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5 questions to ask before you invest in startups

Insight: How to choose between 'angel' investing and private equity funds

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When it comes to private equity investing, investors generally have two options: decide to fund new companies as an "angel" investor, or become a limited partner in a private equity or venture fund and let someone else manage the investments. Your considerations are similar to buying stocks or mutual funds — with some important differences.

As the founder and CEO of an accredited investor crowdfunding platform that offers both direct investments in consumer products companies and investments in funds of companies called Circles , I regularly see investors considering both options. Here are five questions to ask when weighing angel investing versus investing in a private equity fund:

1. How will I achieve diversification?

Private investing, at any stage, is high-risk and illiquid. You need to consider long horizons of seven- to 10 years, and you should diversify. Private equity funds invest in many companies. That's no guarantee of making money but in a well-managed fund the odds of a total loss are reduced compared to individual investments.

As an angel investor, you are not relying on others to diversify your portfolio, so you must do it yourself. If you're an angel investor, are you setting aside enough to invest into seven-to-10 deals? If not, you are putting your money at increased risk.

2. Can I source and identify quality deals?

Sourcing is another benefit of investing in a private equity fund. In the tech world sourcing and evaluating angel quality deals is almost impossible for all but about 1,000 well-connected angels. This is true, in part, because the entrepreneurs with the best deals already know where to raise money. That means less-optimal selection for the rest of us.

However, in less efficient markets, such as consumer and retail, individuals can still access the best deals. Moreover, the typical investor may have an easier time evaluating a consumer product business than, say, a mobile app. Platforms can help; CircleUp, for example, features companies that have been vetted by our team of investment professionals.

3. What is my net return?

Fees will eat into your investment return. The typical VC fund has an annual management fee of 1.5%-2.5%, plus carried interest fee of about 20%. Union Square Ventures partner Fred Wilson wrote one of the best posts I've ever seen about the expense structure of a VC or private equity fund.He points out that a fund needs to get 4X return on its investments to generate 2.5X in distributions to its limited partners.

To avoid surprises or unnecessary stress, you need to get a good understanding of the expense structure of the fund before putting money into it. In comparison, angel investors making a direct investment into a company typically will not pay management fees or carry.

4. How involved do I want to be?

Sometimes people invest directly because they love helping companies. Many angel investors are former entrepreneurs and are enthusiastic about sharing their knowledge and expertise.

As an investor in a VC fund you are a limited partner and have almost no connection with the startups and their CEOs. As an angel investor you may be deeply involved. You may have access to the CEO and provide guidance. It's not uncommon for young businesses to seek angel investors who have experience that is relevant and useful to the company. Are you looking for that sort of responsibility?

5. Am I confident about the people?

People make a company. Does the CEO have a history of success? Do you believe in management's vision and ability to execute?Are they passionate about the venture and their vision? Do you trust them?

If you are investing directly, look for a platform or network that gives easy access to information about the founders and executives of companies. In this way, you can do thorough due diligence before you invest and can stay in touch after you invest.

With a fund, look also at track record and strategy. Data abounds on VC firm websites, and check out the National Venture Capital Association and the top venture investors on Forbes' annual Midas List . Does a fund's thesis make sense or is it a "me-too" approach (i.e. "I will source tech deals better than the 10,000 other managers out there")? What is the managing partner's competitive differentiation and ability to access the best deals and help those companies grow? How does the fund manager think about valuation and do you share that view?

Just as there are momentum investors and value-driven investors in the public market, in private equity there are different overarching strategies that inform a fund manager's investment decisions. Understand the manager's investment philosophy before you give it any money.

Ryan Caldbeck is founder and CEO of CircleUp, an equity-based crowdfunding platform. Follow him on Twitter via @CircleUp.