Has Venture Capital Strayed From Its Roots?

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Take a step back in time to observe how Georges Doriot – the founder of both VC and INSEAD – set up a machine to fuel and fund innovation and development.

“…I want money to do things that have never been done before,” proclaimed Georges Doriot, almost 75 years ago. His was an era where venture capital (VC) had not yet been defined as an asset class, the world was recovering from the war and backing unprofitable companies seemed like an insane idea. Yet the relatively unknown creator of VC and one of the founding fathers of INSEAD took his risks and laid down the tenets of early-stage investing as we know it today by setting up the “American Research and Development Corporation (ARD)” in 1946, technically the first VC firm. How does the world today match up to the principles of the first venture capitalist?

The Doriot way of investing

Doriot’s interest in backing early-stage ventures was sparked in the Second World War, where as part of the military planning division he was tasked with investing in and inventing solutions that would help soldiers perform better in battle. While uncovering new technology spanning footwear, protective gear and even nutrition, he got a taste for allocating scarce capital and generating returns. ARD was created soon after the war with a clear and concise remit: *"[I]t does not invest in the ordinary sense. It creates. It risks. Results take more time [...] but the potential for ultimate profits is much greater."*

Doriot's investment philosophy was characterised by a deep sense of commitment towards the founder and the inventor. He took great pains to identify people he believed in, sometimes even spending time with their families. Managing talent was the most important part of the start-up equation and once he identified his target, he would go all out to support the team and the business. This was possible given the amount of money he was managing – his first fund raised US$3.5 million.

His passion for early-stage ventures was deep, yet he never underestimated the bumpy ride that came with the decision making required. He was known for saying, "*Never go into venture capital if you want a peaceful life."* He appreciated the learning curve for the entrepreneur and was also known to say "*hopes, disillusions, hard work, are all necessary, particularly during the first ten or fifteen years before a […] corporation can begin to exist*". He truly believed that his formula for success lay in ARD's ability to mentor and guide these businesses, help as it could with Doriot's network of Harvard graduates to support the growth of each company. As he said, "*The venture investor must always be on call to advise, to persuade, to dissuade, to encourage, but always to help build."*

He believed that VC should align interests with the founder in a way that allowed both to share in the ultimate success. Doriot brought his experienced team and capital to the table and entered into an intentionally long-term relationship with his investee companies – giving them the time and space to grow. Each investee company or affiliate was treated equally, given the same level of support and attention as one would a child. He was even known to say, *"When you have a child, you don't ask what return you can expect [...] if you build great businesses, returns will come."* While he was under pressure to deliver returns to his investors, he was clear about the fact that he was in it for the true joy of building. He was reluctant to acknowledge the term 'speculator' and described his role as "*building men and companies*".

He ran ARD with a sense of military frugality. The team received consultancy fees charged to the affiliates (as opposed to management fees) and the costs of ARD were at a low 1 percent of assets under management. The team scrutinised every single deal in the pipeline and in any given year only funded 2 percent of deal flow. ARD was motivated and aligned to drive the success of its entrepreneurs and portfolio companies in the form of capital gains.

ARD, in its original form, kicked off what was very much a small cottage-industry-style pilot in the world of institutionalised VC.

Comment from James M. Stone, founder, Chairman and CEO of the Plymouth Rock group of companies

"General Doriot (as everyone called him) might well have been disappointed to observe today's venture industry on two counts. First, he often stated that he would never abandon a company he invested in. He counted on skill and hard work, not the luck that can come of many draws. And, second, he was never in a hurry for a liquidity event. He built, he advised, he partnered, and - if necessary- he effectively ran the companies he invested in. He had zero interest in taking a quick profit and exiting. But I have often said that, if he returned today, his greatest source of pride would not be venture capital but INSEAD, which turned out to realize, and even exceed, his dreams for it."

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Drifting away from its origins

Fast-forward 75 years to today where 'venture capital' has become a household concept. There is a proliferation of funds, valued at almost US$300 billion globally. It has turned into an asset class of its own – generating interest from traditional sources of finance like pension funds and family offices but also the retail investor who wants a slice of the entrepreneurial action. We see the rise of the professional entrepreneur, a career path that seems as normal as banking or engineering.

