# Asset Allocation and Portfolio Strategy for Angel Investors

By William H. Payne
Entrepreneur-in-Residence
Kauffman Foundation

Most angels are exited entrepreneurs or experienced businesspersons who are no longer employed on a daily basis and have time to be involved with their invested companies as mentors, advisors and directors. Typical angels, such as the author, start working with and investing in entrepreneurs because they enjoy helping start and grow new ventures. Asset allocation and portfolio strategy were not serious considerations as we made our first few investments. Only after experiencing the exhilaration of success and the agony of failure have we begun to integrate angel investing into considerations of our financial planning. Yet, we readily admit that our portfolio of angel investments is part of our financial estate and many of us adjust the remainder of our investment portfolio to compensate for the level of risk involved in angel investing.

Participants in Kauffman's Power of Angel Investing seminars with little or no experience as angels are indeed curious about how much of their net worth should be dedicated to their angel portfolios and how to structure their portfolio to accommodate high-risk angel investing. Those of us who have been investing as angels for 20 years have scratched our heads and given this subject some serious consideration. This analysis is the outcome of some pondering on the subject.

## Introduction

Seed investing is a high-risk, high-return opportunity, as is indicated in this graphic from Venture Economics and the HFRI Equity Hedge Index (2001).

### Historical 20-Year Returns

| Seed Funds | All Venture Funds | Hedge Funds | Buyout Funds | S&P 500 | NASDAQ |
|---|---|---|---|---|---|
| 22.4% | 18.7% | 18.7% | 16.5% | 14.9% | 13.2% |

Out of each ten angel investments, investors experience 3-4 business failures and an additional 4-5 exits which will return only part of the invested capital or a modest return on investment. Just one or two investments of out ten provides most of the portfolio return on investment, with a 10-30X ROI expected on these few successes. With a small fraction of investments providing the bulk of the reward, angels need a significant number of diversified investments to optimize ROI. Angels with only two or three investments are managing risky portfolios indeed!

As exited entrepreneurs and businesspersons, angel investors typically have a portfolio of conservative investments reserved for retirement and legacy. Only a fraction of net worth is dedicated to angel investing. While some have as much as 50% of net worth committed to angel investments, conservative pundits suggest that accredited investors commit 5 to 15% of net worth to these high-risk angel investments, with the remainder of their portfolios in less risky investments.

In 1994, the Center for Venture Research published the results of a survey that showed the following net worth allocations to angel investments by 146 high net worth individuals who had made investments in entrepreneurial ventures in the Northeastern US:

**Survey of Angel Investors: Allocation of Assets to Angel Investments**

| **Maximum Allocation** | | 1-4% | 5-9% | 10-14% | 15-24% | 25-50% | >50% |
|---|---|---|---|---|---|---|---|
| **Fraction of Angel Investors** | | 7% | 18% | 25% | 21% | 19% | 9% |

“Angels and Non-Angels: Are There Differences,? J Freear, J. E. Sohl and W. E. Wetzel, Jr., Journal of Business Venturing, **9**, 1090-123 (1994)

Experts on angel investing suspect, but have not confirmed, that those investing >25% of their net worth are very wealthy (>$25 million) angels who are investing capital, which if lost, would not negatively impact life style.

Here are several additional unique tactics and observations typical of angel investing:

- Typical individual angel investments range from $25,000 to $100,000, investing with 6-10 other angels in investment rounds totaling $250,000 to $1,000,000. (There are many angel investors who regularly invest more than $100,000 in seed and startup ventures.)
- It is not uncommon for startup ventures to require additional cash to achieve profitability. Companies that run out of cash before achieving key milestones without prospects for additional funding become targets for bargain hunters. Prudent angels reserve 50 to 100% (or more) of invested capital for follow-on rounds in invested companies.
- Angels are patient investors, with expectations for exits within five years, but often waiting seven years or more to enjoy positive returns on investment.
- Some angels restrict their investments to narrow business models, based on their individual business experiences. Others are comfortable investing in a spectrum of business models and industry segments. Still other angels seek a few investments in new and exciting technologies as opportunities for new learning experiences.
- Investing in multiple seed and startup companies is a key angel strategy. Many feel a portfolio of 10-12 angel deals is adequate diversification to assure a reasonable ROI and that six or less angel investments is too risky.

## Asset Allocation and Portfolio Strategy

A portfolio strategy emerges from observing prudent angel investors. Half of angels commit no more than 15% of the net worth to seed and startup ventures. A typical angel portfolio is made up of ten or more such investments of a minimum of $25,000 per investment and reserve at least 50% for future rounds of investments in the same companies. These facts alone suggest a minimum net worth required for sustained commitment to angel investing.

A conservative angel portfolio:
$25,000 per investment x 1.50 (a reserve of 50%) x 12 investments = 15% of net worth
Net worth required = $3,000,000

A less conservative angel portfolio:
$25,000 per investment x 1.35 (a reserve of 35%) x 6 investments = 25% of net worth
Net worth required = $1,000,000

A very conservative angel portfolio:
$25,000 per investment x 2.0 (a reserve of 100%) x 15 investments = 10% of net worth
Net worth required = $7,500,000

## Summary

Angel investors are wealthy, successful and experienced businesspersons. We have described some typical angel investing characteristics and portfolio scenarios. It has not been our intent to recommend minimum net worth requirements to engage in angel investing, nor are any of the listed typical features of seed and startup venture investing necessarily considered appropriate for individual investors. Our suggestion is that new angels and those considering making their first angel investment consider this information in developing a personal portfolio strategy.

WHP: 14Feb04