

Institutional Investor's Decision Making Criteria for Investing in Venture Capital Funds

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Abstract

Finland's venture capital history is relatively short and has changed greatly in the past decade. In 1992 venture capitalists (hereafter VC) raised €14 million of new funds. Ten years later they raised €657 million with institutional investors playing a significant role representing 71%, or €457 million, of all new funds. The main problem of this study is two-fold: Why do institutional investors invest in venture capital funds (hereafter VC fund) in the first place, and what criteria do they use to choose between different funds? Despite its importance, comparatively little academic research has been done on this subject. This study is empirically oriented consisting of nine interviews with Finnish institutional investors. All relevant institutional types are represented in the sample. The main objective of this study is to clarify why Finnish institutional investors invest in VC funds and how they choose between different funds. The study helps to better understand what drives institutional investor venture capital investing in Finland. Venture capitalists, institutional investors and policy makers are all expected to benefit directly from the findings in developing their practices and the Finnish capital market.

Keywords

diversification of the portfolio, investment council, principal-agency theory, track record, venture capital

Acknowledgements

I would like to express my gratitude to the following people for their support and assistance with this paper. First of all, I would like to thank all those nine respondents who agreed to be interviewed, who made this study possible. I would like to thank also Marko Seppä who has helped me through the whole process as well as Hannu Jungman, Carl Löfberg and Juhani Raatikainen who have helped me in many ways during my work. I want to also thank Geoff Parkhurst who gave me linguistic help. There are also many other people who have supported me during my writing process for which I will always be grateful.

Objective of this study

The history of the venture capital industry is relatively short in Finland and there are many areas of research that need more attention. There are a number of studies about venture capitalists' decision criteria concerning their target companies (see, for example, Seppä 2000), but relatively little attention has been placed on institutional investors' decision criteria concerning the venture capital funds they invest in.

Institutions such as pension funds and insurance companies play an important role in venture capital fundraising in Finland. There are studies based on empirical findings in other countries dealing with institutional investors' decision criteria. One of the objectives of this study is to find out if these studies and theories are valid in Finland or if there are some specifically Finnish features affecting fundraising. One interesting characteristic of the Finnish venture capital industry is the strong position of the investment councils composed of representatives of limited partner investors. Chapter 'Covenants vs. a strong investment council' deals with this issue to some extent.

The two main questions in this study are, 1) why do (Finnish) institutional investors invest in VC funds, and 2) how these investors choose between different VC funds. Principal-agency theory provides the main theoretical framework for the study. Section 'Principal-agency theory' is strongly based on Schleifer (2000). He introduced different situations where decision making power and resources are separated by agency relationship.

Contracts between VCs and investors are referred to as Limited Partnership Contracts, in which context an investor is a limited partner. Nevertheless, the investor has some powers to restrict the VC's or the General Partner's actions. In Finland investment councils are set up to represent investors in decision making, which is to some extent contradictory to the original spirit of limited partnership contracts. The strong position of investment councils is more or less a Finnish phenomenon. In many other countries such contracts include more covenants, which serve the same purpose as the investment council; to make sure that the investor's benefit is the first priority. In the chapter 'Covenants vs. a strong investment council' I will compare those different practises and I will also share observations on what respondents think about the strong position of the investment council and whether there have been changes in the contracting culture in the Finnish venture capital history according to the respondents. This chapter continues with the principal-agency theory to which an important theoretical addition is Gompers and Lerner (1996b) which handles the commonness of the covenants in the venture capital contracts.

In the chapter 'Why invest in venture capital funds?', I will focus more on the first main problem of this study: why the institutional investor actually invests in VC funds? This chapter is highly focused on the concept of risk and expected returns. Diversification is very important when an investor is dealing with large portfolios. But portfolio theories are not as easy to use when we talk about venture capital investments. Still in last few years there have been a growing number of studies covering this issue. Cochrane (2001) researched this area and emphasized the individual venture capital investment perspective. Baierl, Chen & Caplan (2002) studied the same subject and tried to investigate the correlation between venture capital investments and large capitalization stocks. Born (2004) approached this subject from a different view, studying funds' risk profiles. Also Manyem (2002) and Barry (1998) have explored this area. I present these studies and interpret my observations from the interviews; how well these former studies and their results are supported when institutional investors make investment decisions. Or more clearly, does the possible diversification-effect matter in investment decisions?

