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Performance reversals and attitudes towards risk in the venture capital (VC) market

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ABSTRACT

In this paper, we find evidence of reversals in relative exit performance between the “short” and “long-run” in the VC market, with the short-run defined to be the first 5 years of business, and the long-run, the 6th year of business onwards. Using proxies for the risk of venture capital assets that are derived from VCs’ risk management strategies—investment staging and deal syndication—we find reversals in relative performance are explained by the coexistence of persistent and non-persistent attitudes towards risk along two complementary dimensions. First, while syndication strategy is persistent, attitudes towards portfolio risk reverse between the short- and long-run periods, such that syndication is associated with high risk portfolios in the short-run, and low risk portfolios in the long-run. Second, VCs that hold high quality portfolios in the short-run do not persist with this strategy; however, high quality portfolios are associated with superior long-run exit performance. The performance effects of the transitions in attitudes towards risk that we observe are consistent with theories of costly reputation building in markets characterized by adverse selection problems and empirical evidence that VCs’ deal screening skills are more important for success than advisory or monitoring skills.

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In markets that are at least weak-form efficient, past performance is not expected to have a significant impact on future performance. Hence, both performance persistence (momentum trading), as initially documented in Jegadeesh and Titman (1993), and performance reversals, as initially documented in De Bondt and Thaler (1985), are market anomalies that have been documented in public equity markets.

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In the venture capital (VC) market, Kaplan and Schoar (2005) examine the relation between past and future performance, and find evidence for performance persistence. That is, follow-on funds raised by VCs whose initial funds perform well, continue to perform well, based on returns delivered to investors. In a complementary study that compares the returns delivered by VCs to different classes of investors, Lerner, Schoar, and Wong (2005) find some investors (“smart” institutions) are better at picking winning funds relative to other investors such as banks and investment advisors. Specifically, Lerner et al. (2005) find that smart institutions are less likely to invest in a follow-on fund raised by a VC in which they are currently invested, suggesting, in spite of the documented persistence in individual VCs’ performance, that relative performance is not persistent in the VC market.

In this paper, we study the evolution of *relative* exit performance in the VC market. Using a VC firm’s excess performance with respect to exit success (exit performance relative to all firms that commenced business in the same year) as the measure of relative performance, we examine the relation between initial and future exit performance within the VC market. Given the empirical findings in Metrick and Yasuda (2007), and Gompers, Kovner, Lerner, and Scharfstein (2008), we consider the first 3 or 5 years of business as potential time frames for VCs to establish a venture capital portfolio or track record (for ease of exposition, we label this initial period the “short-run”), and find, by examining the relation between past performance and future fund flows, that the 5-year horizon provides a more robust definition of the short-run. The short-run is thus defined to be the first 5 years of a VC’s life, while the long-run is the 6th year onwards.¹

Our empirical findings show a strong negative relation between excess long-run and excess short-run exit performance, with the observed performance reversals occurring regardless of whether VCs commence business during relatively hot or cold IPO periods. These performance reversals are not explained by survival bias, the notion that superior short-run performers’ deal flow ran dry, or systematic changes in VCs’ exit opportunities. Performance reversals also persist when we exclude the oldest VCs from our venture capital sample.

In order to better understand why performance reversals occur within the cross-section of the VC market, we draw on the extant literature, which has documented performance reversals in public equity markets (see for example, Chopra, Lakonishok, & Ritter, 1992; De Bondt & Thaler, 1985, 1987), and the mutual funds industry (see for example, Chevalier & Ellison, 1997; Ippolito, 1992; Sirri & Tufano, 1998).

In the mutual funds industry, explanations of performance reversals are linked to the convex relation between future fund flows and past performance (see for example, Berk & Green, 2004; Lynch & Musto, 2003). As in Kaplan and Schoar (2005), however, we find the relation between future fund flows and past performance is concave within the VC market, with average past performers associated with larger fund flows relative to superior past performers. The shape of the flow–performance relation thus rules out explanations of performance reversals that are based on fund flows to superior short-run performers.

Explanations of performance reversals observed in public equity markets are either risk based (see for example, Fama & French, 1996; Fama, 1998) or behavioral (see for example, Barberis, Shleifer, & Vishny, 1998; Lakonishok, Shleifer, & Vishny, 1994). Given the returns VCs deliver to investors are largely private information, the VC market need not be weak-form efficient, and explanations of performance reversals can either be risk-based or behavioral. In this study, we focus on a risk-based explanation of performance reversals that is based on the following premise. If all VCs maintain their short-run attitudes towards risk in the long-run, risk-based explanations are insufficient to explain performance reversals. Similarly, if all VCs change their attitudes towards risk in exactly the same manner, risk-based explanations are insufficient to explain performance reversals. If, however, some classes of VCs persist in their short-run attitudes towards risk, while some classes of VCs switch attitudes, the coexistence of persistent and non-persistent attitudes towards risk can be sufficient to explain performance reversals within the VC market.

¹ Kaplan and Schoar (2005) find a positive, concave relation between past performance and future fund flows.

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