Investment Strategy for Angels

By Bill Payne / February 23rd, 2012

After participating in a seminar I delivered a couple of years ago, an experienced angel investor commented to me he would never write another check for $250,000 to a single startup. Instead his new strategy would begin writing checks for $25,000 to $50,000 for many companies.

Rob Wiltank's study a few years ago validated what many angels have suspected for decades – angel investing is a high-risk asset class and that risk can only be reduced by investing in many startup companies. Here is what Wiltbank taught us: For every ten startups angels finance, we can expect the following outcomes:

- Five companies will fail without returning any or all capital to investors
- The best we angels can expect for nine of the ten companies (including the five failures) is the return of capital for the ten companies funded.
- All of our upside (return on investment) for our portfolio of ten companies will be earned by less than 10% of the startups (about 1 in 10). Using a baseball analogy, these few are called our home runs.
- Considering that it usually takes 5-10 years to grow a home run and execute an exit, a reasonable return on all ten investments can be earned only if these home runs provide a return of 20-30 times the investment in that startup company.

Wow…to be successful angels really need a few home runs to justify their investments.

Two implications of the conclusions of the Wiltbank study are critical to the success of angel investors:

1. Angels need to invest in lots of companies to beat the odds of failure. Most of us urge angels to consider a minimum of ten but more probably 25 lifetime startups investments to enjoy reasonable returns on investment. Diversity in numbers (not necessarily types of companies) is really important.

2. Since 10% of our investments must provide us with returns of at least 20 times our investment (and we aren't smart enough to know which of the ten will be successful), then all angel investments must be in startups with the opportunity to grow quickly, increasing value by at least 20 times over 5-10 years. We angels refer to this feature of new ventures as "scalability."

It is recommended that new angels who have decided to adopt this strategy move ahead slowly. Realize that it take 5-10 years to harvest this portfolio of ten companies. Invest in a couple of companies per year for five years, not ten companies in the first two years. You will hone your angel investing skills over time and you will be pleased that your portfolio contains companies at quite different stages of development. Besides, investing in ten companies in two years is simply too much work. Spread your engagement with these companies over a decade or so.

There is another important consideration for angels as you begin writing checks. How large should each check be? Well, this is a personal decision each angel needs to make, but let's discuss how to make this calculation. First determine how much of your total assets you are willing to commit to this risky asset class. Most angels dedicate 3 to 10% of their net worth to angel investing. Let's assume 10% for this example. Then, let's assume you plan to invest in ten companies. And, remember that angels are typically expected to make at least two investments per portfolio company. (Holding "dry powder" for portfolio companies is considered a best practice in all private equity investments.) To invest in ten companies you need to plan on making twenty investments (two per company). The average angel investment in the US is about

$30,000 per check. Thirty thousand dollars times 20 investments is a total commitment to the angel investment asset of $600,000. If you anticipate investing 10% of personal assets to angel investing, then your total net worth needs to be $6 million! If your net worth is only $3 million and you subscribe to the practices described above, then you should probably be writing $15,000 checks to startup ventures as angel investments.

Of course, one additional way to increase your return on investment is working with portfolio companies to exit earlier, rather than later. Early exits is an angel investment best practice that is too extensive to detail in this blog. However, the world's expert is Basil Peters. You can learn about his recommendations on executing early exits at his website: www.Exits.com/blog

Until the Wiltbank study in 2007, angel investing portfolio strategy was based on the best guesses of those who had been funding startup companies for a long time. This study has given us enough data to define a portfolio strategy that provides angels with a reasonable shot at decent returns for investment in this asset class.