

Deep Pockets: Institutional Investor Peer Effect

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Ivory tower investors wear two very important hats during the fund raising process. The first and most obvious of which is that they allocate funds to qualified managers. The second and less obvious is that their actions signal the quality of the venture capitalist group to other institutional investors. This effect can be so strong that some investors are unwilling to reveal their allocation decision to other investors because it could possibly lead to one of two extreme outcomes. If the ivory tower investor reveals that they have made an allocation, it could lead to an oversubscribed fund. In the opposing case, it may literally stifle the fund raising process for the venture capital group.

The aforementioned scenario depicts what is commonly known as the “peer effect.” To industry outsiders this may seem like a strange phenomenon, but like most behavior it does reflect economic rationale. The rationale for such behavior rests on the fact that most of the ivory tower investors are subject to at least one of the following principles:

- **Fiduciary Duty** - A fiduciary duty is the highest standard of care imposed at either equity or law. A fiduciary is expected to be extremely loyal to the person they owe the duty (the "principal"): they must not put their personal interests before the duty, and must not profit from their position as a fiduciary, unless the principal consents. The fiduciary relationship is highlighted by good faith, loyalty and trust. (Source: Wikipedia.org)
- **Prudent Man Rule** - Under the Prudent Man Rule, when the governing trust instrument or state law is silent concerning the types of investments permitted, the fiduciary is required to invest trust assets as a "prudent man" would invest his own property, keeping in mind: the needs of the beneficiaries, the need to preserve the estate (or corpus of the trust) and the amount and regularity of income. The Prudent Man Rule requires that each investment be judged on its own merits. (Source: Wikipedia.org)
- **Business Judgment Rule** - A rule of law that provides corporate immunity to directors of corporations protecting them from liability for the consequences of informed decisions made in good faith. (Source: Dictionary.com)

Conformance with these principles suggest that the investment decision process is diligent and logical.

An additional rationale for the peer effect is that investors gain an added level of comfort if a well known investor has already placed money with the venture capital group. This is essentially the limited partner's synthetic equivalent of syndicating a deal.

The implication of the above discussion is that fund raising may be subject to a momentum component. If that is the case, then there may be a tipping point where fund raising will be substantially easier if ivory tower investors have chosen to allocate to the prospective fund. This further suggests that it is important to build relationships with these groups in order to increase your visibility. Relationship building with these groups can take a number of years. As a final note, these groups are always being approached from groups trying to raise their next fund. In order to differentiate yourself, you may consider visiting these groups when you are not actively seeking assets because it is a great way to build a relationship that does not solely revolve around asking for money.