# The Mystery of Venture Capital: A Mission to Connect Entrepreneurial Capital and Economic Development

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I am not a typical venture capitalist. I started out wanting to change the world through political leadership, and my career has been a winding pursuit of a dream that has—somewhat unexpectedly—led me to this point. In this article, I share the story of my journey and the insights I gained along the way. In particular, I present nontraditional insights into the nature of venture capital, and describe how those insights have inspired the current phase of my personal and somewhat idealistic pursuit of change.

In 1989, as a freshman at Harvard, I started studying government for my planned career in politics and public service. I dreamed of running for Congress before age 30. I was convinced that all we needed to save the world was more decent, hard-working people willing to serve in positions of public leadership to drive positive change. By 1993, I was attending the University of Chicago Law School as another step in that vision. By 1995, I began working on the Presidential campaign trail, first as the fundraising director for the early Texas statewide coordinated campaign and later at the Democratic National Committee as a small part of a team that raised the record-breaking (at the time) amount of $245 million to re-elect President Clinton to his second term. I was appointed by the White House to a position at the U.S. Agency for International Development, told to prepare for bigger things, and encouraged by many key party leaders to aim for statewide office in Texas. Things were looking bright.

At that time, however, my perspective started to change fundamentally. Throughout my journey, I kept asking the same question: "Where is the Solution?" In other words, what was the underlying bottleneck hampering change for the better in society-at-large? What was the fulcrum point of society, where a little leverage could make the biggest difference? Although I began with the belief that the Solution was all about decent, hard-working public leaders, I learned that a vast amount of human energy and dollars in politics and government was spent on things that ultimately did not put more food in people's mouths, enhance the quality of their lives, or build better widgets that reduced their burdens.

Realizing that my Solution must therefore lay outside of public life, I left the world of politics and policy in 1997 to enter the private sector, and started practicing corporate law in Los Angeles. Soon enough, the idealist in me grew restless, and I asked myself again, "Where is the Solution?" One possible answer seemed to be around emerging innovative companies. Since economist Paul Romer's groundbreaking New Growth Theory was published in the early 1990s, economic thinking has evolved to a consensus opinion that the vast majority of the world's economic growth over the past century can be attributed to businesses that use new technologies to create transformative products and services. The revolution in information technology companies in the 1990s and 2000s has been the obvious case-in-point, but one can look across many other sectors for parallel examples.

If the heart of economic growth comes from new technology companies, then I reasoned that my Solution might be found there as well. By 2000, I left the practice of law to manage a little nonprofit that the State of California had chartered to work with technology startup companies. I saw an opening: the opportunity to bridge my interest in public policy and the private technology sector, for the possible betterment of both.

By 2004, we had transformed that nonprofit. I had been observing—with some sadness—that about $2 billion of federal funds were thrown at startup companies run largely by brilliant professors with little idea about how to grow businesses. Today, that nonprofit (the Larta Institute) runs programs to mentor annually over 250 of those startup companies, which are funded out of those federal funds from the National Institutes of Health, the National Science Foundation, the Department of Agriculture, and several other entities.

As an extension of that work, with a small group of investors we launched a private venture firm, T2 Venture Capital, which spun out of the nonprofit in 2007 to focus on a handful of high-potential startups each year. I had arrived at the realization that organizations such as Larta Institute that serve as the connective tissue between new innovations and private markets hold the equivalent of mountains of "unpolished gems." With the right investment of time, skill, and resources, some of these gems can be buffed up to realize great potential. My business partner and I had a vision that a venture capital structure could be created to leverage the untapped and unpolished treasures being uncovered by organizations sponsored by government investment; such organizations are driven by policy goals of economic development and are always seeking better access to high-quality talent and capital. Our underlying hypothesis was bold: The lack of effective structures to bridge the public and the private is hindering the growth of new ventures and retarding economic growth.

My experiences in politics, government, the law, the nonprofit world, and venture capital have given me a unique perspective on how these pieces intersect—or, perhaps more accurately, how they fail to intersect. The result of that failure is the massive and systemic waste of resources throughout the innovation ecosystem. Government programs try to stimulate the growth of startups by building bricks-and-mortar incubators, without recognizing that the venture talents of the people involved are far more important than any physical infrastructure. Think tanks in Washington focus on increasing funding for pure scientific research to stimulate economic growth, without full consideration for how innovation is actually translated into business value or for knocking down the barriers that get in the way of doing so. Venture capitalists often believe that the free markets work just fine, without fully appreciating how they would not have their jobs if the government did not invest billions of dollars each year into creating the fertile environment that makes high-impact startup creation and growth possible. For every high-profile successful entrepreneur of a startup company, there are dozens if not hundreds of unsung heroes in the broader ecosystem, including in government, on whose shoulders that entrepreneur stands.

