Accessing Innovation: The Venture Challenge

Our investment philosophy is to protect portfolios against permanent capital losses by finding value across all major asset classes. Given that venture capital (VC) is one of the riskiest asset classes available to investors, our approach has always been to be as selective and disciplined as possible when considering our investments and commitments in the space. While VC currently represents one of our smallest asset allocation buckets, it is nonetheless one that clients frequently ask about as a means of investing in next-generation technologies.

This presents an interesting challenge for BigSur. As a Firm, we are careful to always do our best to "de-risk" investment opportunities and to only invest in our highest conviction ideas. In many ways the VC approach of "spreading your bets across ideas you aren't really that sure about" goes directly against this core philosophy. And yet, it is impossible for us to ignore the outsized returns that top VC managers have generated over the last decades, or the important economic function that VC funds play as engines of innovation. Historically, our approach has been to educate clients on the binary nature of most VC outcomes, establishing "sweet-spot" position sizes (big enough to feel the upside, but small enough to not permanently impair the portfolio), while also working to gain access to the highest quality fund managers.

In this write up, we will elaborate on that approach as well as explore alternative ways of participating in the trends that have benefitted VC (without taking on idiosyncratic VC fund risk). We would like to thank our Advisory Board Member, Mr. Amitabh Dutt, for inspiring us to write about this topic, and for providing valuable contributions throughout.

Academic Research = 30% Survival Rates

On average, 7 out of 10 VC portfolio companies will not return the money invested into them (meaning they are in most cases written off). The result is that 3 out of 10 portfolio companies do the majority of the heavy lifting. Two are expected to return enough to cover all of the losses, and the third provides the fund's target 20-30% IRR. The difficulty in achieving a balance between highly successful and completely unsuccessful investments is what often detracts many investors from investing in VC, which begs the

The Thinking Man's Approach

April 2021 | Series #84
Ignacio Pakciarz | CEO
Salvador J. Juncadella, IV | Senior Analyst
Rene J. Negron | Analyst

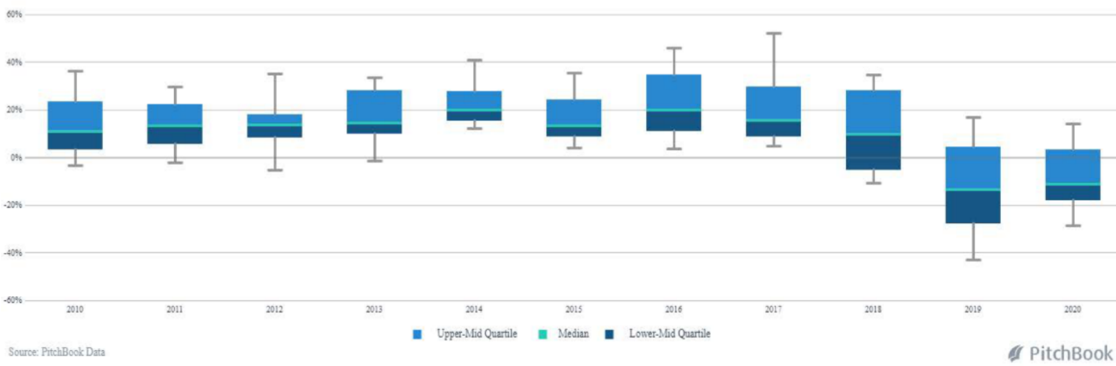
- Our investment philosophy is to protect portfolios against permanent capital losses by finding value across all major asset classes.
- As a Firm, we are careful to always "de-risk" investment opportunities and to only invest in our highest conviction ideas
- Technology companies are choosing to stay private for longer, therefore investors seeking to achieve early-stage, innovation-based wealth creation must invest via private markets.
- Our approach has been to educate clients on the binary nature of most VC outcomes, establishing "sweet spot" position sizes (big enough to feel the upside, but small enough to not permanently impair the portfolio).
- In our view, the Fund of Funds model is currently the best option for BigSur clients to invest in venture capital.

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com question, is the risk worth the upside? One argument in favor of this is the fact that leading technology companies are choosing to stay private for a longer period of time. Therefore, if an investor is concerned with achieving early-stage, innovation-based wealth creation, there are simply few alternatives to doing so outside of private markets. Additionally, it is important to note the meaningful differences between average manager performance (which we cited above) and top quartile/decile manager performance. Early-stage fundraising is never just about raising capital. Young companies want the expertise and guidance of VC's with proven reputations and track records (which is why top VC funds generally position themselves as growth-enabling partners and not just silent sources of capital). The result is that the top VC funds tend to attract the best companies, thus setting off a virtuous cycle where the best VC funds continue being the best VC funds simply because they already are.

