Consider the power of thesis-driven investing

When asked what makes an investor successful, many people will say it's the quality of their deal flow, but in today's environment the best answer is not that simple.

Investors who hang their hat on deal flow primarily rely on their networks to produce enough deals to minimize their chances of missing out on the good ones. This passive method of investing presupposes that investors merely have to announce to the world that they have money, show entrepreneurs impressive résumés, and sit back while the best deals parade through their well-appointed offices. Thirty years ago, this approach worked because there was far more demand for capital than supply, and the average venture firm had less than $50 million under management.

Fast forward to today and it quickly becomes clear why this way of thinking is archaic.

While reputation and networks still matter, the venture capital industry has evolved. There are now more than 450 venture capital firms in the United States, managing more than $175 billion in committed capital and investing more than $20 billion each year, according to the National Venture Capital Association. Supply has caught up with demand, despite the fact that there are more aspiring entrepreneurs today than ever before. As a result, the parade of deals has grown, and it's becoming increasingly difficult to identify winners.

To make matters worse, entrepreneurs are not unlike drug dealers, with ideas being their drug of choice. Anyone who is involved in early-stage venture capital understands just how addictive ideas can be. Investors are regularly seduced by persuasive entrepreneurs pushing ideas that seem poised to change the world. But like many drug addicts, we sometimes need an intervention to reintroduce the reality of the world in which we live.

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Thesis-driven investing is a powerful first step towards rehabilitating one's investment philosophy. This approach begins with being self-aware. Investors must first understand exactly what skill sets they bring to the table and in what areas those skills are best applied. By leveraging their expertise, they can better map out what is happening within their areas of focus over the next five to 10 years.

A disciplined investor will then evaluate each investment in the context of a particular thesis. Thesis-driven investors will not sit back, however, hoping an entrepreneur will walk in the door with a deal that fortuitously aligns with their beliefs. Instead, thesis-driven investors proactively seek innovative companies that fit their theses. And if no such company exists, they just might help start one.

At TEXO Ventures, for example, while we maintain more than one thesis, each originates from a singular problem statement: The U.S. health care system is on a dangerous path, with a toxic combination of high costs, uneven quality, frequent errors and limited access to care. (See the book "Redefining Health Care" by Michael Porter and Elizabeth Teisberg.) We operate under the conviction that the unsustainable state of this industry will drive innovation for the best long-term solutions while delivering incredible returns for investors who truly understand health care. But like any industry undergoing disruption, there is no shortage of interesting ideas. So we rely heavily on our thesis-driven approach to remain disciplined and avoid trading focus for deal flow.

Thesis-driven investing not only keeps investors on track, but also levels the playing field. The competition today for top-tier deals is intense, and it's increasingly rare for these deals to be actively circulated beyond a predetermined syndicate. For these deals, it will always be a seller's market, but this market is typically cornered by a short list of renowned venture firms.

But an interesting thing happens when investors force themselves to craft and adhere to a thesis. Those who do it well quickly become luminaries in their areas of focus, and entrepreneurs welcome their involvement even if it means turning down a much more well-known firm. Starting a company is hard, and many entrepreneurs are coming to realize that for good ideas, capital is a commodity. Many of these entrepreneurs want knowledgeable partners willing to roll up their sleeves and add tangible value beyond the checks they write or the brand recognition that comes with them.

By truly understanding an entrepreneur's space and exhibiting the ability to collaborate in commercializing something truly innovative, a less well-known investor can quickly gain access to top-tier deals. This is the power of thesis-driven investing.

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companies declined more than 50 percent compared with the same three-month period last year.

Austin-area companies collected $258.2 million during the quarter versus $520.8 million during the second quarter 2010. Also, the local amount of venture capital raised by midyear fell sharply to $408.5 million compared with $683.7 million at midyear 2010 — a 40 percent decline, according to Dow Jones VentureSource.

KickStarter, which launched in 2009, operates with a threshold pledge system for music, film and video projects. But projects don't pay KickStarter unless they meet the fund amount within the term set by each project. If that happens, KickStarter generates a 5 percent fee from the total.

The website has enabled the funding of 10,000 projects since it launched. The average pledge is $71, KickStarter officials said.

Several local companies have used KickStarter.com to generate development capital. The approach is a useful one, especially in an area such as Austin where there is not a broad range of funding options for early-stage entrepreneurs compared with other areas of the nation, said Kevin Koym, co-founder of local technology incubator TechRanch Austin.

Koym

He said the funding model spreads the risk out among dozens of investors.

"KickStarter is cool when there is a limited hardware component … to build the crowd around," Koym said.