Today, I am convinced that the Solution is in how these puzzle pieces—government, policy, capital, and entrepreneurial talent—intersect with each other. Most people, particularly those in venture capital, instinctively believe that these jigsaw pieces are meant to belong in separate puzzles rather than envisioning how they might fit together in one integrated picture. However, through my journey, I have been fortunate to find a small yet growing group of individuals who, like me, see the larger puzzle. Every great movement begins from such a nucleus, a small cadre of people with passion, and I believe today that we are seeing the start of a revolution in ways to bridge the public and the private to stimulate venture-based economic growth.

My unconventional career path has led me to recognize what I see as one of the system's biggest breakdowns. If growing technology businesses is the key to economic growth, as economists largely agree, then venture capital—or, rather, dysfunctional venture capital in most parts of the world—is often the gum squeezed into the lock that prevents the key from turning. From the viewpoint of economic development, venture capital is actually a necessary evil. If markets were truly efficient, then money would naturally flow to all the entrepreneurial opportunities that deserve a shot. But the truth, of course, is that there are many good opportunities lost in the turbulent currents and eddies of the venture capital river. For example, if the technology underlying Google's search engine had been invented by two researchers at a university in, say, Alabama rather than at Stanford, would Google be a ubiquitous household name today? The unfortunate answer, of course, is almost certainly no.

What then makes venture capital "happen" in places like Silicon Valley but not in Cairo, Egypt or Cairo, Illinois? This is what I call the Mystery of Venture Capital. Venture capital—that is, high-risk, early-stage capital for entrepreneurs—does not naturally form on its own. Most venture capitalists think they know the way to win the venture game as it exists, but I believe most venture capitalists do not appreciate the assumptions that underlie why the game is the way it is. Thus, top venture capitalists can be good at practicing venture capital yet ineffective at building venture capital in new markets (just as Nobel Prize-winning professors often prove to be terrible teachers in the classroom).

The trailblazing Peruvian economist Hernando de Soto observed in *The Mystery of Capital* (2000) that economic value may be ubiquitous but that "capital" requires a multifaceted set of public policy decisions, including legal protections of property rights and lowered barriers for creating liquidity (i.e. easier access to banks and loans). That explanation, however, seems incomplete for *venture* capital. As a case in point, Silicon Valley and Cairo, Illinois are governed by essentially the same base of property laws derived from the common law, federal securities laws that dictate how money can flow, and general access to banks and other financing. In addition, the Midwest universities capture even more federal funding for scientific research than the Bay Area universities. The Solution must therefore be deeper than purely legal or financial considerations.

Trying to solve this mystery is a path littered with dead bodies of the formerly well-intentioned. Josh Lerner in his 2009 book *Boulevard of Broken Dreams* recaps how governments worldwide have invested and lost billions (if not hundreds of billions) of dollars in creating venture ecosystems and venture capital structures. Most mainstream venture capitalists do not appreciate—but I have seen firsthand—just how much regional governments from Maine to Arkansas to Arizona have invested in pursuit of creating their own venture capital industries. What was an accidental creation in Silicon Valley has been the intentional pursuit, largely ineffective, by hundreds of other governmental entities around the U.S. and the world.

So, we need to solve the mystery in a fundamentally different way. As my boyhood idol Sherlock Holmes once famously exclaimed, "When you have eliminated the impossible, whatever remains, *however improbable*, must be the truth." Since so many permutations of capital have already been tried—money has been sliced and diced in too many ways to count—we must reach the unlikely conclusion that virtually every policy effort to create venture capital has focused on the wrong thing, the capital. It seems intuitive that venture capital ought to be about the capital, but I believe that this intuitive fixation on capital is the siren song that has lured most such efforts onto the rocks.

 

The right answer is not so obvious: successful venture capital is more about the people than it is about the capital. Practicing veteran venture capitalists intuitively know this truth, but it is not obvious to policymakers and its implications are profound. So what does this mean? Successful venture capital requires high-touch mentoring and apprenticeship within a globally networked community for linking markets, insights, talent, technologies, and partnerships. Venture capital, when it is done well, demands extreme levels of integrity, personal transparency, and a willingness to invest time and "pay-it-forward" without any immediate expectation of return. It is a human game, above all.