Chapter 'Criteria for choosing a venture capital fund' continues with the concept of principal-agency theory, which was already presented in the earlier chapters. In that chapter I will concentrate on the second main problem of this study: how an institutional investor makes a

selection between VC funds? Former chapter explained that investors can not focus on the future expected rates of returns when they evaluate venture capital firms' capability to invest their funds, because they do not have same kind of special knowledge as venture capital firms. That is the reason why an agent's (a VC's) past performance is the most important factor when the principal (an institutional investor) is making his investment decisions. Earlier chapters present principal agency framework in general and in this chapter I will focus more on that phenomenon at the fund's level. Former studies usually employ principal-agency framework in studies handling mutual funds. In many of those studies, former track record has been indicated to be the most affecting factor in fundraising. For example Sirri & Tufano (1998) and Gorjaev, Nijman & Werker (2003) and Hong, Huang & Kelsey (2004) have researched that issue. I will introduce those studies in more detail and I will also present the respondents' answers and analyse how well these former studies match with those answers.

Background

Venture capital in Finland

Finland's venture capital history is relatively short and the Finnish venture capital industry has changed greatly in the past decade. In 1992 venture capitalists raised €14 million of new funds. Ten years later they raised €657 million with institutional investors playing a much more significant role than in the early 1990's.

In 2002 71% of all new funds were raised from institutional investors like pension funds and insurance companies, amounting to a total of €457 million. There have been several studies on how VCs choose their portfolio companies, but comparatively little academic research on how institutional investors choose the VC funds they invest in. Seppä (2000) proposed six archetypes of venture capitalist strategy logic, which could be evaluated as indicative of the motivations of the venture capitalists, but not of their investors, at least not directly.

As I mentioned earlier, the main problem of this study is two-fold: why do institutional investors invest in venture capital funds in the first place, and what criteria do they use to choose between different funds?

Pension funds and insurance companies invest their funds in many asset classes with solvency requirements restricting their actions. They have a strong emphasis on capital preservation on their portfolio as a whole. Yet at the same time, they are under pressure to generate higher returns. How do these portfolio managers make their investment decisions?

It is understandable that an institutional investor mainly invests in assets with comparatively low risk. A minority of total funds can be invested in instruments with high expected-rate-of-return and high risk, among them VC funds. These legal restraints, which I will not go into in detail, are described to some extent in Finland's Ministry of Finances' study 'Pääomarahoituksen tarjonnan lisääminen Suomessa' [Increasing supply for venture capital financing in Finland] (Niemi 2003, 37-39). It is however important to note that since institutional investors have such a significant role in the Finnish venture capital industry, so does the solvency requirements that affect these institutional investors.

The Finnish fund structure

Before we can concentrate in detail on how Finnish institutional investor's operate, we will take a look at the basic structure of a venture capital fund in Finland. VC funds are quite homogeneous in many countries, though there are still some differences in the decision-making process and decision-making power. Figure 1 shows the typical structure of a Finnish venture capital fund.

