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INFORMAL INVESTORS IN CANADA:

THE IDENTIFICATION OF

SALIENT CHARACTERISTICS

A Report submitted to the Federal Department of Industry, Science, and Technology Canada and to the Ministry of Economic Development and Trade of the Province of Ontario.

May 23, 1993

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RESOURCE CENTRE
DOCUMENT #:
DATE: Sept 18.95

INFORMAL INVESTORS IN CANADA: THE IDENTIFICATION OF SALIENT CHARACTERISTICS

Executive Summary

Background

Informal risk capital is capital provided by private investors to growing small businesses. Informal investment is *the* primary source of equity capital for new firms and for firms undergoing early stages of expansion. Such expansion supports most new job creation in the economy. Facilitation of access to informal capital would have several benefits, each of which would improve the viability of SME's.

- It would sustain the expansion of growing firms and the attendant job creation.

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- It would enable entrepreneurs to focus more on the development of the operational aspects of their businesses.
- It would incorporate the managerial talents of informal investors into the business.
- It would allow for competitive bidding with the attendant reduction in the cost of equity capital.
- It would permit larger more viable start-ups.

This study attempted to advance knowledge about the supply side of the informal market so that policy initiatives can be founded on a stronger knowledge base. Informal investors and other individuals were surveyed from across Canada. Of 411 respondents, 279 were informal investors. The other 132 respondents provided benchmark data against which the responses of informal investors could be compared. The findings include the following:

Patterns of Informal Investment

- The informal market is a local marketplace and a personal marketplace.
- Interactions among investors form an important part of informal risk capital investing decisions.
- Investments were uniformly distributed as to size and embraced all industrial sectors. The natural resource, manufacturing, and service sectors accounted for more than half of all investments.
- Investors tended to be male, were highly educated, had previous experience at the managerial levels of new firms, were among Canada's most wealthy individuals, and had an average age of 50.
- Informal investors demonstrated more risk tolerance than did less wealthy non-investors.

(2) Tax Policy

- The current exemption from capital gains tax is not particularly effective in prompting informal investment. Investors would, of course, prefer some exemption to none.

- Investors suggested such additional measures (among others) as:

    - reductions in corporate taxes;

    - the elimination of capital gains taxation on the proceeds of investments in small businesses;

    - expansion of the ability to write off investment losses against income.

Two aspects of taxation policy were problematic: instability occasioned by frequent changes to tax regimes, and tax benefits that distort capital markets.

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(3) Investment Vehicles

- Provincial venture capital corporations were seldom used by informal investors. The high cost of compliance and the bureaucratic burden were cited as deterrents, especially for smaller investments.

- Local municipal endeavours were found the most effective means of supporting the informal market.

- Local intermediation services (often including a matchmaking facility) have evolved and require support. A national conference for the organizers of such services would provide significant benefit.

- Support of local endeavours is the most effective way to stimulate incremental informal investment.

(4) Addressing the 'Gap'

- There are no shortages of capital, innovations, or entrepreneurial ideas. Access to a potentially large supply of informal capital can only be facilitated by reducing the deterrent that investors perceive. The primary deterrent is the risk associated with financing small businesses and start-ups. The primary source of this risk is the pervasive perception that the principals of the firm lack the managerial skills to convert effectively an innovation or idea to a ***business*** opportunity. The gap, then, is one of education.

- Based on these results, the gap that needs to be addressed is one of training, of converting entrepreneurs into managers.

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INFORMAL INVESTORS IN CANADA: THE IDENTIFICATION OF SALIENT CHARACTERISTICS

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1. Introduction

It is well known that financing is a constraint to growth faced by many firms. This is especially true for those firms that are seeking equity in amounts less than $1,000,000.[1] The costs of evaluating and monitoring small investments limit the interest of institutional investors. Therefore, firms that require $50,000 to $1,000,000 of equity capital must depend on the **marketplace for informal capital**.

In the informal marketplace, wealthy individuals invest their personal funds directly in the small businesses of other individuals.[2] Such individuals are known as **informal investors**.[3] The role of informal investors in the risk capital market in Canada is a crucial one. The size of the market for

[1] Strong evidence to this effect has recently been reported in Competing in the New Global Economy, Vol. II of the Report of the Premier's Council. The researchers who prepared this report have found that a "lack of equity capital" was cited by 74% of the 71 firms they interviewed as either a "major constraint" (54%) or "a constraint" (20%) to growth. It should be noted that the sample of firms on which this finding is based had "survived to tell the tale"; the degree to which a lack of equity capital (or other factors) might have contributed to the failure of other firms remains unknown.

[2] Historically, informal investment predated organised stock exchanges and venture funds. It is by means of such investment that most older firms originated. Little is known about informal investors in spite of their historical significance.

[3] After the fashion of show business angels (people who provide financial backing for plays and musicals), informal investors are also frequently called *angels*.

informal capital has been estimated (in the U. S.) as being at least as large as (and according to one estimate, several times larger than) the formal institutional market for venture capital. Informal investors have been found to be *the* primary source of equity capital for new firms.[4] Moreover, the time and effort involved in the entrepreneur's search for expansion capital involves a significant expenditure of managerial time and attention. Other activities of the infant companies may suffer while their owners attempt to procure investment capital. Constraints on expansion and the potential failure of the firm are likely consequences of fruitless attempts to obtain growth financing.

Therefore, the facilitation of access to equity capital would have several benefits. First, it would directly sustain the expansion of growing firms and the attendant job creation. Second, easing access to equity capital would permit entrepreneurs to focus more on the development of the operational aspects of their businesses, a focus that enhances the likelihood of business success. Third, the managerial talents of informal investors can provide significant guidance for the business owners, guidance that also helps ensure success. Fourth, improvements in the efficacy of the market for informal capital would provide for a greater degree of competitive bidding. This might result in reductions in the cost of equity capital. Finally, once it becomes common to be able to obtain finanancing, firms would be better able to use it, resulting in larger startups, startups that are better able to be sustained.

An improved understanding of how the informal investment marketplace functions and of the nature of informal investors is necessary to obtain the above benefits. Little is known about informal investors' characteristics or about how the informal market functions;[5] less is known about the motivations, decision-making processes, or salient characteristics of informal investors. In the absence of this knowledge, policy initiatives may lack a sound basis and might be ill-advised.[6] It is argued, therefore, that public policy development requires a much more developed knowledge base than has heretofore been available: hence this study.

This report outlines the findings of a cross sectional research study that seeks to identify more meaningful and salient attributes of informal investors, and attempts to develop policy implications based on these attributes. One objective of the research project is the identification and evaluation of specific ways in which informal investors differ from otherwise comparable people who do not invest in small

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[4] For example, Wetzel and Frear (1988) have found that in the U.S., the role of informal investors is complimentary to that of institutional venture capital sources and that informal investors are the single largest source of equity financing for those business seeking less than $1,000,000. See W. Wetzel and J. Frear, "Equity Financing for New Technology-Based Firms", Babson Entrepreneurship Research Conference, Calgary, Alberta, May, 1988.

[5] Preliminary profiles of informal investors were compiled by Wetzel (1985) and by Gaston and Bell (1986) based on data from the U. S., and by Short and Riding (1988) using data from one site in Ontario. Because of the seminal nature of this literature, the profiles have, of necessity, been limited to superficial attributes and demographic descriptions.

[6] A recent example is the COIN program, a national program that sought to use computer technology to match investors with entrepreneurs. This program failed for a number of reasons, reasons that will be addressed subsequently in this report. However, inherent in COIN's failure were the following misperceptions: that the marketplace for informal capital was national, when, in fact it is a local marketplace; that the marketplace for informal capital is impersonal, when, in fact, it is intensely personal; and that the investors in the marketplace desired access to a wider range of investment possibilities, when, in fact, they perceive a more than adequate stream of such opportunities.

firms. Additional objectives are: to document the processes according to which informal investors make investment decisions; to identify the criteria behind their choices; to report on the nature of the marketplace for informal risk capital; to learn about the psychological characteristics and motivations of informal investors; and to identify informal investors' perspectives regarding the barriers and opportunities inherent in the market.

This report documents the findings of this study. In Chapter 2, previous work is summarized and examined critically. The third chapter presents the methodology used to draw the sample and reports on the process by which the data were compiled. The fourth chapter describes background material pertaining to patterns of informal investment across industrial sectors, by size of investment, etc. In Chapter 5, the process by which informal investors make decisions is detailed, along with rejection rates at various stages of the process, and analysis of the reasons that led to rejections. Investors' expectations are also detailed in Chapter 5. The factors that motivate informal investors to be active are reported in the sixth chapter. The ways in which the informal marketplace operates are described in Chapter 7, along with reports on two case histories of attempts to provide remedial assistance to the market. Personality profiles of informal investors are described in Chapter 8. Investors' responses to and advice on public policy as it relates to informal investment are reported in the ninth chapter. The report closes with a summary of the findings and recommendations.

2. Previous Research and Motivation for This Work

Research on informal investors is recent in nature and at an early, indeed, exploratory, stage. The seminal research on the informal market for risk capital in the U.S. was carried out by William Wetzel. In his 1983 study, he provided evidence that informal risk capital investors may represent one of the largest pools of venture capital in the United States. Short and Riding (1988a) have reported some preliminary estimates of the size of the pool of risk capital in the Ottawa-Carleton region. Their estimates are consistent with Wetzel's contention that the market for informal risk capital is of a significant size. These preliminary estimates of the size of the informal market rate it as at least as large, in dollar terms, as the institutional venture capital market. Moreover, the *potential* size of the informal market is yet many times greater.

Wetzel found that informal investors often invested in those areas experiencing so-called capital market gaps. (Here, a gap is defined as the difference between the demand for, and supply of, capital.) Wetzel contended that while the perception of gaps is understandable, actual shortages in the supply of risk capital may not exist! Wetzel argued that the perception that a gap existed was more a reflection of the disorganized and fragmented marketplace for informal capital than a true fact. Wetzel therefore advocated the formation of a central clearinghouse of investment information. As a result, he developed the Venture Capital Network, a predecessor for other computerized matchmaking services. These services attempt to mate investors with opportunities.

Profiles of informal investors compiled by Gaston and Bell (1986), Wetzel (1983), and Short and Riding (1988a) suggest common elements in the profiles of informal investors. They are well-educated individuals of means who have had experience, at the management level, in the start-up of new business ventures. The research is agreed that investors typically prefer to invest geographically 'close to home', although exactly what 'close to home' means is not completely clear. Investors exhibit a preference for investing in common stock and for syndicating with other informal investors in the financing deal.

Short and Riding have noted some differences between Ottawa-Carleton investors and their U.S. counterparts. Investors in the Ottawa-Carleton region are characterized by higher levels of activity, lower levels of involvement in the management of the firm, and higher rates of rejection of possible deals. Investors in the Ottawa-Carleton region also have more capital committed to individual investments than do U.S investors.

Riding and Short (1987), in a related study, found that *entrepreneurs* perceived the marketplace for informal risk capital to be inefficient. Entrepreneurs believed that gaps in the informal marketplace were real and that these gaps were significant impediments to growth. These perceptions, however, were *contrary to the impressions of informal investors.* Informal investors were satisfied that they were exposed to a more than sufficient deal flow. Consequently, investors expressed a low level of interest in matchmaking systems and they did not place a high priority on remedial action for the informal marketplace.

Short and Riding (1988b) also noted that Ottawa investors were convinced that the management team in young or start-up companies makes the difference between success and failure. The researchers also noted that investors held realistic expectations regarding the outcome of their risk capital investments. The study concluded that informal investors were sophisticated investors.

While investors recognize the risks inherent in investing in young or start-up companies, they do not appear obsessed with those risks. Ottawa-Carleton investors expressed risk/reward expectations consistent with those of investors from the San Francisco Bay area (Krasner and Tynes, 1983). They perceived less risk than did New England investors. The similarity between the risk perceptions of Ottawa and California investors may, in part, be explained by the concentration of technology-based firms in both areas. This is what Wetzel (1985) calls the "silicon valley phenomenon". According to this phenomenon, individuals in areas dominated by high technology firms would perceive these firms to be less risky than would individuals from other areas. It follows from this finding that the preferences of informal investors may differ from region to region. Accordingly, it remains to be ascertained to what extent the findings of Short and Riding are generalizable across Canada.

