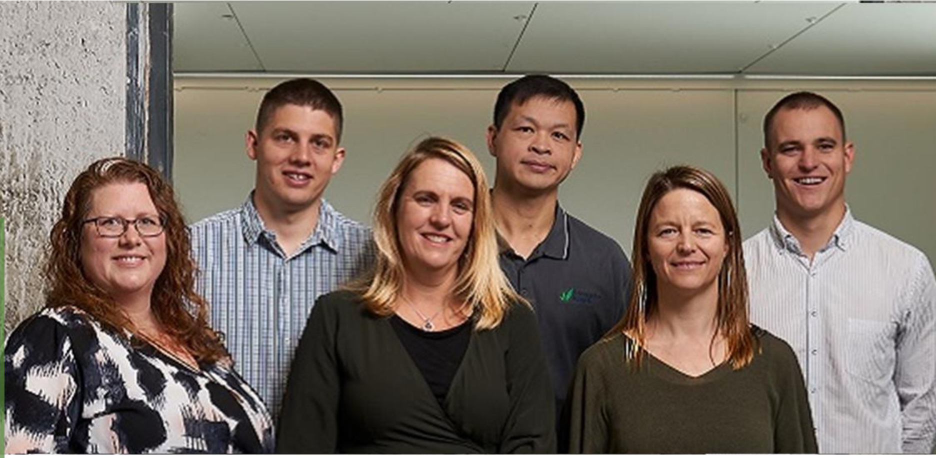

The Importance of Diversification

How investing in a fund can help

You know the old saying 'don't put all your eggs in one basket'? Well it is certainly true when it comes to investing. A key strategy in any investment portfolio is diversification – invest in different asset classes and within those asset classes, invest in different industries, regions and stages. By diversifying, you spread your risk, minimise loss and maximise returns.

In this guide, I'll briefly cover risk and return, asset allocation and diversification and how a fund can play an important part of your investment portfolio.

What is your appetite for risk?

Understanding risk and deciding what your appetite for risk is, is an important part of building your investment portfolio. Your risk profile will take into consideration several factors including stage in life, investment goals, income level and personal preference. Your risk profile drives the decisions in setting the asset allocation of your portfolio.

Asset allocation to balance risk and return

Asset allocation is the way in which you spread your investments across different asset classes, e.g. equity, property, fixed interest (bonds etc) and cash (money in the bank). Each asset class has a unique risk and return profile. Generally, the higher the risk, the higher the return and vice versa. Cash typically carries the lowest risk and therefore earns the lower returns, while shares carry the higher risk and earn higher returns. Our strategic partner, Craigs Investment Partners, provide a wealth of investor education here with more detail on this topic.

Angel investment can be considered an alternative asset class and depending on your risk profile and wealth, could form an important part of a broader investment portfolio. Angel investing carries a high risk and can potentially earn high returns.

Minimise risk in angel investing

Angel investors seek to mitigate the risk of investing in early stage businesses through careful screening of deals, extensive due diligence and post investment management. This can be achieved more efficiently by joining angel groups and investing with other angel investors. By actively assessing investment opportunities together and providing expertise, networks and guidance to investee companies post-investment, angel investors can substantially reduce the rate of failure.

Another risk mitigation strategy is diversification.

Why should I diversify?

The 2016 Wiltbank Study[1], one of the largest studies on angel investment in North America, showed that the overall cash on cash multiple is estimated at 2.5x capital and the holding period was approximately 4.5 years with a gross IRR of 22%.

An earlier study indicated that if an investor invested in 6 investments, they had a 50% chance of return of capital (1x), with 12 investments this increases to 75% probability of 2.6x return and with 48 investments there was a 95% probability of 2.6x return.

Given that the typical angel investor in New Zealand invests between $10,000 and $50,000 in each startup, the only way to invest in so many companies for all but the most active and wealthy angel investors, is to invest via a fund.

Obviously, there are no guarantees that a large portfolio will give you better returns, but the odds are certainly better! It's important to also note that large does not necessarily mean diverse. It's not the quantity that counts, it's the quality and range of startups that you invest in, e.g. different industries, stages and locations.

What is exit envy?

When making individual investment decisions, angels tend to invest in what they know and understand. We have some very smart investors, however it's impossible to be an expert in everything!

Imagine you decided not to invest in a deal because you didn't get time to review the due diligence report or it was outside your area of expertise, so you skipped that investment opportunity – 18 months on, it's the company that returns 4x! There you have it – exit envy!

At Enterprise Angels, we've had fifteen positive exits to date. Recent successes include companies such as Moxion, which returned 5 times investment in under five years, Merlot Aero, which returned 2.6x in five years, and back in 2018 there was local company SwipedOn, which returned 2.4 times in less than 12 months.

- Less than 5% of EA members invested in Greenbutton and AskNicely. Both were before EA had a fund.
- 82 Enterprise Angels investors benefited from the SwipedOn sale, 63 of those investors were part of EA Fund 2.
- Merlot.Aero, Moxion, SwipedOn,Volpara and OneSixOne were invested in by EA Fund 1 or 2 and have returned funds to the Fund Investors.