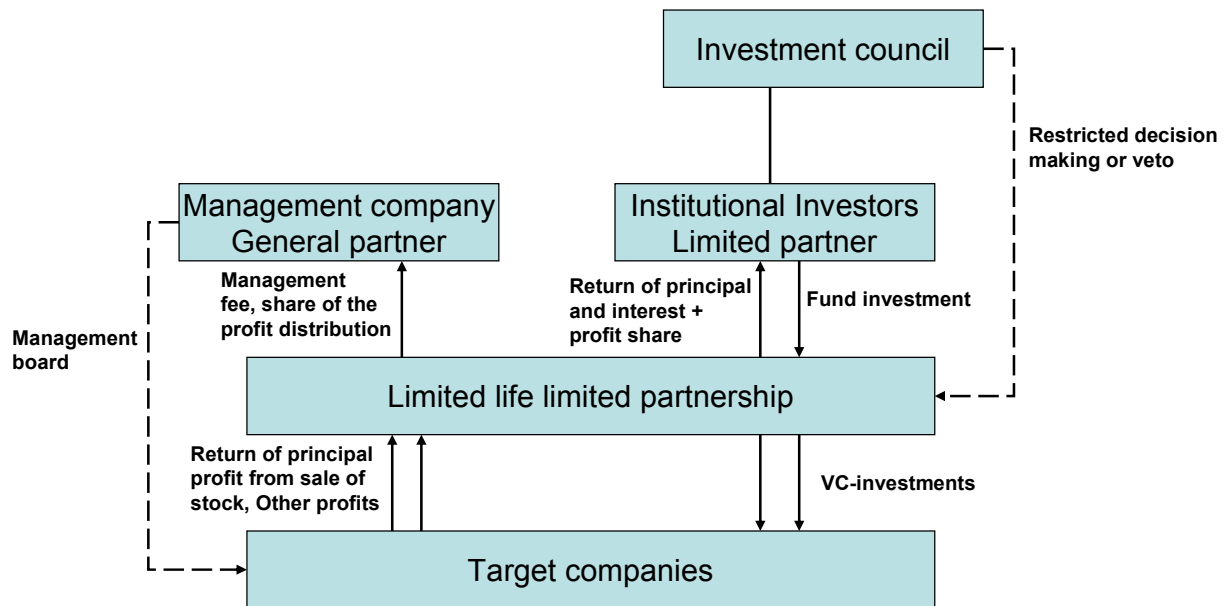


Figure 1. The structure of a typical Finnish venture capital fund

Usually a venture capital fund is structured as a limited partnership. These partnerships have usually finite lifetimes. The institutional investor provides the capital and takes part in the decision making process through the investment council. The core of the structure is the VC fund, which is organised as a limited lifetime limited partnership. The management company is the general partner and the institutional investors are limited partners.

Usually the general partner has full decision-making power in a limited partnership, but as we can see, in the Finnish VC fund structure the limited partners have also some decision-making power through the investment council. In many cases the venture capitalists have to introduce their investment proposals (concerning target companies) to the investment council, which has veto right on them. In Finland the investment council has traditionally had a comparatively influential position. One purpose of this study is to find out institutional investors' attitudes towards the role of the investment council. This will be discussed further in later chapters.

Methods

The study is based on a theoretical discussion and empirical research. The empirical work consists of nine interviews with Finnish institutional investors. One interview was made via telephone and the others were recorded face-to-face interviews of 30-45 minutes. All relevant institutional types are represented in the sample. Three interviews, out of 12 planned, were

cancelled. Interviews comprised of open space questions, as well as qualitative and quantitative questions.

Institutional investors' venture capital investing

The principal-agency theory

Before taking a closer look at the Finnish venture capital scene, I will consider theoretically how investors can monitor their investments in a VC fund. VCs are not investing their own money, they are investing the institutional investors money (where the managers in turn are not investing their personal funds but in many cases taxpayers money). One approach to analysing the management of 'other people's money' is the principal-agency theory. This framework is widely used in different studies. The basic idea of the principal-agency theory is to analyse a situation where the 'brains' and the resources are separated by an agency relationship. How can we then be sure that both parties have converging objectives?

Andrei Shleifer (2000) has used the principal-agency-framework to clarify how different parties make their decisions when investing. Shleifer based his writings on Ippolito (1992), which gives the empirical facts for his study. Shleifer's methods and theories are used mainly to analyse mutual funds but we can apply his model to venture capital funds as well. In his book: "Inefficient markets: An introduction to behavioural finance", Shleifer separates two different situations. First he considers a situation where arbitrageurs use their own wealth to trade and they are limited only by their own risk aversion. In the second case arbitrageurs invest other investors' funds. We therefore have principal (investors) and agents (arbitrageurs). This is also the case in venture capital investing where the venture capitalist plays the arbitrageurs role.

In Shleifer's model, arbitrageurs invest investors' funds using highly specialized knowledge, but how can institutional investors be sure that their capital is invested wisely, if they don't have the same knowledge the venture capitalist has? When arbitrageurs are investing their own money they are (supposed to be) interested only in their investment's expected rate of return. The institutional investor cannot however make his decision based on the expected rate of return (ERR) because by definition, he does not possess the information required to make an educated estimate of the ERR. For the institutional investor, the only way to estimate a venture capitalist's performance is to look at the VC's past performance, not the expected rate of return.

Shleifer refers to the phenomenon of responsiveness of funds under management to past returns as performance based arbitrage (PBA). The essential difference between the investor who invests his own money and an investor who gives his money to a fund manager to invest is the direction they look at. The investor who invests his own money is interested in the expected rate of return, i.e. the future. When an investor uses professional fund managers they must look at the agents' earlier investment track record, i.e. the past. (Shleifer, 2000, 89-96)

Shleifer's interpretation of the principal-agency-theory gives us guidance on how we can use this framework when we are examining VC funds. My presumption is that when arbitrageurs invest 'other peoples' money' they will be largely evaluated according to past performance.