Quality Matters = Best Attracts Best

Below we provide performance data for 2010-2020 VC vintages, for Primary Funds sized between $100 million and $1 billion.

As we have noted, the dispersion of VC fund performance is wider than in most other asset classes. The first step in managing this dispersion is being able to identify and gain access to the top venture capital managers. This is an increasingly difficult challenge. In most cases, funds are over-subscribed years in advance or require lofty minimums (typically ranging from $5-20 million per investing entity). Even if we achieved access to the best managers, none of our investors would have the risk appetite or profile to make an investment of that size.



Vintage Year	# of Funds	Max IRR	Top IRR Decile	Top IRR Quartile	Median IRR	Bottom IRR Quartile	Bottom IRR Decile	Min IRR
2010	16	43.90%	36.16%	23.64%	11.20%	3.32%	-3.18%	-9.00%
2011	19	70.30%	29.56%	22.20%	13.53%	5.50%	-2.12%	-21.80%
2012	16	37.64%	35.26%	18.08%	13.75%	8.37%	-5.31%	-10.52%
2013	21	46.30%	33.41%	28.32%	14.49%	9.90%	-1.51%	-17.30%
2014	26	593.62%	40.97%	27.70%	19.93%	15.23%	12.22%	-6.30%
2015	46	45.00%	35.55%	24.46%	13.57%	8.58%	4.00%	-15.11%
2016	54	71.44%	45.96%	34.79%	19.90%	10.91%	3.72%	-5.20%
2017	48	106.30%	52.29%	29.67%	15.76%	8.86%	4.98%	-8.80%
2018	46	105.00%	34.61%	28.30%	9.74%	-5.05%	-10.75%	-29.27%
2019	45	42.58%	16.86%	4.50%	-13.24%	-27.83%	-42.91%	-53.18%
2020	22	20.50%	14.25%	3.46%	-10.88%	-18.15%	-28.41%	-30.73%

There are three potential solutions for surmounting these challenges:

1. The first is to invest in "up-and-coming" venture capital managers. These are successful and coveted venture firms with 1 to 3 funds of historical performance, but are not yet considered traditional household names like Sequoia Capital, Kleiner Perkins, and Andreesen Horowitz.

   At BigSur, one example of a manager we have invested with manages ~$500MM across four funds. This manager takes a "land and expand" approach to VC investing, focusing on building instead of betting on portfolio companies, and avoiding the "spray and pray approach." Investments start small, and then build up to 20-30% of the company through subsequent rounds of financing.

   Minimum investments are typically still high (although not as high) with many of these smaller managers. However, investing in the fund has the added benefit of allowing us to co-invest alongside the General Partner (GP) in their highest conviction ideas throughout the holding period.

2. The second solution for accessing direct venture funds is creating a special purpose vehicle (SPV) that aggregates client commitments into a single investment entity (similar to our approach to past co-investments). Though the SPV approach would likely still require us to negotiate minimums, we would do so from a stronger negotiating position.

   While this approach introduces an additional layer of operational complexity for BigSur, it would allow us to potentially gain access without having to make any compromises on manager quality, strategy, or scale. It is important to note that under this approach, we would need to ensure that there was sufficient demand for subsequent SPV fund commitments (in order to achieve vintage and manager diversification).

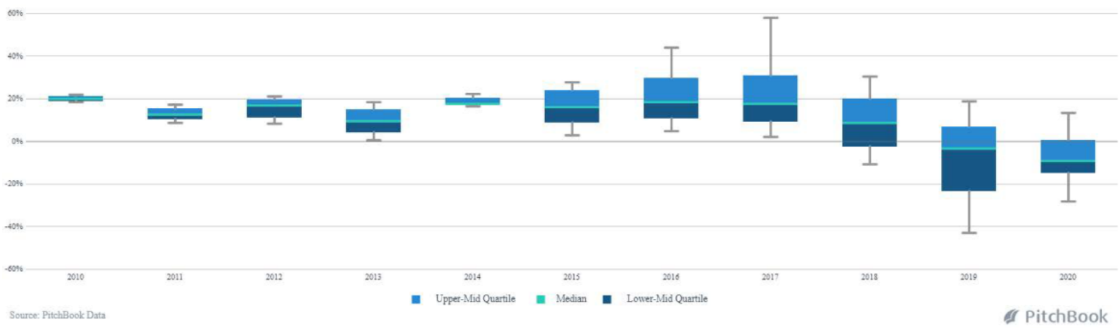
3. The third solution, and one that we have implemented before, is to bypass the venture stage and invest in software and technology- enabled businesses via growth equity and/or buyout funds focused on mature, but still growing businesses. This approach would allow us to align ourselves with innovative technologies, while eliminating venture risk. Though our upside would likely be more limited, we believe that there is still the potential to generate attractive risk-adjusted returns.

