# Venture Capital: Access is Everything

GEM

## Key Takeaways:

- Venture capital is an important driver of returns for leading endowments. Accessing venture capital managers that are likely to outperform takes time, networks, and expertise which create significant barriers to entry for individuals and small investors.

- Investing on behalf of mission-driven organizations has resonated with the venture capital community. The top managers often have a stable group of existing investors, and are only willing to add new investors if they support values-aligned missions. At GEM, our clients are a key differentiating aspect in this regard and something we are proud the investment community recognizes.

- Selection is critical: Top quartile venture capital firms have added at least 14% above the S&P 500®, but the median fund has beaten the S&P by merely 2%.[i]

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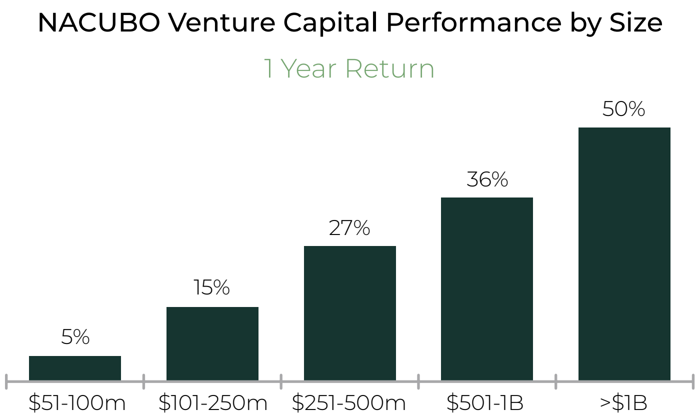
## Venture Allocations Driving Endowment Portfolios

There is an old saying in the investment business—size is the enemy of returns. However, that has certainly not been true for endowments. As of fiscal year 2021, the 20-year average return for an endowment over $1 billion was 8.0% annualized, compared to 5.9% for endowments less than $1 billion.[ii] We believe the key contributor to this performance gap is the fact that larger endowments can allocate a larger percentage to higher risk and more illiquid asset classes like venture capital. The average allocation to venture capital for endowments over $1 billion in 2021 was 13.4%, compared to less than 5% for endowments with less than $1 billion.[ii] Venture capital is not an asset class for the uninitiated. Larger endowments can typically afford to dedicate the time, resources, and staff required to build out a venture capital portfolio over decades. This focused effort has generated the results shown in Chart 1, where the performance of larger endowments with higher venture capital allocations was meaningfully better than smaller endowments.[ii] While this data represents precisely one year, itshows just how meaningful manager selection can be. In order to fully appreciate the competitive advantage that large endowments hold in the venture capital universe, it's important to understand the history.

Chart 1 [ii]




## History of Venture Capital

**Venture capital is typically defined as a form of private equity investment provided to early-stage companies with high growth-potential.** In its earliest days, venture capital was an asset class only for wealthy individuals.[iii] Then, during World War II, the US government initiated funding for researchers in academia when it became clear that the US was falling behind their adversaries in war-time technological innovations, like radar technology.[iii] East coast universities like Harvard, MIT, and Columbia all benefitted from these public funds and founded laboratories to attract researchers from across the country, establishing a tenured relationship and comfort with research and innovation.[iii] Soon after the war ended, the former head of Harvard's Radio Research Laboratory returned to his alma mater at Stanford as Dean of the School of Engineering, and spearheaded the creation of Stanford Industrial Park (now known as Stanford Research Park), a cornerstone for Silicon Valley and a mecca for venture capital activity.[iv, v] Thus, venture capital owes its founding and roots to large universities, and those same universities became the earliest institutional investors in venture capital funds. Venture capital as an asset class has been an increasingly important component of endowment portfolios ever since, as institutions have sought additional exposure to alternative asset classes with the potential to generate returns in excess of public markets.[vi]

**Venture capital as an asset class is an increasingly important component of endowment portfolios.**

# Why Invest in Venture Capital

Venture capital offers access to investment opportunities generally unavailable in the public markets. We have observed that many technology companies are waiting longer to go public due to private funding's abundance, which means that greater value is being transferred from public market investors to each company's earliest backers: venture capitalists. Having access to these opportunities is a crucial component in generating excess returns over the long term. Historically, top performing venture capital opportunities have outperformed the public markets by a meaningful margin.[i] However, there is wide dispersion in venture capital returns, and the median fund has added merely 2% annualized over the S&P 500 from 1990-2018, not properly compensating investors for the additional risk and illiquidity associated with venture investing.[i] Many third and fourth quartile firms have detracted value relative to public investment alternatives, but top quartile firms have added at least 14% above the S&P 500 during the same period.[i]