Since VC funds are limited life funds, VCs will be cyclically looking for capital for a new VC fund. When a venture capitalist begins raising a new fund, his former track record is the best proof of his capability to produce more prosperity for his investors.

Covenants vs. a strong investment council

No two actors can have fully converging goals. As long as there is scarcity there will be always some conflict of interest in human action. The question is, is this conflict of interest any significance? When it comes to venture capital investing, it is. The institutional investors will always want to monitor and restrict the VCs actions in some way.

The Finnish fund structure with the influential investment council was already presented in the former chapter. If there is a clear need for monitoring and restrictions, why is the Finnish model of a strong investment council not more common? Are Finnish investors just more suspicious than foreign institutional investor because they want to have someone to look after their interest and have veto power in the investment council? Or do they possess some knowledge which foreign institutional investors don't? Naturally US institutional investors want to monitor their investments too. This has traditionally been done with covenants.

In the US, venture capital firms are highly restricted by contract agreements. Gompers and Lerner (1996) have analysed the use of covenants in venture capital agreements. They examined 140 partnership agreements establishing venture capital funds in 1978-1992 and noticed that these contracts are quite heterogeneous in their inclusion of covenants. They formed 14 different covenant classes, which they divided into three different covenant sets. The first set included covenants relating to overall fund management, the second set included covenants relating to activities of the general partner and the third set included covenants restricting investment types. Gompers and Lerner found out that fewer restriction were found in funds established during years with greater inflows of new capital, funds in which limited partners do not employ investment managers and funds where general partners enjoy higher levels of compensation. (Gompers & Lerner. 1996b, 463-493).

In Finland covenants have not played an equally significant role as in many other countries. The investment council with the institutional investor's representatives have a comparatively big role in the management of a fund even after the investment into the VC fund is made. There are signs that this is changing though.

According to my interviews, in the mid 90's when many institutional investors started to invest in VC funds, partnership contract agreements were much shorter than nowadays. As one of the respondents said:

“Generally speaking the contracts are getting thicker. You could say that everything is specified and defined much more specifically and in detail ... the Anglo-American way of doing business is spreading.”¹

¹ Original Finnish quote with colloquialisms edited to written language: ”Yleisesti ottaen sopimusniput paksuuntuneet. Eli tästä voi sanoa näin, että kaikki asiat määritellään ja definoidaan huomattavasti tarkemmin ja yksityiskohtaisemmin... Angloamerikkalainen tapa tehdä businesta leviää.”

Gompers and Lerner also found that covenants, which were related to the management of the fund or investment type had increased with time. At the same time covenants restricting the activities of the general partner had decreased. When the venture capital limited partnerships were a relatively recent phenomenon, investor hadn't very much knowledge about the venture capital industry. The easiest way to control the action of the general partner was to make restrictions on how they can make investments. As investors learned about venture capital, they also learned which agency costs were most probable and which actions should be most restricted. (Gompers & Lerner. 1996b, 484).

Because of the traditionally strong role of the investment council in the Finnish VC fund structure, this issue was addressed to some extent in the most of the interviews with open questions.

When asked how they view the council's strong position, the majority of the respondents thought it to be (at least a little bit) too strong. As one of the respondents said:

“Why on earth would we want to have the decision making power, after we have chosen a management company?”²

Still, the views were mixed. One of the respondents thought that the role of the investment council could be even stronger. The majority did not see any urgent need for bigger changes (5 out of 7 respondents). Only two of the respondents stated very clearly that they thought the role of the investment council to be too strong. Two others expressed more cautious views in this direction. So, 4 out of 7 saw the role of the investment council as too strong or slightly too strong. Two respondents saw the current Finnish model as more or less good without a need for any major changes. One respondent said he was starting to lean more and more towards favouring a less influential investment council.

Still, at least 3 respondents out of 7 were clearly reluctant to give up their veto power. In addition the investment council was seen as a good source of information.

Why invest in venture capital funds?

Finnish institutional investors put only a small fraction of their total portfolio in VC funds. What are the institutional investors incentives to invest in VC funds in the first place? We can approach this question by looking at a single venture capital investment from a risk and return perspective or we can look at the big picture, namely how a venture capital investment affects the investors' portfolio as a whole.