Nor is it clear to what extent gaps in the supply of early stage venture capital exist or to what extent policy initiatives have ameliorated ineffective market mechanisms, mechanisms that may contribute to the perception of a gap. Thus, considerable further research about informal investing is also required in order:

- to conduct a more comprehensive comparison of informal investors with non-investors and to assess differences among investors;
- to assess more extensively the impacts of, and responses to, government policy initiatives;
- to obtain a better understanding of the motivations of informal investors, so that future policy initiatives may be targeted with enhanced precision;
- to examine the informal risk capital marketplace for operational and allocational efficiency, its size, and its relative importance compared to the institutional segment of the venture capital market;
- to examine the impact on informal investors of a variety of public and private sector initiatives; and, finally,
- to determine what demographic or personal attributes are characteristic of informal investors.

Previous studies have shown that the informal market is very much a local marketplace and a personal marketplace. Interactions among investors form an important part of informal risk capital investing decisions. The investigation of the social interaction among investors may assist in determining whether or not certain investors are more prominent in influencing the investment decisions of other investors.

None of these issues yet appear to have been addressed in the published research literature. The next section outlines the methodology used in this study, a study that seeks to build upon the findings of previous research.

3. Methodology

To accomplish the objectives of this study, two tasks need to be accomplished. First, the research must identify characteristics that distinguish informal investors from people who do not invest. Second, the predictive power of these characteristics needs to be assessed. As minimal empirical research has been published about these issues, there is little to guide the a priori selection of potentially germane characteristics. The organizational behaviour and finance literatures suggest that the constructs listed in Table 1 may independently or in combination help discriminate between investors and non-investors.

Table 1: Potential Factors of Relevance to Informal Investors

Attribute	Specifics
Demographics	Gender, education, age, marital status, age and number of children, ethnic origin, life-cycle stage, number of financial dependents.
Family Situation	Age and education of spouse, employment history of spouse, life-cycle stage of spouse, career cycle stage of spouse, investment experience of spouse.
Investment Experience	Past investments, value of investments, investment partners, involvement with investments, geographic and sectoral preferences, required rate of return, liquidation expectations, expected future investment, performance of past investments, previous investment partners, impacts of and responses to public policy incentive programs.
Financial Status	Family income, net worth, total personal assets, liquidity of assets, spousal income, spousal net worth, spousal personal assets.
Communication Networks	Sources of investment opportunities, perceived usefulness and effectiveness of sources, number of sources.
Personality	Locus of control, need to achieve, need for power, flexibility, tolerance towards risk, need for security.
Investment Opportunities	Geographic area, number and value of investment opportunities of which aware, familiarity with available investment opportunities.
Employment History and Knowledge Base	Position in place of employment, business experiences, number and types of previous employers, awareness of processes of informal investing..

This research had three stages. The objective of the first stage was to develop appropriate survey instruments for the balance of the study. In this first stage, investors and non-investors were interviewed and gathered into "focus groups" to describe aspects of the investment process. On the basis of these discussions, structured questionnaires were prepared and pre-tested. The various agencies that supported this research all were provided with the opportunity to amend the questionnaire to meet their respective objectives for the research. The result was a lengthy questionnaire and, therefore, one best administered by personal interview. Reliable, valid, pretested measurement instruments from the literature were used when possible. A copy of the questionnaire employed in this study is included as Appendix A to this report.

The second stage of the research involved administering the questionnaires. The majority of questionnaires were administered by personal contacts and interviews to verify and enrich the questionnaire findings. Sampling was employed based on a nominated sample technique (see Short and Riding, 1988). Data were collected from investors and from non-investors encompassing a variety of geographic and economic regions. This aspect of the research was carried out by a combination of personal interviews and endorsed questionnaire mailout techniques. Interview subjects were identified in a variety of ways. Initial contacts were established through the good offices of Canadian New Ventures Ltd., the Canadian Opportunities Investment Network (COIN), and those of several Boards of Trade. Appendix B outlines the specifics of the data-gathering phase.

Potential respondents were contacted and personal interviews carried out during the period May 1991 through December 1992. In several instances, the intermediary assisting organization (e.g., COIN, sevral Boards of Trade) chose not to identify the potential respondents to the primary researchers. In these cases, the organizations mailed questionnaires to their contacts on behalf of the researchers. Such mail-out packages included:

- a personal letter from the local Board of Trade to endorse the research;
- a letter from the primary researcher that stated the goals of the study and which promised confidentiality;
- the questionnaire and a self-addressed return envelope.

A total of 411 completed questionnaires were received.

Identification of investors and non-investors was accomplished by interpreting the responses to the questionnaire. An informal investor was defined as a person:

- who had made multiple investments directly in small businesses (Question 25); or,
- who had made only one investment directly in small business but who did not participate directly in the operation of the business (Question 43).

On this basis, 279 of the respondents were identified as informal investors. The other respondents included 14 individuals best described as professional venture capitalists. Among the other respondents were 23 entrepreneurs (people who had made only one investment and who were actively involved in the management of that business) and 95 people who had not invested at all in small businesses.

Table 2 presents a breakdown of the geographic representation of the respondents. Because of its size, Ontario is subdivided into five separate geographic regions.

The third stage of the research involved the analysis of the responses to the questionnaires and the reporting to research supporters. The specific analytical procedures are described, in subsequent sections of the report, in the context of the findings drawn from their usage. This stage is an iterative process, with the principal researcher providing an initial report, then expanding and amending the report to accommodate, where possible, additional findings of particular interest to the sponsors.

Table 2: Geographic Distribution of Respondents

Geographic Region	Non-Investors	Informal Investors	Entre-preneurs	Venture Capitalists	Total
Maritime Provinces	41	58	7	4	110
Western Provinces	3	40	2	1	46
Quebec	3	19	2	1	25
Ontario Totals	48	162	12	8	230
Ontario: Toronto	14	71	2	6	93
Ontario: Central	13	35	3	2	53
Ontario: North	1	5	0	0	6
Ontario: Niagara	7	13	1	0	21
Ontario: East	13	38	6	0	57
Totals	95	279	23	14	411

4. Patterns of Informal Investment

4.1 Patterns of Investment Activity

The informal investors who responded to this research study reported having invested in 1,172 investments domestically and 162 investments located outside of Canada. Table 3 provides a breakdown of these investments according to region.

Table 3: Breakdown of Investments by Region

Geographic Region	Investments in Canada	Offshore Investments	Total
Maritime Provinces	185	29	214
Western Provinces	255	28	283
Quebec	84	8	92
Ontario Totals	648	97	745
Ontario: Toronto	330	57	387
Ontario: Central	112	14	126
Ontario: North	10	3	13
Ontario: Niagara	64	11	75
Ontario: East	132	12	144
Totals	**1,172**	**162**	**1,334**

The 1,334 investments represented a total stake of more than $171 million over the 1986-1991 period, an average of approximately $126 thousand per investor per year. The distribution of the number of investments, by size of investment and by region, is reported in Table 4. It is seen that informal investment activity is approximately uniformly distributed across size categories. However, because the frequency of small deals is similar to that of larger deals, it is clear that most of the money flows to the larger deals. For example, more than 85 percent of the informal investment capital had been invested in deals of greater than $100,000.

Table 4: Distribution of Investments by Size:
Number of Investments

Size of Investments	Maritime Provinces	Quebec	Ontario	Western Provinces	Total
Less than $10,000	18.8	13.0	15.6	17.7	16.4
Between $10,000 and $24,999	19.8	15.2	15.1	12.4	15.2
Between $25,000 and 49,999	18.8	5.4	12.5	22.6	15.1
Between $50,000 and $99,999	11.6	17.3	15.9	13.8	14.9
Between $100,000 and $250,000	19.8	12.0	25.1	11.7	20.6
Greater than $250,000	11.1	37.0	15.9	21.9	17.8
Total	99.9	99.9	100.1	100.1	100.0

The distribution of the number of investments by industrial sector is reported in Table 5. These data reflect that the commercial foci of the regions differ significantly from each other. The preponderance of investments are in the manufacturing, resource, and services sectors. However, it should be remembered that a disproportionate sampling of respondents was from Ontario, hence, the Canadian totals are influenced towards the Ontario norms.

Previous work in both Canada and the U.S. found that 80 percent of investments were located within 50 miles of home or office. While a majority of the investments reported in this study lie within this radius, a significant proportion, approximately 30 percent, of investments are located more than 300 miles from investors' home bases. While many investments are indeed made nearby, for Canada as a whole, and for each of its major geographic regions, a high proportion of investments is made at a significant distance from the investors' home bases. These results are at some variance with the previous U.S.-based studies. This finding may reflect the geography of the country; however, this finding could also be consistent with larger investment dollar commitments or with a perceived scarcity of attractive investment opportunities locally.

It was also found that Canadian informal investors generally invest as members of syndicates. Overall, 74.6 percent of the investments involved informal investors additional to the questionnaire respondent. Investors other than informal investors were involved as participants to a much lesser extent: 8.7 percent of the deals included institutional venture capital companies, and the FBDB was involved in 5.2 percent of the deals. Nationally, only 2.7 percent of the deals were structured as provincial venture capital companies (e.g. SBDC in Ontario, etc.). Even in the province of Ontario, where SBDC's have been most prevalent, only 3.9 percent of the deals employed the SBDC vehicle. This finding suggests that the SBDC structure is not meeting the needs of informal investors and may need significant review and remediation.

The primary means by which informal investors learned about investment opportunities were from business associates and through active personal search. Investor respondents rated business associates as the single most useful source by which they learned of business opportunities. Business associates were responsible for more than 60 percent of the referrals. Seventy percent of respondents confirmed that they regularly refer entrepreneurs to other investors. The high incidence of referral activity and the frequent use of syndication implies that the informal market may not be as fragmented or as inefficient as had been commonly believed. These data, in fact, suggest that the market operates at a surprisingly high level of efficiency despite its low profile in Canada's capital marketplace.

This suggestion of efficiency is reinforced by the low levels to which institutionalized matchmaking initiatives have been employed by investors. A majority of investors were simply not familiar with COIN. Of the 279 investor respondents to this research, 23 had used COIN, less than ten percent. Moreover, it is even this large because COIN cooperated with this research by sending every investor on its database a copy of the questionnaire. Because of anonymity, it is not possible to estimate the percentage of people listed as investors in the COIN database who did respond. Only five of the respondents who stated they had used COIN indicated that they were frequent or very frequent users of COIN, and only 11 indicated that they would use COIN again.

These negative findings lie in contrast to the relative success of the Investment Opportunities Project (IOP) operated by the St. John's Board of Trade. The IOP, as near as can be estimated, has as many investors listed with it, in Newfoundland, as did COIN nationally. In addition, 87.5 percent of the investors who had used the IOP indicated that they would use it again. The differences between COIN and the IOP will be considered in more detail in a subsequent section of this report.[7]

[7] For now, it should be noted that the IOP extends investors services that COIN did not provide. The IOP provides advocacy to investors with respect to negotiating and structuring deals. The IOP operates at a local level and has built up a reputation for integrity and professionalism within its sphere of influence. It also provides counsel to entrepreneurs with respect to business plan presentation, referring them to consultants as necessary so that investors are not exposed to inchoate or unrealistic propositions. By taking advantage of the local nature of the informal investment market, and ensuring that the entrepreneurs listed with it have reasonable business plans, the IOP has apparently succeeded where COIN has failed and at a fraction of the cost.

Table 5: Informal Investments: Breakdown by Industrial Sector

	Proportion of Investments				
	Maritime Provinces	Quebec	Ontario	Western Provinces	Total
Retail & Wholesale Trade	13.7	10.7	12.3	3.6	10.7
Manufacturing: High Tech	7.3	8.6	14.2	10.4	12.0
Manufacturing: Ind'l & Consumer	11.0	21.5	16.4	10.4	14.7
Service	23.7	1.1	12.9	9.4	13.1
Construction	16.9	5.4	4.3	5.8	6.6
Financial	7.3	7.5	6.1	5.0	6.2
Natural Resources	10.1	21.5	14.9	27.3	17.0
Real Estate	6.4	18.3	12.1	24.8	14.1
Other	2.3	5.4	5.1	2.9	4.2

4.2 Characteristics of Canadian Informal Investors

Almost all of the informal investors involved in this study were male (273 of the 279). The age distribution of informal investors is shown in Table 6. Approximately 60 percent of the investors were less than 50 years of age. This age distribution is marginally lower than that reported in previous studies.