Chart 2[i]

**Pooled Direct Alpha for VC vs Public Indices**
1990-2018

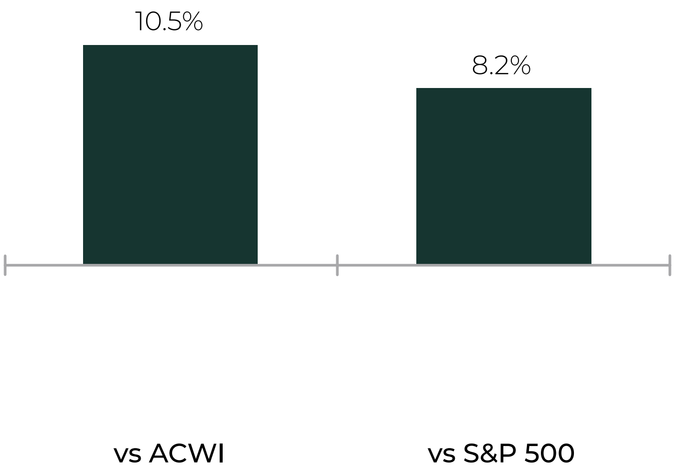
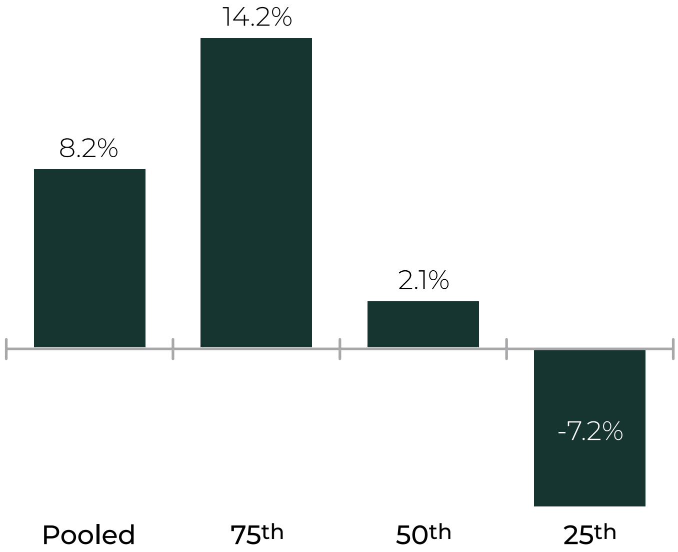



Chart 3[i]

**Direct Alpha vs S&P 500 by Quartile**
1990-2018

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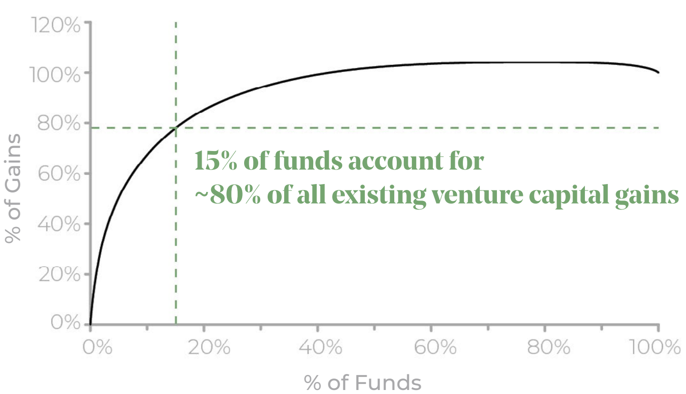
# Power Law and Persistence

Wide dispersion in return outcomes exists because venture capital follows a power law distribution curve, meaning a small percentage of the firms account for a large percentage of the value created. This phenomenon makes sense when we consider that underlying venture capital-backed companies follow the *same* power distribution curve. For example, Uber—the market leader in ride-sharing—had a market cap of approximately $63 billion as of June 30, 2022. Lyft, the second largest player, had a market cap of approximately $7 billion on the same date. And the third largest US player is unknown to us and likely unrecognized by the vast majority of ride-share users. In Chart 4, we show that 15% of venture capital funds accounted for 80% of all gains over more than two decades.[vii] Practically speaking, as an endowment investor, this means that there are a limited number of opportunities to identify and invest in one of the funds that will drive outsized returns.