In the last few years there has been a growing number of studies concerning risk and return in venture capital investments. The risks and returns of private equity differ from the risks and returns of publicly traded stocks. For this reason, we cannot use traditional finance theory as such. Poor diversification can be one reason that makes standard asset pricing theory unsuitable. Differences between private equities' and publicly traded stocks' liquidity, information and monitoring issues are other reasons. Poor liquidity is typical for private equity investments and thus investors may require higher average returns to compensate

² Original Finnish quote: ”Miksi ihmeessä me haluttaisiin päätöksenteko sen jälkeen, kun me ollaan valittu se (hallinnointiyhtiö).”

higher risks. When investing in publicly traded stocks, investors invest only money. However, when dealing with private equity, a VC often invests their time and ‘management capacity’, that is, more than just money. VCs have a seat on the board of directors and may have the right to appoint or fire the management. (Cochrane 2001, 2, 33-34)

In his research, Cochrane used the VentureOne database which includes nearly 17000 financing rounds in nearly 8000 venture capital projects. He points out that we can only measure a return when a firm goes public, is acquired, or gets a new financing round. This will cause selection bias because these events are more likely to happen when the firm has achieved a good return. By using such a sample, results will be too optimistic. He points out that if we want to have proper answers we have to correct this selection bias. Cochrane uses log returns which improves the quality of the results. Cochrane found that single venture capital projects are not particularly attractive from a profit/loss point of view, but adding a single venture capital investment to a stock portfolio provides some diversification benefits. (Cochrane 2001, 1-6)

Cochrane’s results reveal very well the basic nature of the venture capital industry. When analyzing his results, he noticed that most of the returns are modest but there are some exceptionally good returns. This also reveals how risky an individual venture capital investment can be.

Cochrane compared venture capital investments to the S&P500 index. Standard deviation of the venture capital investment was much larger than the standard deviation of the S&P500, but when venture capital investment was compared to individual large publicly traded stocks, the difference was much smaller. According to Cochrane, after correcting the estimation bias an individual venture capital investment is not necessarily so different from publicly traded securities as we usually think. Cochrane emphasizes also the portfolio view in his study. He observed that individual venture capital investments are not particularly attractive because of the high volatility of the venture capital investment. His second observation was that adding a single venture capital investment to a portfolio doesn’t increase performance of the portfolio dramatically, but putting some weight to venture capital investment could still increase the performance. When investors put substantial weight to venture capital investment, portfolio volatility rises dramatically. (Cochrane 2001,10-34).

Barry (1998) observes that venture capital investments correlate strongly with small cap stocks, but they have low correlation with larger cap stocks and bonds. These observations are interesting but his sample was calculated from appraisal data which is not necessarily valid as it includes cases which haven’t been exited; only cases which have been exited can be valued correctly. (Baierl, Chen & Caplan 2002, 1-9).

Baierl et. al.(2002) have investigated correlations between venture capital investments and large capitalization stocks. They included only liquidated funds in their sample when they calculated average returns, standard deviations and correlations. Thus they made sure that their data was correctly collected. Their sample included 148 funds, which were liquidated during 1960-1999. One observation was that correlation between venture capital investment and large-cap stocks was very low. These results imply that venture capital investment might have actually a total risk reducing impact on an investor’s portfolio.

In my interviews almost every respondent emphasized that VC fund investments are a good tool for diversifying their portfolios. According to one respondent:

”We want to diversify our portfolio, so that we have different kinds of investments which act differently in different markets. When we compare private equity profits, hedge fund profits, they should have as little correlation with publicly traded stocks, bonds and the real estate market as possible.”³

But we have to remember that venture capital investments represent only a small fraction of an institutional investors total portfolio, usually in the ballpark of 1-2% rather than several percentages. Two respondents stated clearly that they thought the diversification effect to be negligible. One said:

”On the venture capital side the share [of the portfolio] is so small. We are only looking for profit. So, this doesn’t work as a diversification instrument or diversification for correlation... here the main goal is profit”⁴

Baierl’s et. al. (2002) study reinforces this view. In their study, they found that if the aim was to create a minimum-variance portfolio, the allocation to venture capital should be about 2%. If the aim was a portfolio with the same standard deviation as the S&P 500 index, the allocation should be 4%. For the maximum Sharpe ratio portfolio, the allocation of venture capital should be 9%. (Baierl et al 2002, 6). Their material consists of VC’s investments and public equity. Institutional investor’s portfolio includes more asset classes than these. Thus their findings are not applicable as such to in this study. It raises however the important question: does venture capital investment truly diversify portfolio risk for institutional investors? When we add that Finnish venture capital has shifted significantly towards buyout investing in the past to years (FVCA Yearbook 2004, p.33) it is truly prudent to ask has venture capital investing any real or significant diversification effect on the institutional investors portfolio? This is backed up by Mayhem (2002) who refers to a 2001 Gompers and Lerner study pointing out that a 15% share of private equity in a portfolio has a clear diversification effect. The average return increases but also standard deviation increases a little. (Manyem 2002, 4). But we have to be more cautious about a possible diversification effect when talking about significantly smaller shares, as in this study.

