor or gambler? V2

### What is the purpose of this article?

Help you identify whether you are an Angel investor or a gambler.

This article does not provide tax, legal, or financial advice.

### What are the critical learnings in this article?

- 1) You may need to create a portfolio of 20 or more companies.
- 2) You might need to invest \$800,000 or more.
- 3) You need the skills and time for both due diligence and helping founders succeed. Money by itself is not enough.
- 4) You need to determine if you're putting capital into early-stage companies because: you are an investor; you are a gambler; or this is a charitable activity and not part of your overall investment portfolio.

### How do you recognize if you are an investor?

- 1) The primary purpose of your investments is to grow and preserve your financial wealth.
- 2) There may be secondary purposes such as enabling social good.
- 3) You may have a variety of asset classes. These provide diversification, which may increase the probability of financial return and reduce the probability of financial losses.
- 4) You are tracking the return of your investments.

### There are many other ways to spend money, other than investing

- 1) For most people, the major of their spending does not go into investments.
- 2) Hobbies, entertainment, social activities, intellectual stimulation, charities, giving back, and gambling are just some of the ways money is spent. E.g. I buy 6 lottery tickets a year at \$3 each.
- 3) These other activities are not investing. I might win millions with my lottery ticket. Lottery tickets are not where I invest money.
- 4) If the primary purpose of your spending is other than growing and preserving wealth, then that spending is not part of your investing.

### How do you recognize if your Angel investments are actually gambling?

Let's assume you've decided to make Angel investments with the primary objective of making, growing, and preserving wealth. You may be doing this because you've heard that this Asset class outperforms publicly traded equities but that the chances of an individual investment are low. What are the odds of success? You don't want to "invest" in a casino or lottery tickets.

### What are the facts?

The following findings are from a 2020 study of more than 10,000 individual early-stage portfolios on AngelList.<sup>1</sup>

- 1) Angel investments, as an asset class, generate 15% IRR (combination of realized and unrealized gains)
- 2) Investors who made 1-5 investments had a median return of 0.0% IRR.
- 3) Investors who made 10 investments had a median IRR of about 6%. 32% of these investors lost money.
- 4) Investors who made 20 investments had a median IRR of about 7%. About 16% of these investors lost money.
- 5) Investors who made 50 investments had a median IRR of about 10%. About 11% of these investors lost money.
- 6) Investors who made 100 investments had a median IRR of about 14%

Many, if not most, angel investors have a limited return, although the asset class as a whole performs relatively well. A small portfolio of investments has low median IRR and significant chance of losing some or all of your capital.

### How do you change the odds to be an investor rather than a gambler?

There are four ways to be an angel investor rather than a gambler.

#### #1 Create a portfolio of 20+ investments

This will require significant amounts of your time and capital.

#### #2 Spend more than 40 hours on your personal due diligence.<sup>2</sup>

- 1) Spend more than 20 hour of due diligence time for each potential investment.
- 2) Angels who spend less than 20 hours have an average return of 1.1X capital.
- 3) Angels who spend more than 20 hours have an average return of 5.9 X capital.
- 4) Angels who spend more than 40 hours have an average return of 7.9 X capital.

You must consider if you have the skills and knowledge necessary for an effective due diligence. I don't know the relationship between increased due diligence and the number of investments.

### #3 Join an angel investor group

- 1) The rationale is to reduce your due diligence workload.
- 2) I have no advice on how you can conduct due diligence on an angel investor group, considering its members, its processes, and its results.
- 3) I don't know the relationship between increased due diligence and the number of investments.

### #4 Invest in an angel fund

- 1) The fund should have a large number of investments in its portfolio.
- 2) I have no advice as to how you could conduct due diligence on an angel fund, considering management, processes, and results.

### **How should you think about the amount of capital needed to become an angel investor and not a gambler?**

The following example is based on assumptions:

- 1) You're going to make 24 upfront investments over 1-3 years. As noted above, your median return may be a little more than 7% IRR. Like that any exits in the first three years will be failures. These early exits may not provide any capital for reinvestment.
- 2) You'll invest in pre-seed: 75% fail<sup>3</sup>
- 3) You'll invest at seed stage, 50% fail<sup>3</sup>
- 4) You'll invest in Series A; 50% fail<sup>3</sup>
- 5) You're investing at seed and Series A for two reasons: these companies have survived; and later stage investor may impose terms (such as liquidation preferences) which reduce the value earlier investments.
- 6) At each stage, each individual investment is \$25,000. In some cases, the startup may have larger minimum cheque sizes.
- 7) Your capital requirement may be: (Pre-seed: 24 X \$25,000) + (seed: 6 X \$25,00) + (Series A: 3 X \$25,000) = \$825,000

### **What are your next steps?**

- 1) You cannot predict the future. The above fact-based analysis is historical. Many changes have occurred in the past few years: the amount of capital available at the early stage has exploded; many early-stage funds have been created; the number of early-stage investors has grown. You'll have to determine what the future scenarios could be.
- 2) The angel asset class as whole may do well, but your personal results depend upon your investment process and thesis. Assess whether you have the appropriate skills and process to be an Angel investor.
- 3) Carefully review and understand published reports from investors and funds. Some state their results as including both realized and unrealized gains.
- 4) Make your own assumptions and analysis regarding the amount of capital you're going to devote to angel investing.
- 5) Determine if you're putting capital into early-stage companies because: you are an investor; you are a gambler; or this is a charitable activity and not part of your overall investment portfolio.

### **Footnotes**

<sup>1</sup> Nigel Koh, Abraham Othman, "How portfolio size affects early-stage venture returns", AngelList,

<https://angel.co/blog/how-portfolio-size-affects-early-stage-venture-returns>

<sup>2</sup> Robert E. Wiltbank, PhD Willamette University, Warren Boeker, University of Washington, "Returns to Angel Investors in Groups, November 2007"

<https://www.angelcapitalassociation.org/data/Documents/Resources/AngelGroupResearch/1d%20-%20Resources%20-%20Research/ACEF%20Angel%20Performance%20Project%2004.28.09.pdf>

<sup>3</sup> "Startups' success and failure rate in 2023"

<https://spdload.com/blog/startup-success-rate/>

### **What further reading should you do?**

How profitable is angel investing?

<http://koorandassociates.org/selling-a-company-or-raising-capital/how-profitable-is-angel-investing/>