Chart 4 [vii]

Power Law Distribution in Venture Capital




Furthermore, venture capital is an asset class that demonstrates persistence in returns from one fund to the next. In November 2020, Steve Kaplan, a tenured professor and research associate at the National Bureau of Economic Research, updated his previously-published white paper that studied the persistence of returns by venture capital managers. The study proves that persistence exists in successive fund performance for a given manager over time.[viii] Stated simply: A manager that outperforms once is more likely to do so again in future funds.

Because venture capital funds can take a while to develop and mature, the ultimate performance of a prior fund is often unknown to potential investors in the *next* fund at the time they are conducting their due diligence. Kaplan demonstrates that persistence exists even when only using the limited information available on prior funds at the time investors are typically asked to make a commitment to a new fund.

Chart 5 [viii]

| | | Current Fund | | |
|---|---|---|---|---|
| | | Top Quartile | Above 50th% | Bottom Quartile |
| Previous Fund | Top Quartile | 45% | 69% | 12% |
| | Bottom Quartile | 9% | 28% | 46% |

So not only are there a limited number of firms driving most capital gains, but those firms are well-known by LPs, leading investors to compete for access to the same groups. The combination of these two headwinds leads us to believe that venture capital is an asset class that should only be undertaken by those with the ability to invest in cultivating relationships in the space. In our experience, building a successful venture portfolio is a multi-year endeavor requiring dedicated resources and long-term commitment.

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## The Key to Access

Since GEM's inception, we have had the opportunity to work with venture capital managers we believe are some of the best and brightest in the industry. In that time, we've learned that not only is it critical to build the infrastructure required to establish deep roots in the space, it is also important that the investors we represent are funding important missions and causes. We have gained access to some managers through sheer persistence, spending countless hours pounding the pavement and building authentic relationships with individuals who have ultimately advocated for us during their fundraising. However, there are times that it's actually our clients and their missions that have given us an edge in accessing these elite managers. Our clients and the causes they represent have resonated in the venture community where many practitioners are not just interested in wealth generation, they are excited to partner with a firm like ours because what we do makes a genuine difference for our clients and their constituents.

For example, Y Combinator (YC) accepted GEM's commitment in 2020 following a multi-year effort to build relationships with their partners during which we shared details about our clients and stories of the missions they serve. We believe YC is the preeminent incubator platform for aspiring technology founders in the US and abroad. YC built its reputation by seeding some iconic companies that are widely-recognized today, including Stripe, Airbnb, and Coinbase. Their success has continued into recent years with the seeding of rising stars like Faire, Brex, and Rippling. We believe YC has created a sustainable moat around their brand in the incubator space and are excited to support them through commitments to their platform.

We believe that venture capital is an essential component of an endowment portfolio that—when approached with a long-term mindset and dedicated resources—has the potential to generate outsized returns relative to other public and private equity alternatives.

## About GEM

GEM is a leading provider of institutional investment solutions for endowments, foundations, sovereigns, families, and other long-term investors. Since 2007, GEM has specialized in delivering the highest quality service and support to our clients, enabling them to achieve their long-term investment goals. With a global reach, broad investment capabilities, and an experienced team, GEM strategically tailors solutions to meet the unique needs of each investor we serve. For more information, visit www.geminvestments.com.

## Endnotes

[i] Burgiss Manager Universe for US Venture Capital Funds, 1990-2018.

[ii] 2021 NACUBO-TIAA Study of Endowments. Includes performance of 720 institutions representing $821 billion in endowment assets. Returns for endowments <$1B were estimated using the weighted average of returns by endowment size based on number of respondents.

[iii] Nicolas Colin. "A Brief History of the World (of Venture Capital)." Medium. The Family, February 18, 2018. https://salon.thefamily.co/a-brief-history-of-the-world-of-venture-capital-65a8610e7dc2.

[iv] "Frederick Emmons Terman." Encyclopædia Britannica. https://www.britannica.com/biography/Frederick-Emmons-Terman.

[v] About | Stanford Research Park. https://stanfordresearchpark.com/about.

[vi] Analysis of US university endowment annual reports.

[vii] Burgiss Manager Universe for US Venture Capital Funds, 1990-2016.

[viii] Robert S. Harris, Tim Jenkinson, Steven N. Kaplan, and Ruediger Stucke. "Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds." Becker Friedman Institute for Economics at The University of Chicago, November 2020. https://bfi.uchicago.edu/wp-content/uploads/2020/11/BFI_WP_2020167.pdf.

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