Doriot would be heartened to see that some of the original principles of venture capital investing exist today. Marc Andreesen's belief that "**building**" is the only way out of the Covid-19 crisis is very much 'post-war Doriot'.

The search for new, groundbreaking technology that fuels the desires of the firms on Sand Hill Road would have delighted him. Even the principle of an 'operating partner', someone a VC drops in a company to help management turn things around, is something Doriot did with all his companies, often bringing his star Harvard students into his investee companies. Today's venture capitalists continue to place an oversized emphasis on the founding team and talent, again something that Doriot believed in and backed, right from the start.

But Doriot was really in it to build, to build companies, to build entrepreneurs. Have venture capitalists forgotten this very fundamental trigger for the creation of the VC industry? Are there other incentives at play that have changed the way the industry has played out over the last seven decades or so?

Venture capital, just by the size of the funds under management today, has become a 'financial art' of sorts. It has not only become institutionalised, one could say that it has indeed become commoditised. Consider the portfolio approach to investments, where one bets on the probability that some will pay off while others won't. The "1 in 10" thought process also means that venture capitalists today have to be brutal about cutting off the losers and backing the winners, doubling down on those that may stand that 10x chance of winning the odds. A complete contrast to how Doriot may have treated his "children".

The affinity towards the entrepreneur and the building of a business is lost. There is a distance between the funder and the founder that makes it much harder for the VC firm to appreciate the ups and downs of running a company. Indeed, in some parts of the world, only around 6 percent of VC employees have true operational experience. The rest of them come from a financial background where 'spreadsheet engineering' is the norm. The value that was historically created through execution (by the likes of ARD) is traded in for value created through financial engineering and, on judgement day, the portfolio companies are reviewed by their outputs (sales, users, scale, growth) without any true understanding of what went into designing the business.

While venture capitalists tend to claim they offer their portfolio companies advice, support and deep engagement (as Doriot did), a recent study published in 2018 shows that they are not as helpful as they claim to be.

They score their impact and helpfulness almost 32 percent higher than their own portfolio companies do.

And as the statistics in the Kauffman report show, “We have met the enemy, and he is us.” Venture capital has delivered poor returns in the last couple of decades, sometimes returning less cash to the investors than they originally put in. A lot of this comes from the belief that venture capitalists have to be compensated for the process of selecting their portfolio companies (i.e. 2 percent management fees) versus their ability to pick winners that deliver returns in the long term (20 percent carry). Perhaps Doriot would also have been horrified by the generosity of the VC firms towards their employees (and associated lifestyles), far from the frugality of ARD.

Doriot said, “*Ultimate success will result when the arrangements are regarded as equitable and satisfactory by all the parties concerned.*” As a believer in creating a fair deal for everyone around the table, he might have found the term sheets, preferential shares, ratchets and the ugly negotiation in early rounds of funding unpalatable.

Is there a way back?

Has the time come for us to rethink VC in today’s world? Perhaps take a step back in time to observe how Doriot, in 1946 – also a crisis-ridden world that was reeling from the effects of the war – set up a machine to fuel and fund innovation and development. A system that aligns incentives with founders and not funders. Doriot’s philosophy was steeped in a sense of integrity that perhaps deserves a comeback. Business, if treated as a force for good, can only create a system that generates returns in an ethical, balanced way.

As authors representing various facets of the venture capital industry, we would like to begin the process of crafting what we call the #DoriotVCPrinciples. And we recognise we cannot do it alone. It takes a village. If you have ideas on how the venture capital industry could reshape itself – returning to its original form while staying true to some of the tenets laid out by Doriot – do write us at **DoriotVCprinciples@insead.edu**. We are looking for guidance on what the #DoriotVCPrinciples could be and we welcome suggestions from practitioners, academics, entrepreneurs and anyone who wishes to see a change in the way capital backs enterprise, especially at the early stage.

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