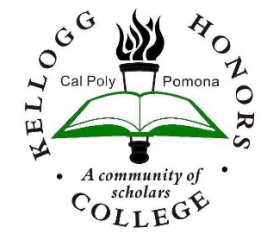




Venture Capital Decision Making



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Abstract

Investing in startups is a long yet high stakes process. All investors want their money to grow, but investment decisions are steeped in the uncertainty of trying to figure out which firms will endure long-term. If investors cannot know in advance what investments will pan out, then how do they decide? In this project we will explore how investors differ on “reasoning style” – meaning some lean more into “gut” feelings and away from objective facts, because investment decisions involve a high degree of uncertainty – and how those differences shape what investors are looking for and the accuracy of their predictions about future success. In creating surveys to measure how venture capitalists assess risk and funding decisions, we will borrow some survey concepts from previous studies of what factors investors tend to focus on, what factors more intuitive vs. less intuitive thinkers to focus on, and from the literature on entrepreneurial cognition. Our research will uniquely weave together research on decision making psychology with research on both sides of the funding decision process.

Introduction/Information

I am researching how investors decide which startups to fund, and whether investors are actually able to predict down-the-line startup success. Entrepreneurial investing is something with so many factors and a great deal of uncertainty, so the issue we are dealing with is trying to figure out how decision-making cuts through this certainty (effectively or not) and figure out where to devote their resources. We are running phases of a surveys to investors. We plan to incentivize the participation of investors by offering a donation to charity on their behalf. While there is pre-existing literature on how investors make decisions, most of it focuses on self-reports of what investors think is important. We would be the first to bring in expertise in psychological decision making that will allow us to measure the more emotional and less conscious influences on investor decisions.

Method

We propose developing a theory and methodology to capture predicting which investors go with more heuristic (and usually faulty) decision-making strategies over more analytical ones. In creating surveys to measure how venture capitalists assess risk, we will borrow some survey concepts from previous studies of what factors investors tend to focus on (e.g., Zacharakis & Meyer, 2000), what factors more intuitive vs. less intuitive thinkers to focus on (e.g., Stein, Swan, & Sarraf, 2020 finding that more intuitive thinkers weigh experiential evidence more than empirical evidence), and also from the literature on entrepreneurial cognition.

Zacharakis, A. L., & Meyer, G. (2000). The potential of actuarial decision models. *Journal of Business Venturing*, 15(4), 323–346. [https://doi.org/10.1016/s0883-9026\(98\)00016-0](https://doi.org/10.1016/s0883-9026(98)00016-0)

Stein, R., Swan, A. & Sarraf, M. (2020). “Hearing from Both Sides: Differences Between Liberal and Conservative Attitudes Toward Scientific and Experiential Evidence.” *Political Psychology*, forthcoming.

Hypothesis and Expected Results

What we aim to show here is that more intuitive thinkers are not only prevalent among investors, but they also tend to underestimate the existence of “unknowns” in predicting investment success, tend to ascribe their decision making to their gut, and tend to ignore known issues with an investment (i.e., if there are issues with the product or market) if their “gut” tells them otherwise. Because our survey is still being processed, we do not have final results for our sample. I will have final results to present at the Convocation. We expected that investment performance would be lowest for those who think intuitively and have the control orientation. The chain of results we were hoping to see for this group was worse because they tend to ignore uncertainty.



Survey Example Scenarios/Questions

Loss Aversion (adapted from Fehr & Goette, 2007 and Bodnaruk & Simonov, 2016)

-Below is the description of two lotteries. Read each carefully, and note whether you would participate in or reject each.

Lottery A: Win \$6 with probability 1/2, lose \$4 with probability 1/2. If you reject this lottery, you receive nothing.

(I would participate in this lottery/I would reject this lottery)

Lottery B: This lottery consists of six independent repetitions of Lottery A. If you reject this lottery, you receive nothing.

(I would participate in this lottery/I would reject this lottery)

Questions based on Wiltbank et al 2009

1. Investment size – How much money did you invest in deals in the past 10 years? How many ventures did you invest in during the past 10 years?
2. How many exits did you have in the past 10 years?

Controls: 1. How many investments have you made in the past 10 years? OR What is the approximate total number of investments in deals in the past 10 years?

2. How long have you been investing in entrepreneurial ventures? Provide the number of years

Questions based on Kollman & Kukkers et al. 2010

During the investment evaluation process, to what degree is it possible for you to evaluate certain aspects of a typical investment proposal? Use modified Likert Scale (Very unlikely – very likely)

	During the initial screening stage	During the due diligence stage	During the deal structuring process	Not possible even after deal structuring
Product or service quality				
Market potential				
Financial potential				
Experience of the entrepreneur				
Personality of the entrepreneur				