Table 6: Age Distribution of Informal Investors

Age Category	Number of Respondents	Proportion of Respondents
Less than 35 years of age	50	18.2
36 to 50 years of age	113	41.1
51 to 65 years of age	95	34.5
66 and over	17	6.2

Of the investors who responded to the question on marital status, 84 percent reported being married or living with a significant other. Of these spouses, 53 percent worked for pay, primarily in managerial or professional capacities. Informal investors were well-educated, with almost forty percent of investors reporting a post-graduate degree. Table 7 presents a breakdown of the education levels reported for informal investor respondents.

Table 7: Educational Backgrounds of Informal Investors

Educational Background	Informal Investors (% of total)
High School or less	10.9
Community College	7.0
Some University	12.0
University Degree	30.2
Post-Graduate Degree	39.3

One significant way in which informal investors differed from the other categories of respondents was with respect to their financial resources. Table 8 summarizes the average values, standard deviations, and number of cases for family incomes, total assets, and total personal net worth for each of three categories of respondent.

Table 8: Aggregated Financial Backgrounds of Survey Respondents

Financial Attribute		Informal Investors	Non-Investors
Family Income	Mean	176.8	126.5
($000)	Standard Deviation	72.8	63.3
	N Cases	256	86
Personal Assets	Mean	1,469.5	775.7
($000)	Standard Deviation	732.5	714.9
	N Cases	259	86
Personal Net Worth	Mean	1,362.9	681.3
($000)	Standard Deviation	785.4	726.8
	N Cases	248	75

The non-investors surveyed here reported financial resources that were much greater than those of most Canadians. However, the resources of informal investors were greater still. On average, personal assets reported by investors were almost twice those of non-investors. Personal net worths of informal investors also averaged almost twice those of non-investors. Further, income levels of informal investors were significantly more than those of non-investors. Potentially, this is a finding that could prove of value for public policy targeting.

With such substantial financial resources, it is hardly surprising that informal investors did not limit their investments to small businesses. Of the informal investors who responded:

- 74 percent also reported investments on Stock Exchanges;
- 69 percent reported investments in real estate (other than principal residence);
- 53 and 50 percent reported investments in GIC's and bonds, respectively; and
- 46 percent reported investments in mutual funds.

A minority of investors reported yet other forms of investment. These results strongly indicate that informal investors are highly diversified across a variety of investment categories.

Within the ranks of informal investors, it is also possible to discern sub-categories. For example, Table 9 presents the distribution of the proportion of annual incomes derived by investors from their risk capital investments.

Table 9: Informal Investments as a Source of Income

Proportion of Income Derived from Informal Investments	Proportion of Respondents
Less than 2 percent of income	24
2 percent to 10 percent of income	21
11 percent to 25 percent of income	16
26 percent to 50 percent of income	6
More than 50 percent of income	33

The distribution shown in Table 9 is bi-modal: at one extreme are those investors who glean a minor part of their income from their investments. At the other extreme are those individuals whose incomes are heavily dependent on the proceeds of their risk capital investments. This separation could be the result of poor investment decisions; alternatively, it may represent different types of investors within the informal investor definition.

4.3 Investor Demands

It is clear that equity investments in SMBs have a significant element of risk associated with the investment. As compensation for assuming this risk, investors demand a risk premium.

Since angel investing is characterized by the financing of start-up and young companies, the risk associated with early stage investments is considerably higher than that at later stages.

Ruhnka and Young (1987) found that venture capital firms in the United States demand, on average, an annual rate of return between 55-73% for seed and start-up financing, and 35% for the later stages of development. Plummer (1987) also documented discount rates used by U.S. venture capital firms that average between 41-75% for early stage ventures. Wetzel (1981) recorded that American angel investors demand an average rate of return of 50% for seed and start-up firms, yet only 22.5% for exit stage investments. On average, the informal investors surveyed in this study expected an after-tax, non-compounded rate of return of 32.3%. Since many angels are in the 51% tax bracket, a pre-tax rate of return of 51% is comparable with the findings with other studies.

Risk diversification is commonly used by angel investors to reduce the risk profile of their portfolio of investments. Respondents to this survey invested, on average, in three different industries and, as has been previously reported, typically invested in the stock market and other forms of investment endeavour.

Ruhnka and Young (1991) outline some other commonly used risk reduction strategies employed by venture capital firms. One is a long-term hold strategy so that the geometric average of compound returns from the winners will offset the losers in the portfolio. The average holding period anticipated by the investors who responded was 6.35 years. This confirms the notion that angels provide *patient* capital.

Another way of reducing risk is by becoming part of the board of directors or advisors. Participation in the management of the venture will increase the amount of control an investor has over his/her investment. Of the participants in this research, 89.5% of the respondents said they expected to serve on a board of directors or advisors when they invested in a private company. Moreover, 33.4% participate directly in a business as an operating principal. Again, this study provides empirical evidence that angels provide more than equity financing to SMBs. Ruhnka and Young's (1991) analysis of risk reduction strategies would suggest that the motivation for involvement in investee companies is more than purely altruistic.

An investor will also protect his/her investment by placing operating covenants on the entrepreneur(s). These covenants often take the form of periodic reports, authorization of cash disbursements over a preset amount, control over salaries and dividends, and control of the financial structure of the firm. They ensure that the entrepreneur is acting in the best interest of the company, rather than in his/her own best interest. These expectations were confirmed by this study, which found that 62% of respondents stated that they had negotiated operating covenants in the deals they had made in the past.

There are also legal means by which the rights of both investors and entrepreneurs may be protected: namely, by means of a formal shareholder's agreement. This document provides investors with the legal rights to ownership of the company based on the amount of equity financing. Informal investors do, as a rule, draw up formal agreements: 89.4% of those surveyed insisted on a formal shareholder's agreement for their investments.

Often, investors will hold both debt and equity positions in the investee firm. This may also be considered a risk reduction strategy. Equity may guarantee the investor a share in the profits if the investment is a winner, but debt will guarantee some form of compensation if it is a loser. Of those surveyed, 72% structure their deals to include both equity and debt positions. The debt-equity arrangement often takes the form of convertible debt arrangements or of straight debt with warrants attached.

4.4 Summary

This section documented characteristics of respondents to this research. The attributes of informal investors were found to be, in general, consistent with those derived from previous research. The investors were found to be significantly more wealthy that most Canadians, and to occupy the top stratum (top one percentile) of wealth among Canadian households. In general, they were found to be well-educated. The nature of the investments made by these investors was documented and found to cross most sectors - industrial and geographic - of Canadian small businesses.

Investors were found to work within syndicates and to employ a variety of risk reduction strategies, including diversification and involvement in the direction of the firms. They were seen to demand rates of return that were approximately consistent with those expected by other investors of risk capital. It was also found that investors have not, in general, availed themselves of two important public policy initiatives (COIN and SBDC's), initiatives that had been intended as stimuli to informal investing. It is appropriate that more specific attributes of informal investors be considered at this point.

5. Investor Decision-Making

5.1 A Model of The Decision Process:

The decision process faced by informal investors was modelled as a three-stage process as presented in Figure 1. This model was presented in the questionnaire completed by informal investors. Most investors (79.2%) agreed that it was an accurate representation of their decision making process. According to this model, the initial step occurs when investors first become aware of a business investment opportunity. Typically this occurs through active personal search or on the recommendation of business associates. At this point, the investor must decide whether to consider the particular opportunity to reject it out of hand.

The second decision moment occurs if the business opportunity has not already been rejected after the investor has contemplated the enterprise. At this point, having examined a business plan and possibly having discussed the matter with associates, the investor must again decide whether or not to pursue the opportunity by meeting with the principals.[8] Alternatively, the investor could elect to reject the proposal.

The third decision point arises once the investor has met with (and perhaps even negotiated with) the principals. The investor is yet again faced with the decision to reject or, alternatively, to invest.

In order to further understand the decision-making process, informal investors were asked to rate, on a 7-point scale, 10 criteria they may take into account when deciding whether or not to invest in an opportunity. Investors were asked to provide these ratings for each of the decision-making moments. Mean ratings give some indication of the relative importance of certain criteria (see Table 10). The execution of the due diligence process is reflected by the manner in which the importance of the various criteria changes through the stages of the decision-making process. The investor becomes progressively better acquainted with all aspects of the investment before an investment is consummated.

[8] The respondents who did not feel that the diagram was an accurate representation of their decision-making process stated that very often Times 0 and 1 are not distinct. Often informal investors receive business plans by mail. They become aware of *and* consider a business opportunity when they review the business plan. With that caveat, this model was deemed to be a reasonable paradigm of the decision-making process, a representation from which fairly accurate inferences may be made about informal investors' decision making and due diligence.

Figure 1: Schematic Representation of investor Decision-Making Process

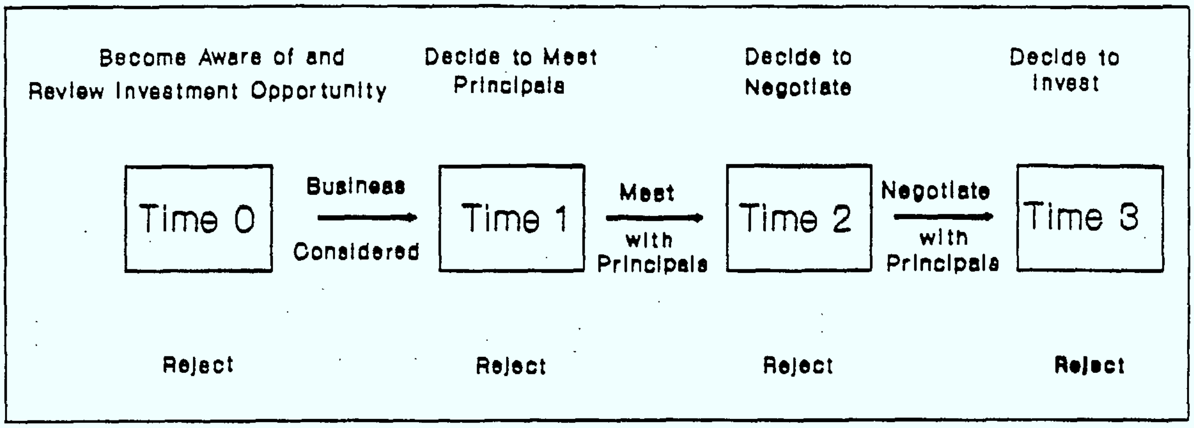

Table 10: Mean Ratings of Importance of Criteria

Criterion	Time 0	Time 1	Time 2
Potential of Industry	5.81	5.68	5.78
Potential Product or Idea	6.25	6.24	6.35
Having a Business Plan	4.87	5.42	5.78
Realism of Business Projections	5.27	5.67	6.01
Opinion of Your Colleagues About the Opportunity	4.12	4.31	4.53
Background of the Principals	5.81	6.12	6.10
Fit with Your Own Background	4.13	4.29	4.13
Fit with Other Investments	-	3.40	3.40
Perceived Financial Rewards	5.89	6.01	6.25

A closer analysis of individual respondents' ratings provides an alternative means of reaching generalizations about the importance of each investment criterion. Table 11 presents the three criteria most frequently rated "very important" or given a score of seven on a seven-point Likert scale for the three decision moments.

It should be noted that the present study cannot tell whether respondents employ non-compensatory procedures, compensatory procedures, or some combination. A compensatory decision procedure is one in which, for example, a very low industry potential can be made up for by a very high rating on the background of the principals. A non-compensatory procedure would reject the opportunity that had a very low potential of industry regardless of the ratings of other criteria.[9] This is an obvious area for further research. Nonetheless, based on the results of this work, the following generalizations may be made about the decision-making process of the average investor.

