



A New Strategy for Venture Investors: Hedge

It's the venture capital investor's rule of thumb: Nine of every 10 investments will not make money. If all goes well, the 10th will make enough money to exceed all the losses.

Given these odds, investors are always looking for ways to increase returns from their winner. [Bill Hilliard](#) and Charles Baden-Fuller, visiting scholars at Wharton's Sol C. Snider Entrepreneurial Research Center, believe they have a strategy that can provide investors with an extra edge from investments that prove to be profitable, and perhaps take the edge off some of the losing ones.

In a paper pending publication entitled, "Should a Venture Capital Fund Act More Like a 'Venture Hedge Fund?'" they propose that venture investors consider a strategy that some investors routinely use in the public markets: Hedge. They admit that there could be legal and ethical issues involved in the process, but having examined numerous legal cases and law review articles, they conclude that these issues are not insurmountable.

Typically, successful venture capital-backed companies act as disruptive forces in their industries. The freshly-conceived products or services they promise to bring to the market threaten the entrenched position of an established competitor, causing any publicly-traded rival's stock price to decline. In that situation, a put option – which is the right, but not the obligation, to sell stock at a certain price by a certain date – acquired on the competitor's stock would be a tool to capture profits that are in addition to those obtained from sales of the new product or service, the two authors say.

The owner of a put option is betting that the option will go up in value as the underlying stock goes down in value; he or she can make money either by selling the option or trading the stock at an opportune time. "Disruptive investments tend to not be as valuable as they should be, and we have found a way to make them more valuable," Hilliard, an entrepreneur-turned-venture capitalist, said in an interview. Baden-Fuller, his co-author on the paper, is a professor of strategy at Cass Business School of City University in London, England.

"This paper will make the case that venture capital partnerships can increase (internal rates of return) and cash-on-cash returns by acting more like venture hedge funds [a term trademarked by Hilliard]. Just like hedge funds, venture capital partnerships should identify opportunities to invest in short positions that relate to their long positions so as to increase returns from profitable investments," Hilliard and Baden-Fuller write. "By making a profit on the short trade, the venture capitalist is able to recapture from the market some extra profits that would otherwise be foregone by their portfolio investment."

In 1987, when privately-held Phoenix Technologies announced it was planning to launch a product that would disrupt Adobe's postscript printer technology, Adobe's stock dropped 36% over a two-month period. "Investors in Phoenix Technologies could have increased their return by purchasing at a suitable time a put on Adobe's stock," the authors write.

Revisiting People Express

In the early 1980s, each of 24 announcements by the discount airline People Express to enter new domestic routes in the United States boosted the airline's stock and depressed stocks of its competitors. The fall in any given incumbent's stock price was about four times larger than the gain in stock price experienced by People

Express at the time of the launch. Hilliard and Baden-Fuller write: "This suggests that the potential gain from trading put options (or some equivalent derivative) may be larger than the potential gains from the discounted cash flow of the investment itself." Although People Express eventually went out of business, its investors still could have made money had they made simultaneous financial plays on its competitors, the authors say.

They also cite two wider studies of the business and stock-price impact of research and development as well as new-product announcements. One study, from 1996, examined 106 announcements of changes in R&D activities by firms from 18 industries and concluded that where R&D activity "was characterized as generating possible strategic substitutes to incumbent firms' products," the incumbents experienced "... statistically significant reductions in stock market value" while "the announcing firm experienced significant, positive rises in market value."

A 2002 study looked at 384 new product announcements from 39 industries and came to a similar conclusion. Where a new product launch announcement was viewed as a strategic substitute for an incumbent product, the incumbent experienced negative and statistically significant reductions in its stock market value within a narrow two-day window.

All this suggests to Hilliard and Baden-Fuller that venture capitalists' financial strategies need to be as innovative as the companies in their portfolio. "Larger companies are very sophisticated in managing their money; venture capitalists often operate by the seat of their pants," Hilliard said.

But can this strategy – of buying put options which is equivalent to short-selling the stock of companies making rival products – run afoul of insider trading regulations that courts and regulators sometimes have applied to people who seem to be outsiders? Would venture investors who try it invite charges of trading on what regulators might consider is material, non-public information? After all, the investors can contemplate short-selling a rival company's stock only because they come to know of the competitive potential of their own company's product before that becomes public knowledge. Might some regulators and courts construe this as trading in insider information even though the venture investors who trade in the stock of the rival company are not really its insiders?

It is a concern Hilliard and Baden-Fuller anticipate, investigate and dismiss. "Not every scholar in the world will agree on every point, but there is a clear preponderance of case law and law review articles outlining guidelines one should follow," Hilliard said.

Case law and literature indicate that the strategy is legally sound if the investors who adopt it – and the companies they invest in – take care not to have any relationship, direct or indirect, with the public company in whose stock the investors are buying options, the authors suggest. Also, investors using this strategy must make sure they are not misappropriating information they have gained from their affiliations with their own portfolio companies. That second issue, the authors say, is best addressed if the investors request explicit permission to use such information as part of the initial investment terms sheets they offer their companies.

"The terms sheet and the documents spun out of it fundamentally define the relationship between the company and the investor – the investors' rights, preferences and permissions. By requesting this explicit permission at the time of the investment, you have preserved the opportunity to take advantage of an arbitrage opportunity later, if one presents itself. The time to get such permission is before writing the check," Hilliard said.

Such derivative strategies improve returns for venture capital investments. Explains Baden-Fuller: "Entrenched competitors often react to disruptive innovations by cutting prices, which in turn reduces the profits available to the innovating company

and discourages such innovations, even socially desirable ones. This discourages investors from investing in disruptive innovations. Our paper shows how investors can overcome these disincentives to invest in disruptive innovations by recapturing the profits that would otherwise be forgone in the absence of our strategy."

Eli Whitney's Missed Opportunity

Eli Whitney, the inventor of the cotton gin, "would have made exceptional profits if he had abandoned his attempts to patent the machine and instead focused attention on investment substitutes by buying up land suitable for raising cotton, which at the time was trading at very low prices. Our proposed strategy for investors is an application of a similar investment substitute strategy," Baden-Fuller adds. "There will be cases where the options trade will allow projects to be financed that could not be financed otherwise, except perhaps by government subsidy."

Any estimates of extra returns from using hedging strategies "must factor in risks and transaction costs," he says. "Stock prices of companies can move up when market experts expect them to move down. There are carrying costs to put options."

But Hilliard and Baden-Fuller write that possession of "asymmetric information shades the risk in favor of the venture investor analogously to the way that card counting adjusts the odds in blackjack." They also maintain that acquiring put options in transparent markets may be inherently less risky than any underlying venture investments made by the venture fund in the potentially disruptive new company itself.

As an angel investor, Hilliard feels comfortable enough with the strategy that he has requested such trading rights in two recent terms sheets, including one concluded late last year with a Pennsylvania-based software company in the wireless market. "There were no concerns from the other side of the table; it was a complete non-issue," Hilliard said. Whether that company proves to upset the market leaders remains to be seen. As Hilliard noted: "You never know."

Published: June 16, 2004

[Back to Article](#)