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V.C. NATION; Pension Fund Managers Come Knocking, in Vain

By Gary Rivlin

THE money managers overseeing the state pension funds in Washington and Oregon have been making the rounds in Silicon Valley in recent months, hoping to find some venture capitalists willing to take their money. So, too, have their counterparts from Ohio, New Mexico and other states.

Scores of V.C. firms are more than happy to oblige. But for most pension managers, the only funds they will be able to invest in are the very ones they would be wise to avoid.

Venture funds are not created equal, and the ones willing to sign up pension funds won't be the top-tier players. The most lucrative venture firms are turning Johnny-come-lately investors away at the door, which is bad news for stodgy pension funds scrambling to get into the venture game.

The rule of thumb in the venture world has long been that unless you can invest with a firm that has consistently cranked out returns that place it in the top 25 percent of firms, don't bother.

A new study to be released on Monday says the chances of making a wise investment are actually far bleaker than that. Of the 1,000 or so active firms, there may be only 50 worth looking at, said the study's author, Steve Bird, a venture capitalist at Focus Ventures in Palo Alto, Calif.

"We're basically saying that if you can't get in the top 5 percent of the funds, you'd be better off putting that money to work in the S.&P. 500," Mr. Bird said. For pension managers, having discovered that the venture game, though risky, can add pizazz to any portfolio, this is a problem.

The rub is that most of the top 50 firms are closed to new investors. Most are now raising only a few hundred million dollars to invest over four or five years, rather than the billion-dollar funds that were being raised just five years ago. So great is the demand to get into one of these funds that even longtime investors are not able to invest as much as they would like.

To compound the problem, some money managers have no choice under the bylaws of some state and municipal pension funds other than to invest a sliver of a fund's assets in venture capital, typically 1 to 4 percent, or $30 million to $120 million for a $3 billion pension fund.

That is, of course, good news for all those second-tier firms and all those second-tier start-ups they finance. But if the past is any indication, that means poor returns for those putting their money at risk.

''It's very frustrating for these guys,'' said Mr. Bird who, as a partner at a firm in the top 50, has had a long list of money managers stop by his offices. The difference between investing with a top-tier firm and an also-ran can mean a difference of several hundred million dollars.

In 1996, the University of California endowment chose only venture winners, including a Kleiner Perkins Caufield & Byers fund that posted an annual return of 286.6 percent. By the time the university cashed out, the $20 million it had invested in Kleiner Perkins's 1996 fund was worth $340 million.

The university was not nearly so lucky in 1997, when records show that it invested in a single fund, raised by Hummer Winblad Venture Partners. That was a very good year for venture capital, with the average fund raised that year earning 53.5 percent annually, according to the research firm Cambridge Associates.

Yet Hummer Winblad fell into the lowest quartile that year, providing a negative annual return of 15.3 percent over the life of its fund. The endowment lost $3.6 million on its $10 million investment in Hummer.

''People tend to look at venture capital as a single asset class,'' said Ted Schlein, a Kleiner Perkins partner. ''But if you look at venture funds over time, the top quarter of the funds provide somewhere around 80 or 90 percent of the returns.''

Or, as Mr. Bird discovered, after sifting through more than 8,000 venture financings from 1980 to 2003, a mere 4 percent of venture firms accounted for 66 percent of the $287 billion in value created by initial public offerings during the Internet boom.

The success of those firms during the boom years was no fluke, Mr. Bird found. Thirty-eight of the firms in the top 50 in the late 1990's also ranked in the top 50 during the early 1980's. And of the 12 newcomers to the list, 4 were what he termed ''reformations'' of top 50 firms no longer in business.

Mr. Bird is not naming names. Instead his top 50 list will remain in an office drawer inside Focus Ventures -- yet one more piece of disappointing news for pension fund managers looking to win at the venture game.

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