Table 11: Most Important Decision Criteria
(Measured by Fraction of Investors that Rated Criteria "Very Important")

Criterion	**Percentage of Respondents that Rated Criterion '7'**		
	Time 0	**Time 1**	**Time 2**
Potential of Product	59.9	59.6	64.7
Potential of Industry	47.6	42.7	47.8
Perceived Financial Rewards	42.5	47.3	57.5
Background of Principals	41.5	55.1	55.4

Initial Impressions (Time 0). At the onset, informal investors judge an opportunity based on the potential of the product, the industry, and its perceived financial rewards. The *potential of the product* is the most important criterion because it is a quick and simple way to assess the investment's soundness. Since new businesses are often created from innovations, the legitimacy of the opportunity is based on the investor's perception of a potential market. Similarly, the *potential of the industry* allows a further measure of an opportunity's viability because it represents a broader classification of the product's potential. *Perceived financial rewards* determine if further investigation is warranted because the cost of investigating the opportunity, or conducting the due diligence process, must be offset by a return better than that of alternative investments.

On average, 72.6% of opportunities presented to informal investors are rejected at this point. If they decide not to reject the opportunity, the business is considered and a due diligence process commences.

Initial Investigations (Time 1). The importance of the *Principals Background* increases at this stage; it becomes more important than any other criterion save only the *Potential of Product.* A lawyer with a long history of informal investing stated that a typical background check involves credit checks and employment history, as well as reference checks. This procedure is a customary part of many of the transactions that this respondent processes.

At this point, investors reject, on average, an additional 15.9% of the opportunities originally presented to them. The cumulative average of the rejection rate to Time 1 is 88.5%, reflecting the high standards that investors require of the investments that they decide to finance.

[9] These two decision procedures are not mutually exclusive. Both could be employed by the same person at different stages of the decision process.

Due Diligence (Time 2). This third decision making moment arrives after once the investor has met with the principals, has performed due diligence, but before negotiations have started. In actuality, it represents a decision of whether or not to negotiate. The three most important criteria at this stage are: *Potential of Product, Perceived Financial Rewards*, and *Background of Principals*. With the performance of due diligence, the investor has a more informed opinion of the opportunity's *Perceived Financial Rewards*, and this now becomes the second most important criterion. Similarly, the ranking of the *Realism of Business Projections* is deemed very important and given a 7 score by 53% of the respondents, compared with 35% who had given it a score of 7 at Time 1. This criterion is rated very important at this time as it is the foundation on which negotiations are based, and as it provides the investor with a means of checking on the managerial abilities of the founders of the firm. The reason for the lower rating of *Background of the Principals* is because if the investor does not like the entrepreneur, the opportunity will already have been rejected at Time 1.

The mean rejection rate at this stage is a further elimination of 6.3% of the original opportunity set. The cumulative rejection rate is 94.8%; in other words an investor will negotiate a price with an entrepreneur for only 5.2% of potential investments.

Consummation (Time 4) The fourth decision-making moment arrives during the negotiations surrounding the deal. Of the original opportunities, 2.82% are rejected at this stage. More than half of the deals that reach the negotiation stage are not consummated. Investors have cited reasons such as "could not agree upon price, or ownership structure", "disliked principals", and "discovered new information about the deal" as the most common reasons for walking away from the investment at this late point.

These aggregate findings, however, are not uniform across all investors. There is evidence that the decision processes of more experienced investors differs from that of less experienced investors. This is in accord with other results in the decision-making literature. The next section, therefore, examines the effect of investors' experience on the decision-making process.

5.2 Investors' Experience and Investors' Expectations

Findings of this study suggests that the decision-making process may be a function of investor's experience. To this end, it becomes necessary to measure "experience". Two alternative measures are employed: one based on investment intensity, the other based on age. To derive the first measure of experience, respondents were classified according to investment intensity. This wss measured by the number of investments made in Canada and abroad for the five-year period prior to completing the questionnaire. Three intensity categories were then developed. The first category contained the 92 respondents who had invested in two or fewer investments over the previous five years. This group is considered as "low-intensity" investors. The second category comprised the 108 angels with three to five investments over the same period - "medium-intensity" investors. The third category contained 70 respondents who had invested in six or more informal investments over the five-year period. These were considered to be "high-intensity" investors.

This intensity factor may not measure experience perfectly since investors were only asked about the number of investments they had undertaken over a five year period. As an alternative measure of experience, respondents were also classified by age. Age should offer an additional surrogate for experience. Surprisingly, the two measures, intensity and age, are not correlated significantly (rank correlation 0.0801). Generation gaps might be expected to exist for no other reason than as a result of changing technologies. The age categories are presented in Table 6.

The five-year time interval used here spans periods of both very high growth (1986-88), and recession (1990-91). It should be noted that in September of 1990, an N.D.P. government was elected in Ontario. At the time the interviews were conducted, this government was considering a Bill that would have made members of boards of directors personally liable for employees wages in the event of bankruptcy (Bill C-70). Since many informal investors sit on the boards of these SMBs (often without salary) to provide guidance, sentiments about the investment climate were negative.

Table 12 presents investors' expectations broken down according to the two alternative measures of experience. The impact of experience is clearly evident from these data. Specifically, younger investors expect, on average, a higher rate of return on their investments than do older investors. This difference was statistically significant at a 90% level. It is not clear why this is so. Perhaps younger investors provide more seed capital than older investors, and therefore demand a higher rate of return. Evidence of this may not be extracted from this data set as investors were asked for details of their investments in both start-up and young companies without having to distinguish between the two. Another possible explanation is that younger investors are more naive and therefore have higher expectations of their investments.

Table 12: Expected Rates of Return and Holding periods by Experience

	Sample	Age				Investment Intensity		
		< 36	36-50	51-65	>65	Low	Medium	High
	n=226	n=43	n=92	n=79	n=12	n=80	n=89	n=57
E(Rate of Return)	32.29% (46.95)	**48.34%** (60.63)	**29.77%** (53.35)	**29.10%** (29.02)	**15.08%** (9.38)	30.98% (45.51)	31.74% (45.51)	35.01% (35.36)
E (Holding Period) (years)	6.35 (2.80)	**5.07** (2.11)	**6.87** (3.62)	**6.87** (3.62)	7.00** (2.86)	7.01* (3.80)	6.18 (2.58)	5.81* (3.17)

Significance tests:

Ho: There is no difference between means across categories. Ha: There is a difference between means across categories.

* denotes statistical significance at 90% level; ** 95% level; bold denotes 99% level; ( ) brackets contain standard deviations

Young investors have the shortest expected holding period, as well as the highest expected rates of return, of the four age categories. The difference among the under 35, the 36 - 50, and the 51 - 65 age categories is significant at the 99% level, and 95% significant for the 66 and over category. This might suggest that young investors do not employ an extended hold strategy to reduce their risk profile. Again, the younger investor may lack the patience displayed by older investors. A significant difference was also viewed between the low- and medium-intensity groups. A possible explanation is that high-intensity investors cannot afford to be as patient as low-intensity investors because their personal stake in informal investments is larger.

It is interesting to speculate on these results. On the one hand, it is conceivable that the lower expected rates of return demanded by older investors may represent the realistic experiences of more experienced investors. Alternatively, they may reflect the patience that often accompanies age. On the other hand, perhaps those older investors who continue to invest are those who always had lower, more attainable, expectations. Investors whose higher expectations may not have been realized may have abandoned the marketplace.

No other significant differences were observed in investors' expectations. This is probably a result of the high percentage of investors that expect to serve on boards of directors or advisors, demand a formal shareholders agreement and negotiate operating covenants. Analysis of investors' decision making process should shed some light on the reasons why differences exist between age and investment intensity groups.

5.3 Impact of Experience on Decision-Making

Table 13 contains the mean ratings of each decision criterion by age categories[10]. The null hypothesis under consideration here is that age populations have the same distributions of decison criteria. In both cases, rejection of the null hypothesis implies that the "bulk" of one population's ratings is higher or lower than the ratings of the other population. The mean ratings are shown in order to better illustrate the differences between groups.[11]

When the data were segmented by age, certain significant differences were observed. The under 35 age category rated the importance of industry higher than both the 36-50 and the 51-65 age categories at Time 1 and 2, with the significance level set at 90 percent. Similarly, the data showed mean differences between the under 35 category and the next two older categories and were significant at the 95 percent level at Time 0 for the rating of *Fit With Your Own Background.* Older investors gave it a higher score, deeming it more important than younger investors. Similarly, older investors rated *fit with other investments* lower than younger investors.

One investor explained that, in theory, it would be ideal if synergies between investments could be realized. However he explained that the entrepreneurs who are focussed on a single opportunity have egos that do not allow synergies to be a reality. These differences may be explained by a comment made by a 28-year-old informal investor. He said industry was perhaps the most important aspect an investor should consider because even if the product fails, valuable industry knowledge is acquired for future investments, or to modify the original business. The concept of acquiring knowledge through experience/experimentation is brought forth in the 28-year old investor's comment. The findings support the notion that younger investors experiment more than older investors, perhaps in pursuit of knowledge. This supports Wetzel's (1983) claim that schools for venture investors are on the streets.

These findings, along with the fact that the mean rejection rate was lower (not significant) for investors under 35 years of age and for the older categories (see Table 16), would indicate that older investors are quicker to reject proposals brought to them, perhaps based on industry. It should be noted that the overall investment rate does not differ significantly between age or investment intensity categories.

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[10] The data were also segmented by investment intensity, but findings were not conclusive.

[11] The Mann-Whitney U-test statistic and the Z statistic (for tests that contained samples with greater than 30 cases) were used to determine whether or not differences between groups within the age and investment intensity categories existed. This test is the most practical alternative to the parametric t-test. The Mann-Whitney mean ranks do not illustrate the differences quite as clearly. However, the significance tests shown in the tables are computed using the Mann-Whitney test statistic, which is more suitable to ordinal scale data.

Table 13: Mean Scores of Investment Criteria by Decision-Making Moment and Age
Ho: There is no difference between mean ratings of investment criteria across age categories
Ha: There is a difference between mean ratings of investment criteria across age categories

Criterion	Time 0					Time 1				
	Mean	Age				Mean	Age			
Importance of ..		< 35	36-50	51-65	>65		up to 35	36 to 50	51 to 65	>65
	n=95	n=21	n=	n=	n=	n=92	n=21	n=39	n=32	
Potential of Industry	5.81	5.91	5.73	5.82	6.08	5.68	6.04**	5.49**	5.64*	5.92
Potential of Product or Idea	6.25	6.16	6.25	6.28	6.39	6.24	6.26	6.14	6.31	6.42
Having a Business Plan	4.86	4.73	4.91	4.84	5.08	5.41	5.28	5.54	5.34	5.42
Realism of Business Projections	5.27	5.14	5.21	5.42	5.31	5.67	5.53	5.72	5.71	5.67
Opinions of Colleagues	4.13	4.31	4.26	3.90	3.85	4.31	4.49	4.48*	3.97*	4.50
Background of the Principals	5.81	5.86	5.71	5.89	5.85	6.15	6.02	6.26	6.12	6.08
Fit with Your Own Background	4.14	3.49**	4.33**	4.29**	4.14	4.29	3.94	4.37	4.46	4.08
Fit with Other Investments	-	-	-	-	-	3.40	3.51	3.63	3.16	3.00
Perceived Financial Rewards	5.89	5.63	6.06	5.82	6.00	6.00	5.85	6.15	5.92	6.09

* signifies statistically significant at the 90% level; ** at the 95% level; *** at the 99% level

Table 14: Mean Scores of Investment Criteria by Decision-Making Moment and Age

Ho: There is no difference between mean ratings of investment criteria across age categories
Ha: There is a difference between mean ratings of investment criteria across age categories

