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A Russian Proverb Explains Investors' Approaches to Risk Management

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***By Joseph Feldman, President, Joseph Feldman Associates*[1]**

The Russian proverb—"Trust, but verify" (in Russian pronounced *doveryai, no proveryai)*—provides a helpful framework for understanding how various equity and debt investors assess and manage risk rather differently. This proverb made famous in North America when Ronald Reagan used it to describe his strategy for dealing with the Soviet Union during the missile reduction talks of the 1980s.

For each investor type shown below, their management of risk reflects a mix of both "**verify**" and "**trust.**" Among the examples of "**verify**" are types of control provisions, contractual enforcements and collateral (including reputational capital in the case of friends/family investors). Risk assessments based on "**trust**" reflect knowledge by the investor of the particular industry, business and founder.

Investors			**"Verify"**	*"Trust"*
Equity	Friends/Family	*Trust*	• **Reputational capital**	• *Familiarity with founder* • *Investment by founder*
	Angel investors			
	Venture capital		• **Control provisions (e.g., strategic decisions, Board members)** • **Anti-dilution protection**	• *Review of business plan* • *Assessment and selection of management team* • *Familiarity with industry*
	Private equity			
Debt	Unsecured lenders		• **Financial covenants** • **Defined repayment schedule** • **Warrants**	
	Secured lenders	**Verify**	• **Security/collateral** • **Defined repayment schedule** • **Personal guarantees**	

The roles and relative importance of "**trust**" and "**verify**" are most divergent when comparing friends/ family investors with secured debt lenders:

- "**Trust**" predominates over "**verify**" for friends/family investing in a start-up, with high reliance on their familiarity with the founder ("she's so passionate about this new business idea") and the founder's own investment ("he's committing all of his limited savings"). There may be little potential for collateral or contractual assurances, rather only the founder's reputation (and perhaps family harmony) may be at stake.
- Alternatively, commercial banks and other secured lenders invest substantially on the basis of "verify", with far less emphasis on "trust." The uncertainty and risk of a business plan, financial projections, or detailed understanding of competitive dynamics, are less crucial when a loan is backed by personal guarantees and collateral (e.g., cash, land, securities).

Private equity and venture capital investors invest with considerations of both "trust" <u>and</u> "verify":

- Through expertise in particular industries, healthfulness (or not) of companies, growth models, and management team assessments, the inherent uncertainty of these "trust" factors can be mitigated… and an assessment of risk more confidently made.
- Nevertheless, through negotiated control of strategic decisions and board appointments, a measure of "verify" remains an important aspect of an investment decision.

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