   An example of an investment we made in this space is committing capital to a pioneer in software investing. Since its inception in 2000, this Firm has raised over $57 billion in capital commitments and is one of the largest and most active investment firms dedicated to investing in the enterprise software and data/technology-enabled solutions sectors, having made more acquisitions than any financial sponsor or strategic investor. BigSur has invested across both this group's private equity and private credit strategies.

The Venture Fund of Funds Model (FoF) = The Middle Way

On the following page we provide performance data for 2010-2020 VC vintages, for Fund of Funds (FoF) sized between $100 million and $1 billion.

Comparing the chart on the next page to the same chart for individual VC funds, we can see that FoF upside capture is not as large as Primary Funds, but downside protection is significantly better. When it comes to the median returns, FoFs returns are fairly similar to Primary Fund returns, but with significantly less risk given underlying diversification (i.e. 20 funds exposure vs. 1). In our view, the FoF model is currently the best option for BigSur clients to invest in venture capital.



Vintage Year	# of Funds	Max IRR	Top IRR Decile	Top IRR Quartile	Median IRR	Bottom IRR Quartile	Bottom IRR Decile	Min IRR
2010	2	22.30%	21.86%	21.20%	20.10%	19.00%	18.34%	17.90%
2011	5	18.90%	17.46%	15.30%	12.74%	10.41%	8.66%	7.49%
2012	6	21.96%	21.01%	19.51%	16.95%	10.94%	8.50%	7.76%
2013	2	20.53%	18.33%	15.02%	9.52%	4.01%	0.70%	-1.50%
2014	5	23.28%	22.18%	20.54%	17.80%	17.05%	16.60%	16.30%
2015	43	43.50%	27.74%	24.00%	16.00%	8.58%	2.77%	-15.11%
2016	55	50.20%	43.93%	29.83%	18.62%	10.57%	4.75%	-5.20%
2017	42	106.30%	58.09%	30.69%	17.76%	9.06%	2.23%	-8.80%
2018	42	102.77%	30.49%	19.90%	8.63%	-2.59%	-10.75%	-24.63%
2019	39	42.58%	19.00%	6.73%	-3.17%	-23.39%	-42.91%	-53.18%
2020	25	20.50%	13.36%	0.75%	-9.10%	-15.06%	-28.08%	-30.73%

An example of a top quartile manager we have a long history of working with is one of the leaders in the venture capital FoFs space for over 20 years. Managers, similar to this one referenced, allow investors to access venture with smaller minimum ticket sizes, while providing access to the most blue chip investment managers (given their decades-long history of having secured access to those funds). In addition, most leading venture capital FoFs allocate a piece of their portfolios to leading emerging managers (those up-and-comers mentioned before), and dedicate a sleeve of their portfolios to co-investments alongside underlying managers. Many established FoF managers also have attractive, independent sub-strategies, such as dedicated secondaries funds and dedicated co-investment funds, which benefit from cross-fund synergies in creating deal flow.

Typically, investment minimums for FoFs can be negotiated down to $250,000 or $500,000 per investor, which is a much more realistic proposition for most of our clients. With FoFs, you eliminate the complexities of having to create a vehicle, have favorable minimum ticket sizes, and achieve access to blue chip names. The FoF approach for venture also allows our clients to invest across vintages, allowing them to spread out their overall commitment to venture over time (given that fund of funds are typically raised yearly or bi-yearly).

The downside to the FoF model is in the case of an investor who only wants exposure to one specific type of technology or sector. The FoF model, by its very nature, is diversified as opposed to selective of specific themes like electric vehicles or artificial intelligence. Additionally, co-investment opportunities are usually reserved for only the largest investors in a fund, or for the dedicated co-investment funds raised in parallel.

Direct Investments = We Know What We Do Not Know

At BigSur, we consider ourselves expert market-generalists – not experts in any particular field of technological innovation. For these reasons, we have not, and in most cases, would not consider investing directly into a single venture opportunity without manager oversight.

Manager selection is our bread and butter expertise for private markets, but not venture portfolio company selection. It is a lot easier to lose principal investing in a direct deal than with a well-diversified Primary Fund or FoF manager. Direct investing without manager oversight would require in-house technical expertise, dedicated resources and manpower, while creating significant operational and regulatory complexities and challenges for BigSur.