The studies mentioned above emphasized the risk profile of individual venture capital investments and diversification of the portfolios with venture capital investments. Born (2004) has taken another perspective on diversification. He used a dataset of 282 European and 745 US VC funds when attempting to analyse the risk-profile of venture capital funds-of-funds. He found out that an investment in a fund-of-funds can significantly decrease risk. Funds-of-funds’ (which have invested to 20 different funds) probability to show negative results was almost zero both in Europe and the US. The probability to gain a less than 5% profit was much bigger in Europe than in the U.S. He also observed that the number of funds

³ Original Finnish quote: ”Me halutaan hajauttaa sijoitussalkkua, niin että sellaisia tuottoelementtejä jotka vaihtelee eri tavalla eri markkinoissa. Verrataan private equity tuottoja, tai hedge fund tuottoja, niin pitäisi olla mahdollisimman vähän korreloivia listattuihin osakkeisiin, korkoihin tai kiinteistömarkkinaan nähden.”

⁴ Original Finnish quote: ”Nyt pääomasijoituspuolella niin tämä osuus on niin pieni. Ja tällä haetaan vain tuottoa. Tämä ei siis toimi hajautuselementtinä eikä korrelaation hajautuselementtinä... Tässä se päätavoite on tuotto...”

in the portfolio and the period of time during which funds are entered matters. A portfolio size of 20 funds already reduces the major part of diversifiable risk. (Born 2004, 1-2)

Diversification was not the only aspect emphasized in my interviews. Respondents also emphasized the high expected-rate-of-returns as one incentive to invest in venture capital funds. Even if the benefits of venture capital investment in portfolio diversification are not totally clear, it can be claimed that there is always the possibility for returns.

But how can the likelihood of high returns be evaluated? In my interviews the importance of the VCs former fund's track came up as expected, based on former studies. (Even if the former funds have not been liquidated yet many exits have been made. Therefore the final results can be comparatively accurately estimated.) It is however good to remember that the funds that are nearing the end of their 10 year life in Finland were founded in the early and mid 90's. The last half of the 90's with its stock market bubble can hardly be used as an estimate for fund performance for the next 10 years.

Another factor that came up in the interviews was IRR. VC's report the funds IRR to the investors. IRR can be a useful tool when estimating the current value of venture capital investments, but there are also some issues that we have take into consideration. The Finnish exit markets have been very challenging on the IPO-front over the past few years. As mentioned before, there has been a strong shift towards buyout investing. With limited exit opportunities even the most profitable investment will be problematic for a VC.

In conclusion, neither diversification as conducted in Finland, nor the possibility for high returns can give an unambiguous answer to the first main question of this study: why it is useful to invest in VC funds. Former studies gave us some guidelines about those benefits, which can be achieved by adding venture capital investments to the whole investment portfolio. These same elements were also found with interviews. We can presume that venture capital investments can give some diversification benefits, but a much greater problem is to solve how large should be the venture capital investments weight in the optimally diversified portfolio. Another problem is the valuation of the venture capital investments. As mentioned earlier it is not easy to evaluate the right value of the investment before exit. If we use past performance, there are some factors that we should notice. First of all we have to understand the short history of the finish venture capital markets. There have been some extraordinary good historical profits, which could give us too optimistic picture of possibilities for future gain. But many of the respondents mentioned late 90's profits and they seem to be very well aware of the future profit possibilities.

Criteria for choosing a venture capital fund

So far we have discussed the specific characteristics of a typical Finnish VC fund, the traditionally significant role of the investment council in Finland, the applicability of the principal-agency-theory on venture capital investing and reasons for investors to invest in VC funds. In this chapter we will concentrate on this study's last main question, which is fund selection, and compare earlier studies with the findings in my interviews.

