Disruption makes startup investors balance caution against fear of missing out

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A new study by researchers from the University of California, Riverside, and the Rotterdam School of Management finds that fear of missing out motivates investors to give money early to startups with a disruptive vision. However, those backers are reluctant to invest too much in unproven ideas that might not take off.

In other words, disruptive startups are more likely to raise money, but they receive smaller amounts than less-threatening ventures.

Entrepreneurs set themselves apart using two primary strategies. The first involves emphasizing the track records and past accomplishments of the entrepreneurs, the startup's initial market success, or its unique resources. The other tack sees them touting what the venture will become and what the entrepreneurs will achieve. Disruptive visions fall in the second category.

Disruptive innovations are those that introduce a fundamental change, disturbance, or re-ordering of the ways in which organizations, markets, and business ecosystems operate. Netflix transformed the video-rental industry, for example, and TiVo changed the way we watch TV. The startup world has a love affair with the concept of disruption, as evidenced by entrepreneurs like Elon Musk, who wins investors by communicating disruptive visions: one where humanity explores Mars, such as SpaceX, and another where the world transitions quickly to sustainable energy, such as Tesla.

In spite of this trend, whether investors applaud or dismiss self-claimed disruptors has never been studied. Ashish Sood, an associate professor of marketing at the UC Riverside School of Business, decided to put that to the test.

To find out how successful disruptive visions were at attracting investors, Sood and his colleagues at Rotterdam School of Management, Timo van Balen and Murat Tarakci, studied 918 startups in Israel seeking a first round of funding. Israel has more high-tech startups per capita than any other country and has produced a number of highly lucrative ventures. The researchers collaborated with Startup Nation Central —a nonprofit that offers an exhaustive platform for the Israeli startup ecosystem—to gather detailed data.

They found that a small increase in the disruptiveness articulated by the startup's communications improved the odds of receiving a first round of funding by 22 percent. Surprisingly, disruptive visions gathered 24 percent fewer funds in the first round. A disruptive vision caused the typical Israeli venture to lose $87,000 in the first round and $361,000 in the second round.

"Why might investors be so positively biased toward disruptive visions, yet opt for investing for so little?" Sood said. "Our research reveals that talking about disruption can be a double-edged sword."

The researchers recruited 203 people with previous investment experience in exchange-traded commodities or funds, government bonds, stocks, unit trusts, angel investing, private equity funds, venture capital funds, options, or crowdfunding to answer questions about two fictitious vision statements, identical except for the degree of disruptiveness they expressed. Each respondent was given only one of the statements, along with other company information, and asked questions about the kinds of investment decisions they would make.

The results of the experiment matched what the researchers had found in the Israeli database. Investors funded disruptive startups eagerly but less generously.

What lured the investors?

"Expectations of making extraordinary returns is what entices investors to fund the self-claimed disruptors," Tarakci explained.

A small increase in the amount of extraordinary returns investors expected made them four times more likely to fund the venture. Nonetheless, investors do not follow the enchanting promises of those disruptors blindly. They are aware that young companies with daring, untried ideas or products stand a high chance of failure. Investing a small amount at an early stage is like buying an option to invest more at a later stage when doing so might be less risky.

The study concludes that a disruptive vision can attract investors who wish to obtain extraordinary returns and join a celebrated group of early investors in unicorns. But it can also deter investors from making large, speculative investments into the venture because they prefer to hedge risk against wait.

"For entrepreneurs seeking early stage investments, we have the following simple but important advice: carefully craft your message," Sood said. "If you are looking to acquire large sums of money, perhaps you should keep your disruptive plans quiet."

The paper, "Do Disruptive Visions Pay Off? The Impact of Disruptive Entrepreneurial Visions on Venture," is published in the *Journal of Management Studies*.

More information: Timo van Balen et al, Do Disruptive Visions Pay

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