How does an angel fund help?

An angel fund pools money from investors and does all the work involved in finding and investing in early stage companies including post investment reporting. The number of companies a fund invests in will depend on the fund's investment mandate and size.

[1] Robert E Wiltbank, PhD, Prof. Wade T Brooks "Tracking Angel Returns 2016" - https://angelresourceinstitute.org/research/report.php?report=101&name=2016%20Angel%20Returns%20Study

As an investor, if you decide to invest in a fund, you would commit to invest a certain amount, pay your initial investment application monies and over time, you pay 'tranches' of your remaining commitment as the fund manager makes investments and requires further capital to invest. The fund manager provides regular portfolio updates to investors.

The fund manager typically charges a fee to pay for the ongoing management of the fund. A 2% annual fee is a typical fee in New Zealand.

Investing in a Fund allows smart investors to build a portfolio of early stage company investments with less money, personal time and effort and provides access they would not otherwise have to a high risk, high reward part of the market investing alongside experienced early stage investors. It is a very efficient mechanism for investors to build a portfolio of early stage company investments.

Why an Enterprise Angels Fund

Our funds rely on a combination of Enterprise Angels professional staff and the enormous sectoral expertise of the group's members (approximately 200 experienced business people). Enterprise Angels staff and investment committee have years of early stage investment expertise and no matter what industry an investment opportunity comes from, there will be an Enterprise Angels member with expertise in the investee company's industry sector.

Enterprise Angels members undertake due diligence and take up directorships on investee company boards using their experience and contacts to enhance investee company success. Early stage investment expertise combined with the business experience of its members are the keys to minimising risk and maximising the return from investee companies.

Enterprise Angels manages three funds which are fully invested; EA Fund 1, EA Fund 2 and EA Fund 3.

These EA funds are 'sidecar' funds – funds established by an angel group that invests alongside it. The funds operate as a General Partnership with Limited Partner investors many of whom are EA members. The funds do not undertake due diligence, but rather rely upon the investment expertise and commitment of EA members in a deal. EA Funds have an investment committee (many of whom are directly involved in assessing investment opportunities through EA's screening committee) but their role on the EA Funds' investment committee is primarily to ensure the Fund is aligned with its investment mandate and is building a well-balanced portfolio.

- EA Fund 1 was launched in 2014 and raised $2.4m. It is now fully paid up and fully invested in 16 portfolio companies. To date it has seen three positive exits in Volpara, Merlot Aero and OneSixOne via WNT. It has also seen two companies fail which is expected in this high risk investment environment.
- EA Fund 2 was launched in 2016 and raised $2.6m. It is fully invested except for an uncalled capital commitment to one of the portfolio companies. It has seen three positive exits in SwipedOn, OnesixOne and Moxion.

- EA Fund 3 was launched in 2019 and raised $3m, closing in July 2020. The Fund is fully invested in 23 companies with followon investment reserved for its best performing companies. Most of the portfolio companies are successfully raising capital to continue their growth, however two have suffered due to the effects of Covid.

EA Fund 4

EA Fund 4 has recently been launched. This fund is similar to previous EA funds in that it will leverage the angel group deal flow and expertise however, it is not a side-car fund, meaning it has the ability to act independently of the angel group and access deals from a broader range of sources providing greater diversification for investors. EA Fund 4 has a target of investing in 35 different companies, offering investors the opportunity to diversify your portfolio in this exciting asset class and be part of growing some of NZ's most innovative companies. Find out more here

Who can invest in an EA Fund?

EA Funds are only for wholesale investors as defined by the FMCA. Click here to find out if you qualify. An EA Fund is an ideal way to reach a good level of diversification, minimise risk, maximise returns and avoid exit envy!

An EA Fund investment is ideal for investors that are wanting an efficient way to invest in early stage companies including: EA Members, Non members, Funds / Trusts, and those wanting to make a difference.

How much should I invest?

When considering the size of your investment, you should consider your overall wealth and the size of your total investment in the angel space. This investment amount should be split into parcel sizes in order to achieve at least 12 – 15 investments. Parcel sizes range from $10,000 to $100,000. For a EA Fund 4 the minimum investment parcel is $30,000 for members and $50,0000 for non members. This will called down over the first 5 years of the Fund.

Next consider how active you intend to be. Will you have time to review and invest in individual deals and how many of these? This will inform your decision as to how much you should invest in a fund versus individual investments.

Bear in mind that your angel investment portfolio is just a small part of your overall investment portfolio as discussed earlier in this article.

What are the next steps?

Enterprise Angels is a membership-based investment network and a wider community of nationwide wholesale investors. The core of Enterprise Angels is its members. Our objective is to connect experienced early stage investors with entrepreneurs and innovators. If you're keen to find out more, partner with us, or ready to leap right in to investing or membership make your choice now.

Visit: www.enterpriseangels.co.nz/invest