In chapter 'The principal-agency theory' I mentioned that former studies have indicated past performance to be an important factor affecting future fund raising. This performance based

arbitrage (PBA) means that investors may rationally allocate money based on past returns of arbitrageurs and withdraw funds after poor past performance. (Sleifer 2000, 88-89)

Fund performance correlation to fund flows has been documented extensively concerning mutual funds. Much of this applies to VC funds as well. Earlier studies indicate that past performance is an important determinant of new capital commitment to mutual funds when comparing funds that have the same investment focus. The relationship between past performance and new commitments has not been linear. If returns are high, funds gain more money but if returns are very low, losses of assets and fees are more modest. (Sirri & Tufano, 1998).

There have been several other studies addressing the relationship between past performance and fund flows in mutual funds. Gorlaev, Nijman & Werker (2003) observed that the impact of past performance doesn't affect fund flows immediately but there is a certain lag. Engström & Westerberg (2004) noted that past performance isn't necessarily the most important factor in future fundraising, observing that a more important factor is information costs. Thus, foreign funds with similar track records as domestic funds don't attract as much investment. In VC funds this is handled with funds-of-funds. My interviews showed that many respondents have some investments in funds-of-funds.

Interviews also indicated that the most important reason why an institutional investor invests in funds-of-funds is not necessarily diversification benefits, as presumed earlier. Instead the most important reason was that with funds-of-funds investors can reach geographical areas or industrial branches which would otherwise be hard to reach (e.g. American venture capital markets). These findings differ from Born (2003) who observed that funds-of-funds enable investors to gain access to a variety of VC funds in a diversified portfolio. On the basis of interviews funds-of-funds diversification wasn't as important as I thought. Some of the respondents emphasized that the total amount of the venture capital investments in their total portfolio is so small that they don't believe that they can achieve any better diversified portfolio with funds-of funds, because the share of the funds-of-funds is quite small even compared to the total amount of their venture capital investments. According to former studies presented in the previous chapter, this is easy to accept. Actually we can also make a question is the total amount of the venture capital investments, which institutional investor has in his portfolio, large enough such that we can speak of diversification benefits at all?

Kaplan & Schroar (2003) found that capital flows into private equity funds are positively and significantly related to past performance. They also found that highly performing funds don't grow as rapidly as average performing funds. In this respect VC funds differ substantially from mutual funds. One reason might be that there is always a limited number of good deals in the economy at any point in time. (Kaplan & Schroar 2003, 21-23)

In 1996, Gompers formed his grandstanding hypothesis examining the importance of track record for future fundraising. He found out that younger venture capital firms have a disposition to exit their first investments much earlier than older venture capital firms. The reason being that younger venture capital firms need to build up their track record for the next time they are raising a fund. Thus, they might act more hastily than well-established firms. (Gompers 1996a, 134)

In my interviews, the respondents were asked to rank different factors affecting their decision to invest in venture capital funds. First they were asked to rank how important the management, the fund (the track record of the VCs former funds, profit distribution clauses, the role of the investment council) and the funds target market were, considered when choosing a fund. Not surprisingly the role of the management was seen as the most significant. Four respondents ranked it as the most important factor and four ranked it as number two. Only one respondent considered the features of the fund and markets more important than management.

Importance ranking	Management	Fund*	Investment market / Target market
1	4	4	1
2	4	-	4
3	1	5	3

Table 1. Criteria for choosing a fund

*the track record of the VCs former funds, profit distribution clauses and the role of the investment council

Follow-up questions were asked about each factor. One intention was to find out about the role of past performance when track record was separated from managements track record and the VC's former funds' track record. When asking about management, track record was the most important criteria six times out of nine, and three respondents considered it to be the second most important.

Importance ranking	Attitude / motivation / skills	Reliability / recommendations	Managements' track record
1	1	2	6
2	3	3	3
3	5	4	-

Table 2. Sub-criteria 1: Criteria when evaluating the management

When asked about the funds characteristics, seven times out of nine the funds former track record was the most important factor. Track record seemed to be much more important than profit distribution clauses. The role of the investment council was considered to be the least important.

Importance ranking	Company's track record	Clauses of profit distribution	The role of the investment council
1	7	2	-
2	1	6	2
3	1	1	7

Table 3. Sub-criteria 2: Factors when evaluating a fund structure

The third sub-criteria was the characteristics of the investment markets. Eight times out of nine the amount of the potential target companies was considered the most important

characteristic of the investment market. It was considered more important than the expected growth rate of the markets or competition between funds.