To clarify, we are open to investing in high conviction ideas with proven technologies that are already venture-backed. We just do not want to be in a position to try and figure out if a technology is viable in addition to figuring out if a business model is viable. Our recent direct investment in a next-generation artificial intelligence (A.I.) company is a great example of our approach. Our decision to invest was the result of having intimate knowledge of the company, a longstanding relationship with the GP, and the fact that it was a subsequent investment round into a portfolio company we already had exposure to via our fund commitment.

In these cases, we examine the trajectory and growth of each potential company, identify who their customers are, how sticky their business model is, the competitive landscape, and the quality of co-investors that have backed the company since inception. If we had a larger funnel of VC relationships, such as the one we have with the aforementioned GP, we would be more open to co-investing smaller amounts into direct opportunities, but never primarily sourcing these ourselves given the volume and variety of early-stage companies that are out there at this moment.

Pre-IPO Market = Only for Highest Conviction Ideas

When analyzing the pre-IPO space, we are extremely cautious, especially in the current market environment, where even young and unproven companies are opting to go public via IPOs and SPACs. We only go forward with a pre-IPO investment if we have a strong, long-term conviction in the company. We do not look at a pre-IPO investment as a venture play, or as a short-term arbitrage, but rather as a long-term core equity holding for client portfolios.

- A great example of this approach is our pre-IPO investment in a leading online marketplace for lodging (primarily homestays for vacation rentals). This opportunity was a high conviction play for us, as we firmly believed the company was a "buy and hold" position for client equity portfolios. We bought into the company in November 2020 at a valuation of ~$40 billion with the view that the company's growth trajectory would easily make it worth ~$100 billion over the next couple of years.

- We transacted on the company through an established pre-IPO manager, who was representing a seller who had sold his business to the pre-IPO company in exchange for company stock. Once we identified the access and the quality of the seller, we began to negotiate fees. We were able to completely eliminate upfront fees, and instead aligned the investment manager with our clients (given that they only get compensated with upside performance). As of March 2021, the company achieved a market capitalization of $120 billion, meaning our $4 million investment is now worth ~$12 million.

Nonetheless, it is important to keep in mind that investing in these companies is high risk, since private valuations often overshoot public market reception. While many IPOs are successful, there are many that perform poorly. Additionally, investors need to keep in mind that investing in pre-IPO shares brings a 6-month lock-up period, where investors are restricted from selling their shares.

Additionally, there are many dedicated funds for pre-IPOs, which is something we may consider in the future for client portfolios. Since our latest pre-IPO trade, there has been demand to gain exposure to other deals, and pre-IPO funds provide a diversified approach to IPO investing by blending the winners with the losers, while capturing exposure to the overall IPO market. For now, we continue to search only for opportunities in which we have the highest conviction.

Liquid Markets = Blue Chip Equities (Strategic Acquirers) & Specialized "Pure Play" ETFs

We firmly believe that technology is the biggest competitive advantage for businesses today. When investing across equities, we seek to find market-leading businesses that produce, use and benefit from emerging technologies. Whether it is upgrading internal systems, or making automation or cybersecurity investments, companies must embrace innovation in order to stay ahead of the curve. Software and technology touches upon every sector and sub-sector of the global economy, and the businesses that are at the forefront of these technological advancements are well poised to create sustainable competitive moats. We like to use the example of Domino's Pizza when referencing this idea, "Domino's is a technology company that happens to sell pizza."

The majority of BigSur client portfolios have significant exposure to Big Tech companies (i.e Apple, Amazon, Alphabet, Facebook, Microsoft, and Disney). These are the largest acquirers of innovative technologies, and are as active in mergers & acquisitions (M&A) and research & development (R&D) investment as most VC or private equity (PE) funds. As such, investing in these companies in itself is a secondary way of participating in innovation trends. In many cases, investing in companies that buy the milk, can be as good as investing in companies that own the cow.

We should also note that there are many specialized ETFs that seek to capture "pure play" tech exposures via public markets. While it is very difficult to create a true pure-play exposure, these investment vehicles can still provide meaningful participation in important disruption themes. Many of these ETFs are still up and coming, and we are following their developments closely, but two examples that sit broadly across client portfolios today include an ETF dedicated to innovation and another one dedicated to cybersecurity.

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BigSur Wealth Management, LLC

1441 Brickell Avenue, Suite 1410

Miami, FL 33131

Office (Main): 305-740-6777 ext. 8006

Fax: 305-350-9998

http://www.bigsurpartners.com