

Passion Plays: Investing from the Heart and the Head

By Iain Silverthorne

Investing is supposed to be a mental exercise: using facts and figures to forecast risk-adjusted returns for different asset classes, poring over income statements to gauge the prospects of one company's stock over another's, and so forth. We're only human, so emotions like greed and fear are always lurking in the background, but as long as we're aware of the role they play and rely on our better rational judgment – and a good financial advisor – we should be able to keep them in check.



A passion project is something different. It's likely to be a private business or some other illiquid, often obscure and opaque asset, rather than a regulated, publicly traded security. And the investment is made with emotional, not just financial, considerations. It could be a startup looking for seed money, running a restaurant with friends, maybe a one-act play that a relative wants to produce off-off-off Broadway, or perhaps paintings, rare coins or vintage wines collected by a hobbyist who wants to kick things up a notch.

What they all have in common is that markets in them are very thin and may not exist at all. If you want to sell a stock, you may not be able to get what you paid for it, and sometimes there isn't a buyer at any price. If no one likes your friends' cooking, by contrast, it may be impossible

to sell the restaurant. If friends ask you to invest in their first restaurant, consider telling them that you will invest in their second restaurant.

Before jumping in, ask yourself some questions. What is the purpose of the investment? What is its personal value or significance? Are there alternative ways to express this interest other than financially? Can you afford to do this? Really? Will it impact your cash flow materially or change the likelihood that you will meet your financial goals if you lose all the money you invest in it? What percentage of your overall assets, liquid or illiquid, will this investment account for?

We would normally classify private-company passion projects as very high-risk undertakings, especially if the funds are invested in a single, early-stage private company. To put a finer point on that, be prepared to lose all of your capital. The exception to that would be for passion investments in tangible assets such as classic cars, rare wine or art. In those cases you may lose money, but unless there is fraud involved, there is usually some residual value.

Your advisors should be able to help you pursue your passion without letting it get the best of you or your portfolio. They can act as a sounding board, a gut check on your investment thesis, and set the investment

criteria and investment evaluations metrics. They should help with legal and tax considerations for passion investments and can perhaps provide access to research and contacts. And they can, as the article below suggests, say “no” on your behalf.

The best way to invest in what you’re passionate about may be to think of it not as an investment at all; instead of money, measure your returns in terms of enjoyment and fulfillment.

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Some passion play tips:

- Make the most of any expertise you have in the domain where your passion resides. Top private-equity firms are successful not just because they invest in the right businesses, but because they have management skills that help the businesses become better.
- Don’t rely solely on your expertise. Just because you know one industry, it may not improve your judgment when it comes to investing in another. Likewise, don’t confuse being lucky with being good. If you’ve had success with one passion project, unless you can point confidently to steps you took that helped to ensure its success, don’t count on it happening again.
- There’s safety in numbers. Consider joining an angel investment group, in which well-off individuals, often retired business owners, pool their financial and cognitive resources for the opportunity to learn and access a network of experts in your field of interest.
- Decide how much time and energy – and passion – you really want to commit. Is this a passive investment, or do you want to be actively involved? Before taking a board position in a private company, make sure you’re covered by director’s and officer’s liability insurance.
- If you’re investing in a startup, be prepared to be hit up for additional cash as the company grows. For instance, if you are investing \$50,000 in a family and friends seed round in a startup that has a \$1 million valuation for a 5% ownership position, then as the company grows and needs additional capital, you will have to add more funds to maintain your ownership percentage if that is important to you.
- Consult your tax advisor and attorney before investing in any entity or private company as some ownership structures can be more tax advantageous than others. For instance, start-up companies in certain industries that are structured as a C Corp versus an LLC may qualify as a Qualified Small Business Stock, or QSBS. Gains from selling QSBS may be eligible for an exclusion of up to 100% from federal income tax on gains of up to \$10 million or 10 times your tax basis.
- Consider your exit strategy, especially if the investment goes bad. How, when and why would you walk away? Sometimes saying “no” to friends can be difficult, especially when they are desperate for additional funding. Working with your financial advisor to set guidelines around the amount you are willing to risk can help clients stay objective. You can always blame the “no” on your financial advisor.

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