Importance ranking	Quality/amount of potential companies of target	Expected market growth rate	Competition between funds
1	8	1	-
2	1	5	3
3	-	3	6

Table 4. Sub-criteria 3: Criteria when evaluating the target market

Because of the small sample available in Finland, we have to be careful how we interpret these answers. We can't have any statistically significant answers but this survey can still help us to build a better understanding of the Finnish venture capital market. Former studies, not focusing on the Finnish market, suggest that past performance is the most important factor when investors are making investment decisions. My interviews seem to confirm that, both when looking at the management's past performance or former funds' performance. Open questions give similar answers. In many of the interviews the importance of the past performance was mentioned and particularly the importance of the management's track record. It seems that track record of fund management is more important than track record of the fund.

The open questions also revealed that ownership and the general structure of the VC fund matters. When asked to choose between three VC fund types: partner driven (or entrepreneurial), institutional (or corporate) and governmental, all respondents picked the partner driven fund as the most attractive. The argumentation was in line with the principal-agency-theory, which indicates that, when entrepreneurial, venture capital firms are most likely to be interested in increasing the value of their investors' investments. The respondents saw greater likelihood for hidden agendas in the two latter structures, hence also supporting the archetypes of strategy logic by Seppä (2000)

Conclusions

The two main problems posed in this study were: 1) why do institutional investors invest in venture capital funds and 2) how do institutional investors choose between different VC funds? A methodological concern for this study was the small number of institutional investors which invest in venture capital funds in Finland. That is the reason why the sample of this study could not be very large.

The first main question of this study focused on the concept of the diversification of the portfolio and the risk profile of the venture capital investments. Traditional portfolio theories cannot give perfect answers as to how venture capital investments should be weighted in large portfolios. Can they decrease the total risk of the portfolio and how large should the weight of the venture capital investments be in the portfolio? In the case of the institutional investor we have to also remember that there are legal restrictions as to how much investors can invest in venture capital markets. Most of the respondents emphasized the diversification effect that

they can achieve through venture capital investments. But only a couple of them noted that the share of venture capital investments in their portfolio is so small that it does not necessarily help the diversification. But still the basic idea of diversification of the portfolio was mentioned almost in every answer, which is in line with former studies. Also the possibility to achieve high returns was a most important factor even if the benefits of a diversification effect were unclear.

The second main question is theoretically based on principal-agent theory. A presumption was that because institutional investors play a limited partner's role, the only way to estimate a VC's capability is the VC's former track record. This is a commonly known fact: when brains and resources are separated by an agency relationship, the only way to appraise an agents' action is their past performance. According to my interviews this is true also in the Finnish venture capital market. Because of the small sample it is not possible to make any quantitative analysis or generalisations but we can still make some observations. When venture capital firm's track record and management's track record were separated, respondents had to rate the most important factors affecting the selection between funds. Former track record seems to be the most important factor according respondents in both cases. Also, open questions supported these observations.

An interesting addition to this study is the role of the investment council. In Finland, the investment council has some decision making power whereas in many other countries this kind of body does not exist. Former studies revealed that in many venture capital markets (at least in the U.S.), covenants play a great role in contracts between investors and the venture capital firm. So there is no need to have an investment council; investors can restrict the venture capital firm's action with detailed contracts. But why do we have this kind of body in Finland? My presumption at the beginning was that respondents would support the council's existence because it should supervise that investment decisions are made wisely. The responses I received did not support this presumption completely. Some of the respondents were quite reserved about the position of the investment council. They thought that such a council could not have better knowledge over the investee candidates than venture capital firms, so how could they evaluate investment decisions more wisely than the venture capital firms? If a venture capital firm investigates potential investment target for months, how could an investment council have a better knowledge? Some of the respondents however emphasized the role of the council as a monitoring and reporting body. They thought that with such an body, investors are better aware of how their funds are invested. Also the contracting practises have changed during the last ten years. In the early years, contracts were quite thin and did not restrict VC's action very powerfully. Nowadays, contracts are written with much more detail and decrease the necessity of a strong investment council. These observations are well in line with former studies which handle covenants in venture capital contracts: Contracts are getting more detailed.

All in all, this work gives some answers to the research phenomenon addressed but also raises new questions that would be interesting to study in the future. For example: what is a suitable weight of venture capital investment in an optimally diversified portfolio? Should institutional investors have fewer restrictions on how they can invest their funds, if they wish to realize that optimally diversified portfolio? What should be the position of the investment council in the future or is there actually any need for that kind of a body – at least when maximal rates of return are targeted by venture capital firms based on entrepreneurial incentives?

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