Criterion	Time 0				
	Mean	Age			
Importance of ..		< 35	36-50	51-65	>65
	n=95	n=21	n=	n=	n=
Potential of Industry	5.78	6.02*	5.67*	5.71*	6.08
Potential of Product or Idea	6.35	6.26	6.35	6.40	6.33
Having a Business Plan	5.77	5.63	5.87	5.76	5.67
Realism of Business Projections	6.09	5.89	6.22	6.06	6.08
Opinions of Colleagues	4.54	4.57	4.61	4.34	4.92
Background of the Principals	6.10	6.09	6.06	6.11	6.50
Fit with Your Own Background	4.13	3.98	4.22	4.14	4.00
Fit with Other Investments	3.40	3.92*	3.62*	3.11*	2.56*
Perceived Financial Rewards	6.25	6.32	6.18	6.26	6.36

* signifies statistically significant at the 90% level; ** at the 95% level; *** at the 99% level

Table 15: Rejection Rates by Investment Intensity, Age Categories and Decision-Making Moments

Group		Time 0	Time 1	Time 2	Time 3	Overall Investment Rate
Sample	n=234	72.55% (25.45)	15.88% (17.56)	6.30% (8.13)	2.82% (4.61)	2.38%
Investment Intensity	Low n=76	70.47% (30.48)	19.27% (22.10)	6.04% (7.83)	2.93% (5.82)	1.29%
	Medium n=89	72.65% (22.29)	14.64% (14.15)	6.62% (7.46)	2.78% (3.70)	3.31%
	High n=61	74.66% (23.82)	13.66% (15.70)	6.16% (9.64)	2.82% (4.29)	2.71%
Age	> 35 n=45	69.73% (25.25)	18.05% (17.46)	6.39% (6.55)	2.70% (3.78)	3.13%
	36 to 50 n=96	71.42% (27.68)	17.38% (19.23)	6.22% (8.00)	2.95% (4.31)	2.03%
	51 to 65 n=81	75.56% (21.97)	12.58% (13.17)	6.60% (9.38)	2.60% (4.01)	2.66%
	>65 n=12	72.08% (30.56)	18.54% (26.49)	5.08% (6.29)	4.00 (8.27)	0.3%

( ) brackets contain standard deviations

Analysis of the reasons for rejecting opportunities shows surprising conformity (see Table 16). The overwhelming majority (80%) of respondents agreed that they had rejected investment opportunities presented to them because of their lack of confidence in the managerial abilities of the principals. This was the single most frequent reason for rejecting. Despite the fact that the majority of angel investors offer guidance to the entrepreneur in their capacity as a member of a board of directors or advisors, they still expect the entrepreneur to demonstrate the skill level required to operate the venture. The angel is investing in the entrepreneur as well as the business.

Table 16: Reasons for Rejection by Age and Investment Intensity

Significance tests:

Ho: There is no difference between % of respondents who agree across categories

Ha: There is a difference between % of respondents who agree across categories

Reason for Rejection	Percentage of Respondents who Agreed they had Rejected an Investment for Listed Reason							
	Mean n=258	Age				Investment Intensity		
		> 35 n=50	36-50 n=106	51-65 n=88	>65 n=57	Low n=86	Medium n=108	High n=63
Unfamiliar with Technology or Nature of Investment	48.4	48	48	47	57	43	49	54
Market Potential Insufficient	56.2	60	54	59	42	56	53	64
Lack of Confidence in Management	80.2	76	81	81	86	73**	82	87**
Unsatisfactory Risk/Return Ratio	62.0	56	61	66	56	59	63	65
Inadequate or Unsatisfactory Business Plan	41.5	30*	42	47*	50	38	42	27

* denotes statistical significance at 90% level; *** at 95% level

A parametric *t*-test was used to determine if differences between groups existed for the rejection rates for the various reasons for rejecting an investment. Once again, there were differences among the different categories for the reason for rejection. The most notable difference was between the low and high-intensity investors. High-intensity investors were more likely to reject an opportunity because of a lack of confidence in management than were low intensity investors. There are two possible explanations for this finding. The first is that high-intensity investors do not have as much time to nurture an investment as do low-intensity investors, and therefore are very careful to invest only in those opportunities with a good management team. Alternatively, high-intensity investors have more experience, and realize that informal investments are investments in entrepreneurs.

5.4 Conclusions

One of the most important findings of this study is that the stages of the decision-making process used by informal investors in Canada can be modelled as a three-stage process. It is a decision-making process that sets high standards for ventures under consideration, and one that leads to a very small percentage of investments actually undertaken. On average, one deal in 40 is financed.

The majority of investments are rejected before the investor ever meets the principals. This finding argues strongly for well-developed and realistic business plans. The business plans presented to investors must accomplish at least three tasks. They must demonstrate the financial potential of the enterprise; and they must demonstrate the managerial abilities of the principals of the opportunity; they must capture the attention of the investor and differentiate the opportunity from the many others that come to the attention of the investor.

In the later stages of the decision-making process, the merits of the investment are judged by financial as well as principal-related factors. Risk is only one component of the high expected rate of return. Compensation for the time and effort invested in monitoring and guiding the venture justifies an expected rate of return that exceeds the risk-free rate by a factor of 6-10. This rate is comparable to expectations held by venture capitalists and informal investors in other areas.

The notion that informal capital is patient capital is confirmed with these findings. The respondents' expected holding period is, on average, just over six years. This is because the return is customarily realized in the form of a capital gain when the informal investor is bought out in a public offering or by a professional venture capital firm.

Age tends to affect an investor's decision-making process. Younger investors are not as hasty as older investors to reject opportunities presented to them, but there is no statistically significant difference in the overall investment rate across ages. Similarly, older investors prefer to invest in opportunities that fit with their background. These findings tend to indicate that younger investors also attempt to acquire knowledge through their investment activity.

6. Informal Investors' Motivations

6.1 Introduction

Little is known about what motivates informal investors. This section outlines findings drawn from the research data about what the motivations of informal investors might be. The results could help entrepreneurs to better fashion their business plans to improve their chances of finding equity financing. For academics, this research seeks to add to knowledge about how this inchoate marketplace functions. Policy-makers can use the findings to better target initiatives designed to redress the perception of a 'capital market gap'. With a better understanding of the motivations of informal investors, policy-makers can target future policy initiatives with enhanced precision. Because informal investors are the target of important government policy initiatives, it makes sense to identify what motivates them to be active in this primitive capital market. Such knowledge may be useful to help encourage more investors to become active.

6.2 Methodology

From the previous section, it was found that investors rejected 97.2 percent of the investment opportunities to which they had become exposed. In 72 percent of the instances, the opportunities were rejected out-of-hand, before any serious investigation of the business. By far, the primary reason for rejecting an investment opportunity was a lack of confidence in management. On the other hand, investors did report a significant level of investment activity, a level of activity that contributes to the importance of the informal marketplace as a vehicle of economic development, enterprise expansion, and job-creation.

6.3 Empirical Findings

Among the hypotheses under investigation in this research is the proposition that informal investors consider non-financial aspects of potential investments as important determinants of their invest/reject decisions. To discern what prompted investors to reach favourable decisions, the survey asked investors to rate the extent to which they agreed or disagreed with a series of statements. These statements, shown in Table 17, related to why they had decided "to invest directly in a business opportunity." This table presents the mean scores (on a 7-point scale where 1 corresponds to complete disagreement and 7 signals complete agreement). Note that financial returns have the fourth highest mean rating; it is rated a '7' by only 27% of respondents.

- Investors protected themselves against risk by diversifying across markets and industries, investing as members of syndicates, involving themselves in operating the firms, establishing contractual arrangements and covenants with the other owners, and using debt.

- Investors expected pre-tax rates of return averaging approximately 51 percent. This rate is consistent with rates required by venture capitalists.

- Investors expected to hold their investments for an average of 6.35 years.

The Functioning of the Informal Marketplace

- Investors had little use for impersonal matchmaking services or provincial venture capital corporations such as Ontario's SBDC's. Investors do not need matchmaking services; they perceived a more than sufficient deal flow.

- The potential supply of informal capital is vast, but remains largely untapped. The gap in the market is the dearth of attractive opportunities. This shortage results from the perception that the principals of firms lack managerial abilities.

- Local matchmaking services were found to facilitate informal capital formation because of the screening and advocacy in their operation.

- Investors learn about potential opportunities primarily through personal means and (especially for distant opportunities) from business associates.

- References from business associates are important determinants of investment decisions.

- The informal marketplace functions at a high level of efficiency; communications and syndication among investors and other participants occur with considerable productivity.

Investor Decision-Making Process

- A three-stage process, investors reject an average of 72.6 percent of proposals out of hand and an additional 15.9 percent after initial investigation. Approximately one proposal of 40 results in consummation of a deal.

- The perceived potential of the product and industry, the perceived backgrounds of the principals, and the anticipated financial payoffs were the primary determinants of investment decisions.

Motivations of Informal Investors

- Three broad factors directed investors' decisions to invest:

    - expectation of financial rewards;
    - level of comfort felt about an investment; and,
    - the degree of excitement and affiliation associated with the project.

Psychological Profiles of Informal Investors

- Investors tend to be men with internal locus of control, very high needs for achievement and dominance, and moderately high needs for affiliation and autonomy.

- Investors are intrinsically motivated, highly involved with their work and their investments, very satisfied with their jobs, and moderately satisfied with their investments' performance.

- Investors report high levels of perceived stress and cope with this stress by working harder.

Therefore, to improve their chances of attracting informal risk capital, entrepreneurs should:

- present the investment as a challenge;

- offer investors a formal leadership position in the organization and include investors in the decision making process;

- offer investors such non-monetary incentives as learning opportunities, media attention, etc.;

- keep informal investors advised on an on-going basis and provide them with opportunities to contribute more than money.

Recommendations

(1) For intermediation

- Boards of Trade and local economic development agencies should be used to house intermediation services.

- Intermediaries ought to incorporate well-known minimum 'listing requirements'.

- Consideration should be given to establishing amendments to legislation such as "Regulation D", used in the U.S., to qualify specific types of investors as 'sophisticated' and exempt them from prospectus protection.

Table 17: Reasons for Investing Directly in Small Businesses

	Text of Statement	Mean Response
F.	I have confidence in the business's principals (n=266)	6.20
C.	I understand the nature of the business opportunity (n=267)	5.50
H.	My research indicated the opportunity had potential (n=266)	5.49
A.	I expect large financial returns (n=268)	5.37
L.	I have confidence in my ability to manage the risks (n=267)	5.35
B.	I value my participation with the individuals involved (n=268)	5.06
I.	I value the recommendations ... by people whose judgement I respect (n=266)	4.90
D.	It is important ... to be a part of creating something (n=266)	4.81
M.	My gut-feeling regarding possible investments is dependable (n=268)	4.63
G.	I value the sense of excitement associated with my involvement (n=268)	4.51
E.	I have had previous experience in this kind of business (n=266)	4.14
J.	The business is the "be-all and end-all" of the principals' financial future (n=264)	3.90
K.	It is more fun than gambling (n=263)	3.46
N.	I am lucky in such endeavours (n=265)	3.01

Examination of the individual items in this table suggests that the highest-rated items with respect to prompting a decision to invest in small businesses were: the investors' confidence in the business's principals, their understanding of the nature of the business opportunities, and that their research indicated that the opportunity had potential. A factor analysis of these items, however, provided further information.

Factor analysis was employed to associate statements with potential underlying motivating factors. Factor analysis is a statistical technique used to identify a relatively small number of factors which govern responses to a larger set of variables. It attempts to measure concepts that are difficult to define using a single variable measure. For example, "athletic ability" may be expressed as a function of agility, coordination, speed, and strength. "Athletic ability" is a concept that is not, inherently, objectively measureable. However, a series of objective measures of skills that relate to the unmeasurable concept can communicate the sense of 'athletic ability'. Factor analysis is a statistical means of identifying factors that govern responses to a variety of seemingly disparate measures.

The results of factor analysis are typically interpreted in raw form as well as after 'rotation'. Pre-rotation results simply identify relationships but it is difficult to identify meaningful factors, unequivocally, from the pre-rotation results. Often the variables and factors do not appear correlated in any interpretable pattern (Norusis, 1989). Rotation is a mathmeatical technique which allows factors to be identified from various 'views' of the data. The results obtained after varimax rotation are used here. Table 18 illustrates the groupings and factor loadings (weights) after varimax rotation. As noted in this table, factor analysis was able to discern four general factors which, together, act as motivations for informal investment decisions: affiliation, chance, comfort,[12] and financial.

