

Predicting the Unpredictable

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AlwaysOn asked Benchmark to pen a blog based on the "trends" that we're pursuing in our investment strategy. This is a frequent question asked of venture capitalists, but one that is perhaps surprisingly awkward to answer.

The most obvious reason not to answer such a question is that if you believe the information is proprietary, why would you share it in an open forum? If you ask a mutual fund manager which stocks he likes, he is apt to tell you what he already owns, not what he is evaluating for the future. Likewise, asking a venture capitalist about future trends is more likely to result in answers that characterize previous investments in the best light rather than provide an altruistic view of the future.

The second reason to shy away from such a question is that "trend investing," especially in venture capital, may in fact be a recipe for failure. By the time something is a trend, it is frequently too late to be making venture investments.

Many years ago, Howard Marks (now of Oak Tree Capital Management), wrote an incredibly insightful article for the Financial Analysts Journal. Marks pointed out that there are four types of investable predictions in the world: accurate and inaccurate, matrixed by consensus and non-consensus. It is fairly obvious that inaccurate predictions are valueless. What most people miss, however, and what Marks so articulately pointed out, is that consensus-accurate predictions are most likely valueless as well.

Predictions that are obvious and well understood offer little opportunity for financial reward, simply because the idea is not unique, and therefore the "arbitrage" is exploited in the financial markets. For a mutual fund manager this mechanism occurs by the fact that today's stock price already reflects extremely high expectations, therefore minimizing future upside. In the world of venture capital, this phenomenon typically plays out through overinvestment in the "trendy" sector. A saturation of startups has huge negative effects on the potential returns for the marketplace.

As a result, we typically find ourselves in search of the non-consensus accurate prediction that will result in superior financial results and that is by definition not related to an overt trend. Finding this type of investment requires a very open-minded approach and a willingness to consider investments that may be out of favor for one reason or another. So we are searching for the nonobvious trends that have yet to be exploited. If you see any companies that meet this profile, be sure to send them our way!