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# The cost of friendship[☆]

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We investigate how personal characteristics affect people's desire to collaborate and whether this attraction enhances or detracts from performance in venture capital. We find that venture capitalists who share the same ethnic, educational, or career background are more likely to syndicate with each other. This homophily reduces the probability of investment success, and the detrimental effect is most prominent for early-stage investments. A variety of tests show that the cost of affinity is most likely attributable to poor decision-making by high-affinity syndicates after the investment is made. These results suggest that "birds-of-a-feather-flock-together" effects in collaboration can be costly.

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## 1. Introduction

People collaborate with others in a variety of settings. Construction of the Panama Canal and group hunting of mammoths are independent examples of mutually beneficial cooperation. Collaboration enables groups to achieve what cannot be accomplished as a result of solely individual effort. Joint work can also increase the efficiency of individual production as in the celebrated example of the multi-stage production of pins. The division of labor, which such collaborations entail, drives economic progress and greater productivity (Smith, 1776). In spite of the tremendous importance of collaborations, we lack a complete understanding of how people select their future working partners and whether there are any economic implications of different selection strategies.

In this paper, we explore two related questions on collaboration using venture capital as the laboratory. First, we ask what personal characteristics influence individuals' desires to work together in venture capital syndication. Second, given the influence of these personal characteristics, we ask whether this attraction enhances or detracts from investment performance. There are four sets of characteristics that we explore in our analysis: educational and professional background, ethnicity, and gender. Some of the

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characteristics are related to ability (e.g., whether a person has a degree from a top university) and have a clear connection with the success of an individual in the venture capital industry. For other characteristics (e.g., being part of a particular ethnic minority group) it is harder—if not impossible—to establish an obvious link with venture capitalists' ability and hence investment performance; these are affinity-related characteristics. We find that individual venture capitalists have a strong tendency to collaborate with other venture capitalists because of affinity. We then show how the similarities between members of a group affect its performance. Surprisingly, collaborating for affinity-based characteristics—shown to be unrelated to venture capitalists' abilities—dramatically reduces investment returns.

The tendency of individuals to associate, interact, and bond with others who possess similar characteristics and backgrounds has long been viewed as the organizing basis of networks (e.g., McPherson, Smith-Lovin, and Cook, 2001). The principle of homophily shapes group formation and social connection in a wide variety of settings, such as school, work, marriage, and friendship, in which similarity between dyad or group members is observed across a broad range of characteristics including ethnicity, age, gender, class, education, social status, organizational role, etc. For example, positive assortative mating along observable inheritable traits (e.g., intelligence, race, and height) discussed by Becker (1973) in the context of a marriage market can be viewed as the micro foundation of homophily in which choosing a partner with similar characteristics increases the certainty about the quality of one's offspring. Currarini, Jackson, and Pin (2009) provide theoretical foundations for the pattern of homophily in social networks using a search-based model of friendship formation and conclude that biases toward same-types in both individual preferences and the matching processes affect pairing outcomes.

Despite growing evidence that people do indeed tend to partner with similar individuals, the success implications of this bias remain unclear. One conjecture is that the more characteristics a pair of individuals have in common, the better performance the dyad is likely to demonstrate. This better performance may result from easier communication, the ability to better convey tacit information, or the ability to make joint decisions in a timely and productive manner (e.g., Ingram and Roberts, 2000; McPherson, Smith-Lovin, and Cook, 2001; Cohen, Frazzini, and Malloy, 2008; Gompers and Xuan, 2010).

On the other hand, however, homophily may induce social conformity and groupthink that may lead to inefficient decision-making (e.g., Asch, 1951; Janis, 1982; Ishii and Xuan, 2014). Individuals in homophilic relationships often have an enhanced desire for unanimity and ignore, or insufficiently consider, the disadvantages of the favored decision as well as the advice from experts outside the group. Furthermore, individuals may lower the expected return hurdle and due diligence standards on a project (consciously or unconsciously) for the opportunity to work with similar others because they derive personal utility from the collaboration. Consequently, under an alternative hypothesis, collaborations based on characteristics unrelated to ability might suffer from a "cost of friendship" and induce a negative relationship between affinity-based similarities and performance.

We test these hypotheses in the venture capital syndication setting, analyzing individual venture capitalists' selection of co-investment partners in syndicated deals as well as the associated performance implications. Venture capital syndication is an important and common mechanism for venture capital investors to diversify their portfolios, accumulate and share resources and expertise, and reduce asymmetric information concerning portfolio companies (e.g., Lerner, 1994). Although extant studies on syndication largely focus on the characteristics of the partnership at the venture capital firm level (e.g., firm reputation and investment scope), investment in venture capital is typically individual-led. The individual venture capitalist pursuing and initiating an investment in a portfolio company (the *founding* investor) normally identifies other individuals at different venture capital firms with whom he or she may wish to collaborate on this particular deal. In other words, consistent with the idea of venture capitalists competing with each other for investment opportunities (Gompers and Lerner, 2000), it is natural to think of a *follow-on* investor as being chosen by the founding investor from a pool of potential co-investors. Both the founding and follow-on investors usually serve on the board of directors of the portfolio company, representing the interests of their respective venture capital firms and seeking to maximize the return on their investment. Depending on the performance of the portfolio companies and the market conditions, venture capitalists may use a variety of exit strategies, ranging from initial public offerings (IPO) to the sale of shares back to the entrepreneur or strategic investors. Although there are examples of successful exits by venture capitalists by means of mergers and acquisitions, the consensus in the industry and academia is that an exit via IPO is the best indicator of investment success, in which venture capitalists achieve not only the highest returns, but also wide recognition for their abilities.[1] The individual-led nature of the venture capital investing and syndication process, the availability of rich biographic information on individual venture capitalists, the existence of frequent collaborations between these individuals aiming for a common goal, the importance of their actions and decisions for the investment's success, and a clear-cut measure of success make venture capital syndication an ideal platform to study the factors that influence individuals' choices to work together and the accompanying value implications.

Using a novel data set of 3,510 individual venture capitalists investing into 12,577 portfolio companies from 1973 to 2003, we first examine the selection of co-investment partners on syndicated deals. In particular, we are interested in determining a set of pairwise personal characteristics based on which people are attracted to work with each

[1] Prior research indicates that the return to venture investing is primarily driven by the small fraction of investments that goes public (Venture Economics, 1988). Similarly, Gompers (1996) demonstrates that venture capital firms are able to more easily raise new funds after exiting a portfolio company via an IPO.

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