The first factor, affiliation, describes how investors agree that active participation, the sense of being part of creating something, and the related excitement are part of informal investing. A second factor also emerged, one that conveyed a sense of 'chance': gambling, luck, intuition, risk, and principal's financial involvement are related because they are all statements that allude to the notion of a "quick and dirty" method of evaluating investment opportunities. A third factor that was discerned was the expected financial factor. The fourth factor corresponded to the level of comfort felt by the investor about an opportunity.

According to the Association of Canadian Venture Capital Companies' 1992 annual report (ACVCC (1992)), the most obvious indicator of management's commitment to the project is the financial commitment of the firm's principals. The 'comfort' factor relates understanding, experience, research, and opinions of others. Compared to the chance factor, the comfort factor may be considered "an educated guess", based on the findings of due diligence, as to the success of an investment opportunity. The financial motivation factor is governed by an investor's perceived financial gain, his/her perception of the entrepreneur's ability, and, to a lesser extent, the entrepreneur's invested interest.

Those variables (statements) that had factor loadings above .55 were averaged into four general indexes, each conveying the investors' scorings of the importance of the summed variables associated with each factor. Cronbach-Alpha values were computed to measure the association of the variables that constructed the factors. This internal consistency technique was selected because it is particularly useful for variables which are measured from Likert 7-point scales. The resulting alpha values may be found in Table 19.

[12] Comfort is really not a motivation, but the variable statements that contribute to this factor all indicate some sort of due diligence, or investigation process that the investor undertakes for informal investments.

Table 18: Varimax Rotation Results of Factor Loadings

Statement	Factor 1 "Affiliation"	Factor 2 "Chance"	Factor 3 "Comfort"	Factor 4 "Financial"
B I value my participation with the individuals involved (n=268)	.7618			
D It is important ... to be a part of creating something (n=266)	.7295			
G I value the sense of excitement associated with my involvement (n=268)	.7290			
N I am lucky in such endeavours (n=265)		.7757		
M My gut-feeling regarding possible investments is dependable (n=268)		.6914		
K It is more fun than gambling (n=263)		.6493		
J The business is the "be-all and end-all" of the principals' financial future (n=264)		.4949		.4582
L I have confidence in my ability to manage the risks (n=267)		<.45		
H My research indicated the opportunity had potential (n=266)			.7027	
C I understand the nature of the business opportunity (n=267)			.6994	
E I have had previous experience in this kind of business (n=266)			.5926	
I I value the recommendations ... by people whose judgement I respect (n=266)			.4502	
F I have confidence in the business's principals (n=266)				.7675
A I expect large financial returns (n=268)				.7303

Table 19: Reliability of Scales for Motivations

Motivation	Contributing Variables	Cronbach α	Mean Score n=268
Factor 1 Affiliation	B D G	.7228	4.753
Factor 2 Chance	N M K	.6565	3.714
Factor 3 Due Diligence	H C E	.4754	5.076
Factor 4 Financial	F A	.5232*	5.740

*As an alternative measure of association, a one-tailed t-test showed a significant (99%) positive correlation between variable statements A and F.

The financial and comfort (due diligence) factors have the highest mean scores, and it is therefore reasonable to conclude that these two factors are the primary determinants of investors'motivations. However, the affiliation factor cannot be ignored since the mean score is higher than neutral, and rests on the 'agree' side of the scale. The chance factor does not seem to be important since its mean score is slightly towards the 'disagree' side of the scale.

Essentially, these results indicate that there are three factors that prompt investment activity: financial, risk amelioration or comfort level, and affiliation. Investors do undertake informal investments for financial gain and they undertake a careful investigation process to assist them in deciding whether or not to invest. Investors also consider group interaction to be an important and attractive attribute of informal investing. Some investors acknowledge that luck and intuition are contributing factors to an investment's success, but most agree that it does not influence their decision to invest.

In order to explore the robustness of these results, the sample was partitioned according to the four geographical regions: Eastern Canada, Quebec, Ontario, and Western Canada. Factor analysis was repeated for the investor respondents from each region to ensure that the full sample results were consistent with regional patterns. It was found that Canadian investors are very much alike. There is a generalized conformity of responses concerning possible motivations. Table 20 contains the mean rating of each statement of motivation by region.

Table 20: Ratings of Statements of Motivations

Statement of Motivation	Mean Ratings				
	Canada n=268	Eastern Canada n=55	Quebec n=18	Ontario n=155	Western Canada n=40
A. I expect large financial returns	5.38	4.93	5.56	5.50	5.46
B. I value my participation with the individuals involved	5.08	4.93	5.56	5.06	5.15
C. I understand the nature of the particular business opportunity	5.50	5.31	5.61	5.60	5.33
D. It is important to me to be part of creating something	4.82	4.84	4.94	4.80	4.82
E. I've had previous experience in this kind of business	4.13	4.66	3.28	3.99	4.32
F. I have confidence in the business's principals	6.22	5.96	6.47	6.29	6.23
G. I value the sense of excitement associated with my involvement	4.51	4.84	4.22	4.39	4.69
H. My research indicated the opportunity has potential	5.48	5.56	5.28	5.45	5.61
I. I value the recommendations about the business made by people whose judgement I respect	4.90	5.26	4.59	4.74	5.18
The business is the "be-all and end-all" of the principals financial future	3.91	3.70	4.53	3.85	4.18
K. It is more fun than gambling	3.47	3.53	3.65	3.43	3.47
L. I have confidence in my ability to manage the risks	5.35	5.36	5.50	5.33	5.33
M. My gut-feeling regarding possible investments is dependable	4.63	4.67	4.94	4.68	4.23
N. I am lucky in such endeavors	3.02	3.09	3.11	3.02	2.84

Table 21 provides more decisive evidence that Canadian informal investors are alike. The table shows the rank correlation results of the mean ratings, pairwise, between regions. All correlations were statistically significant at the 99% level.

Table 21: Correlations of Mean Ratings of Motivations between Regions

Region	Eastern Canada n=55	Quebec n=18	Ontario n=155	Western Canada n=40
Eastern Canada	1			
Quebec	.8080	1		
Ontario	.8926	.9559	1	
Western Canada	.9490	.8276	.9381	1

Factor analysis was performed on each region to determine if non-financial motivations were considered important by investors in each region. Table 22 is a summary of the underlying motivations and their mean ratings. Note that no results are available for Quebec due to the small sample size.

Table 22: Summary of Motivations and Mean Scores, by Region

Motivation	Canada	Eastern Canada	Ontario	Western Canada
Excitement		3.985		4.099
Comfort	5.076	5.394	5.015	
Camaraderie		5.444		5.679
Experience		4.982		5.101
Financial	5.740	4.927	5.882	5.118
Affiliation	4.753		4.760	
Chance	3.714		3.718	
Instincts				3.526

Table 22 illustrates that non-financial motivations exist, and are considered important by investors in all regions. The similarity of the motivating factors across regions is particularly clear. In some regions, larger factors get subdivided into related subfactors; however, the essence of the national findings is found to be consistent.

From these findings, it becomes apparent that informal investors are people whose motivations are drawn from a variety of needs and personal characteristics. Informal investors realize a sense of achievement in two ways: they expect to attain financial gain, and they experience the excitement of being a part of a new creation. Social needs are also met by being a part of the team involved in the development of the enterprise.

6.4 Summary and Discussion

This section has presented the findings of empirical research which investigates the motivations behind informal investment. Investors rejected 97.2 percent of the investment opportunities to which they had been exposed. Based on investors' answers to a series of statements about why they invested, a factor analysis revealed four dimensions that accounted for a significant part of the variation in responses. Primary among these factors were factors associated with investors' expectations of financial returns from their investment and the level of comfort with the enterprise that results from the due diligence process. The other way in which achievement may be experienced is through the senses of involvement and excitement which accompany the creation of a worthwhile enterprise.

These findings are important. They provide entrepreneurs with a better sense of the needs which are important to informal investors. To the extent that entrepreneurs can use the business plan to communicate *both* the financial rewards and the sense of excitement, achievement, and affiliation inherent in the opportunity, their chances of acquiring financing are improved.

Policy-makers may also benefit from the findings. To date, policy incentives have focused on the financial dimension. These incentives typically relate to a variety of focused tax shelters. This research shows that the financial dimension alone may not be sufficient to induce job-creating investment in small firms. The management capabilities of the firms' principals must meet the investors' requirements. The investment opportunity needs to generate a sense of excitement in the investor and to provide the investor the chance to be part of the team involved in the achievement of an exciting objective. Government policy, therefore, may be usefully directed to support advocacy roles in local marketplaces. Trained intermediaries could direct entrepreneurs to management courses when needed. Fiscal incentives linked to job-creation results would be consistent with investors' own needs.

These results are also of value to academics. Without claiming to be either definitive or comprehensive, this research represents an additional step beyond the compilation of investor profiles. As such, new avenues for further research are indicated.

7. Operational Issues Regarding The Marketplace for Informal Investment

7.1 Introduction

Small and medium-sized businesses (SMB's) have consistently lamented the apparent absence of expansion capital, particularly equity capital. Lobby organizations and independent research have both noted that small businesses cite the lack of capital as the most serious constraint to growth. If growth is indeed inhibited by a lack of capital, then job-creation and economic prosperity objectives may be compromised. The claim is that a "capital market gap" exists; governments find themselves under pressure to ameliorate this perception. While pension funds and institutional sources of venture capital abound, few invest in SMB's. It seems a contradiction that small businesses face difficulty obtaining equity capital. It follows that the marketplace for equity capital does not appear to direct effectively capital from suppliers to users. The role of this chapter is to report on an investigation of the nature of this marketplace.

The specific purpose is to document three of the more important characteristics of the marketplace for informal capital. First, it reports on an attempt to provide estimates of the potential supply of informal venture capital. Second, it reports on an attempt to estimate the proportion of the total that is actually in play. Both such estimates, by their nature, are somewhat heroic. Finally, this section reports on the character of the marketplace for informal risk capital and about the effectiveness of attempts at remediation. These findings may indicate the extent to which policy initiatives may be able address the shortcomings of the marketplace, shortcomings that may be either perceived or real.

7.2 Potential Gaps in the Market for Informal Risk Capital

According to the economic theory of efficient capital markets, a capital market gap ought not to exist. If the demand for a commodity (e.g., capital) exceeds supply, economic theory posits that the price of capital (investors' required rate of return) would adjust until supply and demand reached an equilibrium. This aspect of the theory of economics, however, is predicated on several assumptions, including a basic assumption that the communications and information flows within the marketplace are freely available to all participants. In marketplaces where this assumption does not hold, it is not evident that a market-clearing equilibrium is achieved. It has been argued that the informal marketplace is indeed such an arena. The word 'gap', as it has been used in this context, has not had a clear meaning. Sometimes, it seems to mean that no market exists at all. At other times, it appears to refer to a lack of effectiveness of a market which does exist. Therefore, it is essential to identify more precisely the particular lament being voiced by SMB's and their lobbyists.

On the one hand, the claim that a gap exists in the face of received economic theory implies that the market for informal capital has malfunctioned. This claim suggests that the marketplace is not at an equilibrium and that the price of capital exhibits rigidity. There are certain well-known cases of government laws, rules, or regulations which may induce rigidity in financial markets. Appreciation of this is one factor that has given impetus to the worldwide movement towards deregulation of financial markets. On the other hand, it is possible that supply and demand are indeed in equilibrium. In this case, the problem is not that a capital market gap exists; rather, the problem is that the price of equity capital is unacceptably high.

In short, there are four possibilities:

(a) the informal market functions efficiently and perceptions of capital market gaps simply reflect an unacceptably high cost of capital; or,

(b) the informal market does not function efficiently and a gap indeed exists between supply and demand; or,

(c) the marketplace is constrained from reaching an equilibrium by particular barriers (such as poor communications between investors and entrepreneurs), with the result that the price of capital exhibits rigidity; or,

(d) a market for particular forms of financing simply may not exist at all.

These alternatives imply different remedial approaches.