There is a theoretical economic explanation for why a people-centered focus on venture capital might be more effective than a capital-focused one. Economist Ronald Coase won a Nobel Prize in 1991 for his "theory of the firm," according to which economic systems (such as the inside of a corporation) that are able to create lower transaction costs (i.e., where it is easier and less costly to do business routinely) are able to enhance economic output. The modern venture capital industry is like, the geeks might say, a virtual Coasean system on steroids. The lower transaction costs in venture capital are due to the creation of a normative culture—a set of behavioral customs—that its participants have learned to adopt, whether they are conscious of it or not.

Thus, a new, young venture capitalist launching his or her career must learn all the unwritten rules of the business, just as an expatriate does when moving to a new country. These unwritten rules include everything from hard skills like understanding the terms of a deal to softer skills like using the proper tone of communication, persuading others, and building trusting relationships in situations that are simultaneously cooperative and competitive. Venture capitalists therefore frequently sacrifice short-term gain for maintaining long-term relationships. In venture capital, you should act as if you might be on the other side of the table tomorrow, because the odds are you will be—and such a dynamic creates its own internal equilibrium and system of justice. This knowledge of how the system works, however, is not easily obtained by venture capitalists who are trying to gain a toehold in emerging markets, where the opportunities to interact with and learn from others are much, much fewer.

My new career effort, therefore, is building an initiative called the Venture Corps (a name inspired by the Peace Corps) to bridge the divide between private venture capital and government-based economic development, by focusing on the education and nurturing of people. I have been encouraged by and am grateful to the Center for Venture Education (CVE) for the push to turn my field project into a living, breathing concept. From a policy perspective, the world is desperately seeking a solution to the conundrum of why government-sponsored venture capital in new markets has performed so poorly. And the success of CVE has shown the value of training venture capitalists and providing them with support structures for sharing ideas, capital, access to partners and talent, and personal development.

I have been fortunate that the Kauffman Fellows Program has given me peer-to-peer opportunities to interact with and benefit from other "revolutionaries" also trying to bridge the public and the private. I have learned a great deal from Fellows like Koichiro Nakamura (Class 12), who is forging the future of the Japanese venture economy; Brian Trelstad (Class 12), designing new models for enhancing and measuring the social impact of venture investing; Fernando Fabre (Class 14), building a new ecosystem for venturing in Mexico; Saed Nashef (Class 14), launching a venture firm tied closely to economic goals in the Palestinian Territories; Gianluca Dettori (Class 14), working with key foundations and banks to drive economic development in Italy; and Andras Forgacs (Class 14), who is connecting the dots between macro public policy and international venture development. These Fellows are all part of what I think of as a "posse" pushing the boundaries of what is possible in venture capital formation.

Fortunately, we Fellows are not alone—we have found others in key leadership positions worldwide who are grappling with the same issues and are experimenting with new solutions. These forward-thinking leaders include people such as Susana Garcia-Robles, who has essentially godmothered the Latin American venture industry through her service at the Inter-American Development Bank; Nina Fedoroff, who as Science Advisor to the U.S. Secretary of State launched new initiatives for using science and innovation as a tool of U.S. diplomacy; and Al Watkins, who is leading the charge within the World Bank to create innovative new vehicles to solve stubborn problems in the developing world.

Drawing energy from all these efforts, the Venture Corps is focused on working with governmental and quasi-governmental institutions to create customized venture programs and funds to educate and empower new venture capitalists in emerging markets around the world. We will accomplish this by grooming a generation of venture talent in emerging markets in the opaque art of entrepreneurial capital formation, teaching behavioral customs, linking practitioners together in a global network, and giving them a hand in the creation of new venture funds that can accelerate the growth of new startups in new parts of the world. We are already engaged with numerous global development banks, research institutes, national funds-of-funds, and other institutions to build such structures.

So is this "the Solution" that I have sought in my personal journey? The Solution is certainly a moving target, as the world will keep on turning. While I am hopeful we are moving in the right direction, I have no illusions about the challenges inherent in testing this type of hypothesis. On the other hand, *not* pursuing this effort seems to me to be vastly more risky, given the deep hunger of policymakers for guidance that will determine how tens or hundreds of billions of dollars will be invested—or wasted—in the coming years.

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Victor is the co-founder and Managing Director of T2 Venture Capital, focused on breakthrough technology spinning out of government and academia. He is the immediate past President of Larta Institute, one of the nation's leading organizations focused on commercializing technology from key federal agencies, a network of universities, or in global partnerships with other countries. Earlier, Victor was an attorney in the Corporate Securities and High Technology groups of Irell & Manella in Los Angeles, practicing in a variety of legal areas, including negotiating venture capital investments, public and private equity and debt structurings, and mergers and acquisitions. Victor earned an AB from Harvard and a JD from the University of Chicago.

 