FINANCIAL POST

Brad Cherniak: The problem with other people's money

Brad Cherniak, Financial Post · Apr. 11, 2011 | **Last Updated: Apr. 11, 2011 11:18 AM ET**

Venture capital and the state of innovation in Canada have often been in the news these days. But what exactly is wrong with the VC industry today? And what can governments do to save it, boost investment and thereby help increase innovation in Canada?

The answer to the first question is "not much" and to the second, "nothing directly."

Although usually presented as indicative of the industry's troubles, the accompanying table is actually hard evidence it is fine. By fine, I mean it is reacting logically and rationally to events.

Poor returns, not lack of supply, are the problem Single-digit returns in Canada have never justified investment volumes, after risk is taken into consideration. To be fair, Canadian returns have been dragged down by the dismal performance of the laboursponsored investment fund sector -a well-intentioned but ill-fated government initiative to spur VC activity and investment in small to mid-sized businesses.

Average rates of return in the United States have long exceeded those in Canada consistently well, but appear to be largely driven by the 2000 dotcom bubble. After this period of absurdity rolled out of the rolling 10-year averages, U.S. venture capital returns started to look similarly anemic.

The volume of capital raised and invested by VC funds should be falling materially. This is how a free capital market recalibrates. Venture capital should be generating 15% to 25% average returns to properly compensate investors for their risk. This is not happening overall.

Best case scenario is for the flow of private capital to continue unimpeded, but with rigorous regulatory oversight of industry practices, it's also how to ensure a steady, longterm supply of this kind of capital for SMBs.

How to make the situation worse I am continually astounded that industry practitioners keep asking governments to regulate (i.e. boost) the volume of overall investment activity by flowing taxpayer funds into the sector.

Government has no expertise here. Total investment volumes are driven by thousands of individual and company decisions -some smart, some stupid, others in between. The only way any economy has worked in the long term is if these decisions are made as directly as possible by the owners of the capital being leant.

Other people's money The financial crash of 2008 was largely the result of decisions being made in both the private and public sectors with what I'll call Other People's Money. There was too much government interference in financial decision making, particularly in the United States and across Europe. Ideologically motivated laws and regulations abounded, the worst offenders relating to lax mort-gage lending standards. This was coupled with a lack of enforcement of basic existing laws and regulatory oversight relating to fraud, governance and competition. Ironically, this was due in part to the distraction of high-minded government economic and socialengineering initiatives.

The financial services sector contributed to the problem by becoming too remote from the impact of their decisions. For example, driven by government incentives or even direct political pressure, the U.S. mortgage-backed security market only became such a big problem because the owners of the assets (the homes) and the investments (the mortgage-backed securities) were too isolated from the actual homes and the underlying cash. The whole system started to act like it was financed with OPM, and everyone's decision-making suffered.

Since then, governments have overreacted, effectively nationalizing large chunks of the world economy. Rampant deficit spending is simply the government throwing around Other People's Money.

Although the paradigm of OPM has run amuck in the public sector, it has improved somewhat in the private sector since 2008. And, save for the LSIF debacle, venture capital has remained largely untainted by the problems associated with OPM.

The waiting game For things to get better, governments' should limit their initiatives in the VC market to what will increase employment and wealth accumulation. Some of that wealth will stream back into venture capital if and when historical returns warrant it. And when it does, if it is not directly or indirectly misdirected by government, it will tend to flow to the best VCs. When you are spending your own money, you will do the research.

Government flowing capital directly into the VC space will continue to depress returns and delay the recalibration of the market -the unavoidable point of reckoning we are working through today.

Cyclical capital downturns are painful, but regardless of the short-term pain, SMBs and the overall economy can only benefit from the VC sector in the long-term if it is fundamentally sound and free.

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