7.3 Shortages and Surpluses

Economists hold specific meanings for the terms *shortage* and *surplus*. A shortage is said to result if the price of a commodity is too low; a surplus results if the price is too high. Taking the broad view, if there exists a 'shortage' of a good, there is just not enough to go around if everyone is to get the quantity he or she would like to have (at a fixed price). Entrepreneurs commonly complain about their perception of a shortage of venture capital. It is not clear what is meant by this charge. Perhaps the entrepreneur seeks more venture capital than he or she now has. But at what rate of return? A limited supply is typically rationed on the basis of price. In economic theory, if the entrepreneur's firm wants more capital, all it has to do is to raise the return it offers for investment capital. Hence, in a purely competitive market, there are only two interpretations of the lament that a shortage of capital exists, either:

(i) entrepreneurs don't want capital badly enough to raise their offering price significantly; or,

(ii) they are precluded from raising the rate of return by some institutional or legal constraint.

The first alternative is not a shortage in any economic sense. The second is, but the problem is more evident if restated directly: entrepreneurs are unable to raise the return on capital as much as they would like.

The idea, born of the theory of Economics, that supply and demand for capital would equilibrate, relies on several assumptions. One such assumption is that the marketplace is competitive. A second assumption is that the marketplace infrastructure permits the market to clear. These assumption may not hold. At one extreme, the market simply may not yet exist. It may be inchoate and primitive or it may be highly fragmented. Alternatively, the marketplace may have once existed but has disintegrated. The survey data provide some insight about these possibilities.

First, the results indicate that the *potential* supply of informal capital is very large indeed. Informal investors displayed a financial profile that differed significantly from that of non-investors. When investors are compared with non-investors as to assets, net worth, and total family income, it is clear that investors are significantly better endowed financially than non-investors.

More than two-thirds of investors report assets in excess of one million dollars; sixty percent of investors report net worths in excess of one million dollars and almost one-half of all informal investors report total annual family incomes in excess of $200,000.[13] This profile falls into the top one percentile of Canadian families. That is, this income level compares with the income level of approximately one percent of Canada's *families,* that is, approximately, 100,000 families.

The informal investors surveyed for this study report having made an average of 4.2 investments within Canada and .6 foreign investments for a total stake that averages $632,000 per investor (an average of $126,000 per year per investor) over the 1986-1991 period. Clearly, if even a sizeable proportion of the 100,000 Canadian families who have this type of financial wherewithal were active informal investors, there would be no capital market gap. The *potential* supply of informal capital is very large.

This estimate raises two questions. One question has to do with how much of the potential is actually in play. The other question relates to why potential investors do not participate in the informal marketplace.

As to the first question, some minimums can easily be established. The informal investors who responded to this survey together account for annual investments of $34.9 million. The overall response rate to this survey was 42.3 percent. If one supposes, therefore, that this survey successfully identified *every* informal investor in Canada (which, of course, it did not), then a minimum of $82.5 million of new investment is made by informal investors annually in Canada.

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[13] By comparison, less than one-quarter of the non-investors reported assets or net worths in excess of one million dollars; only 16 percent of non-investors reported annual family incomes which exceeded $200,000.

Conservatively, therefore, it is fair to say that the annual rate of new informal investment in Canada is of the same order of magnitude as the annual rate of new institutional venture capital. Due to the 'invisibility' of the informal market, it is more likely that the rate of new informal capital is approximately double the rate of new institutional venture capital (of the order of $500 million to $1 billion).

Even under the most optimistic assumptions, it is also clear that the potential supply of informal capital is barely being tapped. To investigate why this is so, the questionnaire asked both investors and non-investors to rate particular aspects of risk capital investment in terms of the extent to which each aspect encouraged them to invest, or discouraged them from investing. Investors did not differ significantly from non-investors except for one dimension: *non-investors viewed informal investment as significantly more risky than did active informal investors.* The two categories of respondents shared perceptions that related to tax incentives, the number of opportunities, the required size of investments, the lack of liquidity, the time required to search for deals, and the time required to help in the management of the firm. Only in perceptions of riskiness did investors differ from non-investors.

Non-investors were also asked, in a separate section of the questionnaire, if there were specific reasons why they did not invest in small businesses. The most common reason (reported by 40 percent of non-investors) was that too much risk was involved. The next most common reasons were that there was a lack of suitable opportunities (31 percent of non-investor respondents) and that too much capital was required (29 percent of non-investor respondents).

The lack of suitable opportunities was also noted by investor respondents. When asked to characterize the availability of "investment opportunities in which you would be seriously interested", 61 percent of active investors replied that such opportunities were "scarce", 24 percent reported "adequate" availability, and only 15 percent typified the availability as "plentiful". Investors agreed among themselves that it is getting more difficult to find high-quality investment opportunities. Specifically, 58.1 percent of investors reported that, compared with 5 years ago, good investment opportunities are scarcer. In general (44 percent of responses), this was attributed to the recession; however, 27 percent of the replies indicated that the marketplace for good opportunities was becoming more competitive.

From the evidence presented here, it appears that the gap in the marketplace, if any, lies more in the shortage of acceptable investment opportunities than in a lack of capital. It is clear that the potential supply of informal capital is very large and that informal investment activity represents a very small fraction of this total. Both investors and non-investors agree that good opportunities are scarce. Perceptions of risk are found to be the predominant factor that discourages non-investors from becoming active. To attract new investors, entrepreneurs must be able to reassure potential investors about the riskiness of their opportunity. One element of this risk evaluation is the investors' view of the entrepreneurs' ability to manage the firm.

7.4 The Mechanism of the Informal Market: Economic Theory

The Economic theory of price adjustments, a theory that argues against gaps in the capital market, is predicated on an assumption that markets operate efficiently. Akerlof (1970) presents an analysis of one way in which inefficient markets might disintegrate. He considers markets that are characterized by imperfect information and illustrates his reasoning by considering the market for cars. He distinguishes between new cars and used cars and between good cars and bad cars (lemons). The sellers of used cars are able to assess the likelihood that their car is a lemon with greater accuracy than can a potential purchaser. This information asymmetry has several implications.

First, it explains the existence of the large disparity between the average prices of new cars and of old cars. Buyers would logically expect good used cars to be sold to family and friends, leaving the lemons to go to the market. Second, it leads to a market in which good used cars sell at the same price as bad used cars. This is because a buyer cannot *a priori* tell the difference between the two: only the seller knows. In such a market, Gresham's law applies to the point that bad cars drive out the good: they sell at the same price. Under these conditions, potential buyers exit the market. Without intermediation, the market degenerates. This analogy is extended by Akerlof to explain why primitive capital markets, markets potentially like the informal market, do not operate efficiently and ultimately disintegrate.

Campbell and Kracaw (1977) amended Akerlof's argumentation, by introducing into a credit market a financial intermediary who is able to distinguish good firms from bad.[14] Without such an intermediary, the researchers showed that the market deteriorates in the manner predicted by Akerlof. In the presence of such an intermediary, however, firms' true values are reflected in market prices.

Chan (1983) explicitly considers financial intermediation in a venture capital marketplace in which information is asymmetric. Chan postulates the existence of entrepreneurs who put effort into a firm and who use part of the returns from the firms' operations to satisfy their current personal consumption. Potential investors cannot observe either the level of effort or the entrepreneurs' draw without an investigation. The investigation is, by assumption, costly. Chan shows that such a market will also fail without at least one intermediary who can find and evaluate opportunities at zero cost. Entrepreneurs will present only inferior projects. Investors would then have to conduct additional (costly) searches before finding a non-inferior opportunity. The total cost of serial searches reduces investors' anticipated rates of return. Investors then exit the market in favour of alternative investments. In short, marketplace degeneration is avoided only if the market for investment projects is accompanied by a market for information about the projects.

An alternative explanation of price rigidity is that the market infrastructure is inchoate. The extreme of this possibility is that no market exists. For example, researchers have remarked

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[14] One might think of this intermediary as a bond rating service, for example.

on the "Silicon Valley phenomenon". According to this observation, informal investment conforms to the local culture.[15] That is, no market may exist for particular industrial sectors of entrepreneurial endeavour in certain geographic locales. One should not underestimate the joint effect of: (a) the finding that the informal marketplace is local and personal; and, (b) the hypothesis that informal investors invest in projects about which they have good information and knowledge.

Imperfect markets also can result from legislative barriers, both in terms of their nature,[16] and in terms of compliance. The cost of compliance with legislation can be significant. For example, the cost of a preliminary legal consultation can represent a large portion of the annual rate of return on the average informal investment of approximately $100,000.

Additional barriers can take the form of the absence of certain types of information. In particular, some types of information can go a long way towards reassuring potential investors about the riskiness of a given investment. For example, organized marketplaces for capital, such as the stock exchanges, specify "listing requirements". The exchanges and governing bodies (SEC, OSC, etc.) provide a fiduciary role and enforce these requirements. Such reassurance does not exist for informal markets. The closest attribute to a listing requirement might be the role of high profile "lead investors", who may provide comfort to others by their involvement with an opportunity.

Organized exchanges also facilitate the engagement of buyers with sellers. However, in the informal market, central clearinghouses seldom exist. Such clearinghouses can potentially reduce the search costs associated with informal investing; however, the attempt to create a Canadian matchmaking system appears to have failed.

7.5 The Mechanism of the Informal Market: Empirical Findings

The survey data provide some insights about these issues. Fragmentation is assessed by asking investors about their geographic or sectoral limitations. Reasons for rejecting investment opportunities are solicited. The mechanics of the marketplace are evaluated from responses to

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[15] According to the silicon valley phenomenon, investment in high-tech opportunities are relatively more available in geographic areas in which high-tech firms are common, but investment in high-tech is relatively hard to find in areas in which there is already little in the way of technology-based firms. In areas characterized by technology-based firms, informal investors are willing to invest in technology (e.g, Cambridge, Mass., San Francisco Bay area, Ottawa-Carleton). Conversely, in areas in which the culture does not involve technology-based firms (e.g., Sudbury, Halifax), investors are reluctant to make such investments, and no market for capiattal for such firms exists in that area.

[16] Recent legislative initiatives propose to modify the responsibilities of directors. Informal investors frequently take an active role in management of the firm. Hence, investment activity could well be affected by changes to the potential liability of investors.

questions about how investors locate opportunities and matchmaking endeavours are appraised. Respondents are asked to characterize the availability of investment opportunities and to identify the extent to which they participate in management.

7.5.1 Informal Investor Networking

Virtually all previous research about the informal marketplace has documented that investors seldom invest very far from home base. As a result, it has been concluded that the informal market is inherently local. This study, however, brings an additional dimension to understanding how the informal market operates. First, it is true that a high proportion of investments are made in the immediate geographic area and in industries that have a high profile within the locality. In a somewhat surprising departure from results from the United States and England, however, the findings of this research show that as much as 30 percent of the investments were made more than 300 miles from the investors' home bases. The percentage frequencies of the geographic distribution of investments are listed in Table 23 for the various regions in Canada.

Table 23: Proximity Distribtution of Investments

	Canada	Eastern Provinces	Quebec	Ontario	Western Provinces
Less than 10 miles	36.0	54.0	48.9	30.9	39.1
10 to 49 miles	17.3	9.4	2.3	19.8	17.4
50 to 300 miles	17.4	14.0	18.2	19.6	11.0
More than 300 miles	29.3	22.6	30.7	29.7	32.4

Previous research (Short and Riding, 1987) has found that informal investor networks are local in nature and that communications takes place on a personal level. That is, the opinions of business associates and referrals are important. One cannot directly observe a network in operation. Nevertheless, there are a variety of signs indicating that networks are operative. It would be reasonable to conclude that networks operate if:

- investors introduce other investors to opportunities they review, regardless of the decision to invest
- investors cite other referral sources more often than personal active search as the most useful source of opportunities
- other individual investors are frequent co-investors

All three of these indications were found to be present among informal investors.

- 72.4% of respondents said that they introduce other investors they know to investments they undertake. Similarly, 70.6% of the investors who responded said that they refer the entrepreneur to another investor of their acquaintance even when they choose not to invest.

- Business associates and friends were named by 57% of respondent as the most useful source for generating investment leads. In fact, only 29.3% of respondents stated that active personal search was their most useful source for generating investment opportunities. Similarly, business associates received the highest mean rating for frequency of use.

- Of the investments undertaken by the sample of angel investors, 75% were co-financed by other individual investors. In fact, the next frequent co-investor type was professional venture capital firms. However, only 8.8% of investments included professional venture capitalists as co-investors (see Table 24)

Table 24: Percent of Investments Co-Financed, by Type of Co-Financiers*

Other individuals	75.0%
Venture capital firms	8.8%
Public economic development agencies (e.g. FBDB)	5.2%
SBDCs	2.7%
Other	8.8%

* Totals may not equal 100% since different co-financiers may be included in financing the same venture.

These findings indicate that angels prefer to invest close to home, but will not rule out a more distant opportunity if it has its merits. This finding raises the question of how informal investors, operating basically in a local and personal milieu, learn about more distant investment opportunities. The following propositions set forth the parameters of a model of how local networks , networks that operate on a personal basis, relate to other geographically remote local networks. Together, these propositions provide a framework for testing connections within and between informal markets and boundaries that they span. These propositions are:

- there is a positive correlation between the number of local investments and the importance of active personal search;

- there is a positive correlation between the ratio of investments co-financed with other individual investors to total investments, and the investor's rating of business associates and friends as referral sources;

- there is a negative correlation between the frequency of co-financed investments and the importance of active personal search.

All three of these propositions are confirmed by the data. A positive correlation exists between the ratio of investments located within 50 miles of the investor to total investments and the rating of personal active search as a source of new venture opportunities. The correlation is significant at the 95% level. This would indicate that investors actively search for investments close to home (and find them; see correlation chart). Both ratings of the importance of friends and business associates were positively correlated with the proportion of investments that were co-financed with other individual investors. Correlations were significant at 90% (friends) and 99% (business associates) levels (see correlation chart). A significant (99%) negative correlation is observed between the ratio of investments co-financed with other individual investors to total investments and the rating of personal active search as a source of new venture opportunities. Therefore one may conclude that an investor will hear of an investment form a referral source rather tha,n personal active search[17] when the investment is located at a distance.

These findings are consistent with Riding and Short (1988) and Haar *et al.*, (1988), who report that informal networks are composed of friends and business associates. The following conclusions may be drawn from the affirmation of all three propositions about the geographic nature of informal investments networks:

- informal investment markets tend to be local. When investments are made close to home, they are discovered by investors rather than referred to by friends and business associates.

- when investments are not close to home, they tend to be referred to investors by friends and business associates. Therefore, informal markets are very personal.

Together, the findings confirm that informal markets are **personal** and **local**. They add to our understanding by demonstarting that links within informal networks are geographically clustered, however, they are not limited to physical, geographic boundaries. There are linkages between informal networks that originate and develop from personal connections. The result is a marketplace that is surprising in its efficiency. The actions of syndication and personal

[17] Ambiguity surrounds the definition of "personal active search". It may include an investor actively searching through newspapers, initiating contact with an entrepreneur, or promoting him/herself as an angel. In general, personal active search will be considered anything but an opportunity generated from an known referral source. It will include the instances when an entrepreneur initiates contact with the investor if the investor is unaware that he/she was referred by another investor.

communication within a community provide for a high level of efficiency within the immediate locale. Communications by means of business-related networks between locales bring more remote opportunities to the attention of other market communities.

In the context of this model of the operation of the informal marketplace for equity capital, it is instructive to consider the remedial effect of particular initiatives. Two are considered here: the COIN program, and the Investment Opportunties Project of the St. John's Board of Trade.

7.5.2 Some Lessons From COIN

COIN was initiated as a mechanism to connect investors and entrepreneurs in an inchoate marketplace. Based on the assumption of an inchoate marketplace, the intent was to establish a community-based instrument to deliver relatively small amounts of start-up and expansion capital. Three understandings formed the foundation of the initial governmental support for COIN. First, support for COIN was forthcoming because COIN embodied an opportunity to "greatly facilitate the flow of capital from RRSP and Pension Funds" to the small business sector. Second, COIN looked to be a community-based initiative. Support was also predicated on the active involvement of the Ontario Chamber of Commerce [OCC, henceforth], that COIN would make use of the Board of Trade/Chamber of Commerce network. It was also understood that COIN would become self-sufficient and would operate independently of government. COIN did not succeed in accomplishing any of its goals.

The setting for COIN was grounded, on the one hand, in the well-documented problems that small firms face when seeking growth (equity) capital. On the other hand, it was understood that a large pool of capital was held by individuals in the form of RRSP funds. The 1986 Ontario Government Speech from the Throne announced COIN in its original Ontario-only incarnation. The Ontario government committed initial funding. On August 13, 1986, the Ontario Securities Commission ruled that COIN was exempt from prospectus requirements. *The OSC did stipulate that COIN play no screening role nor provide investment advice.*[18] COIN also had to include a disclaimer that network participants must themselves be in compliance with the Securities Act.

The launch of the Computerized Ontario Investment Network, COIN, occurred in November of 1986. A significant media advertising program and a 'road show', which involved the program management, accompanied the launch. The goal of the promotional campaign was to enlist 1,000 users. This was premised on the belief that:

[18] This turns out to be an important limitation. It essentially precluded COIN from providing qualification of any of the investments proposed to investors. In the context of Akerlof and his successors, it may well be argued that this stipulation contributed to COIN's ineffectiveness.

"The identified number of potential users of the system during the first year is estimated to be 17,000" [8,000 entrepreneurs and 9,000 self-directed RRSP's; emphasis that of the original]"[19]

and that "... the credibility of the OCC ... will further enhance the image of COIN". The advertising was a 'broad brush' approach. The thinking behind this strategy was exemplified by assertions such as: "...it's believed that one insertion weekly in the Toronto papers will be needed to generate sufficient inquiries to meet our goal of 1,000 users".[20]

COIN's financial statement data for the four months of operation ending April 1987 reported fee incomes of $9,450 and $13,450 from entrepreneurs and investors, respectively. The fee rates were $150 per entrepreneur and $250 per investor, less discounts ($50 to OCC members) and subsidies to local Boards of Trade ($25 to local branch). These data imply an initial registration of approximately 60 to 75 investors and about 75 to 125 entrepreneurs.[21] These registrations fall far short of the 1,000 participant goal.

In later years, it did not appear that the number of COIN participants increased according to projections. COIN's financial statement data for 1989 and 1990 reported total fee revenues of $51,775 and $48,583, respectively.[22] The $48,583 fee revenues for 1990 embraced $30,578 from entrepreneurs (implies 200 to 400 entrepreneurs) and $18,005 from investors (implies 80 to 100 investors).[23] These data provided some potential insights into COIN's efficacy.

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[19] COIN MARKETING PLAN, August 27, 1986, p.5.

[20] COIN MARKETING PLAN, August 27, 1986, p. 15.

[21] It is interesting that, at this early point in its development, COIN applied for and received a charter by letters patent (applied February 1987, granted March 25 1987) not as the *Computerized Ontario Investment Network*, but as the *Canada Opportunities Investment Network*. The proposal to form a Canada-wide investment network was not advanced until October 1987. That proposal sought $500,000, citing that the program "has proven to be an unqualified success in bringing together entrepreneurs and investors for face to face negotiations" (THE ONTARIO INVESTMENT NETWORK, AN INNOVATIVE APPROACH TO SMALL BUSINESS RISK CAPITAL FORMATION, p.3, attached to correspondence related to proposal for 'COIN Canada').

[22] A September 22, 1988, letter from COIN to the then minister, Monte Kwinter, asserted that "... the Ontario [COIN] program has undercovered [sic?] a hitherto undisclosed pool of available capital within your province of between $65 to 80 million." The COIN file did not contain financial statement data for 1988, so it is not clear how many investors participated in COIN in that year. Other data in the COIN file suggest an average of $450,000 of funds available per investor. Together, these data imply a 1988 investor population in the order of 200.

[23] CANADA OPPORTUNITIES NETWORK - COIN BUDGET 1991.

May 21, 1993.

In 1990, COIN's advertising stated that "about $250,000,000 ... from investors in Canada and up to $25,000,000 from offshore investors" was available in COIN.[24] COIN's own documentation[25] broke down the availability of funds from investors, as shown in Table 25.

Table 25: Availability of Investment Capital through COIN

Amounts Available	Availability from Investors (%)
Under $10,000	0
$10,000 to $25,000	6
$25,000 to $50,000	6
$50,000 to $100,000	17
$100,000 to $250,000	28
$250,000 to $500,000	14
$500,000 to $1,000,000	16
More than $1,000,000.	13

These data imply that the average COIN investor had about $450 thousand available for investment. (The median COIN investor had less than $250 thousand, according to this table.) If COIN indeed had $275,000,000 available, the COIN database must have represented at least 600 investors. This would imply an annual fee income from investors alone of at least $125,000. The data are reconciled if one supposes that the 13 percent of investors who have "more than $1,000,000" to invest include one or more institutional venture capitalists who, in principle, may have had access to very large pools of funds. However, COIN would not be needed for entrepreneurs to locate such investors; nor has previous research indicated that these investors are much interested in the low end of the equity market. COIN has been unable to achieve self-sufficiency, and its financial statement data do not reflect the claims of success in its promotional literature.

Moreover, COIN's impact on the informal market for risk capital appears to have been minimal. In order to evaluate COIN's impact on the market, the responses of 187 individuals, 126 of whom were informal investors, to the research questionnaire were employed. Analysis was restricted to Ontario because of COIN's Ontario origins and the relative emphasis accorded

[24] CANADA OPPORTUNITIES INVESTMENT NETWORK: OVERVIEW OF HOW? WHAT? WHERE? WHEN? AND HOW MUCH?, p.2.

[25] CANADA OPPORTUNITIES INVESTMENT NETWORK August 1990 Business Plan, Appendix C. This same appendix specifies the ratios of investors to entrepreneurs across a variety of industrial categories. In no industry is the ratio less than 1:1. The highest ratio is 8:1. One interpretation of these ratio data is that, on average, there are 3.9 times as many investors as entrepreneurs, when, in fact, the ratio of entrepreneurs to investors was between 2:1 to 5:1.

Ontario in COIN's approach. COIN sent questionnaires to the investors in their database. Fifteen responses resulted from the COIN mailout. One of these respondents did not complete the questionnaire and is not among the 126 investors in the sample.[26]

Awareness of COIN is estimated using the responses of the investors *not* contacted through COIN. The distribution of these responses is presented in Table 26. Investors were asked if they were aware of COIN. If they were aware of COIN, they were asked if they had used COIN. The breakdown of the replies to these questions are shown below. Those investors who had used COIN were asked if they would use COIN again.

Table 26: Awareness and Use of COIN in Ontario

Response	Number of Investors
Not familiar with COIN	58
Aware of COIN, have not used COIN	44
Have used COIN	9
No response	1

These results imply that COIN's advertising was ineffective. More than half the active investors surveyed in this research were unaware of the existence of COIN. Moreover, less than one in five of the investors who did report an awareness of COIN had participated in the program. One of the reasons advanced for this lack of participation was COIN's close identification with Price-Waterhouse, a major accounting firm. Financial advisors associated with other consulting or accounting firms would be understandably loathe to seem to refer a client to a competitor.

Of course, an alternative reason for the low rate of COIN usage is the prospect that investors did not need COIN. As structured, COIN may not have been suitable for their requirements. According to one respondent, the investor's pursuit of the entrepreneur (with COIN, the onus is on the investor to initiate contact) weakened the investor's subsequent bargaining position.

A consistent finding of all previous research is that business associates and friends are the primary sources of information about potential opportunities. These colleagues do not simply provide an alternative matchmaking facility. They also act as mentors in the investing process and may also fulfil an informal pre-screening role. This personal aspect of the market is important. An impersonal (computer-based), centralized (Toronto-based), matchmaking service is at variance with this innate nature of the marketplace.

[26] In such highly impersonal mailed survey research, a response rate of 15 to 25 percent is the norm. A return of 15 questionnaires from the COIN database therefore implies a population of COIN investors of 60 to 100 individuals.

Investors who had used COIN were asked if they would use COIN again. Table 27 breaks down the responses to this question according to the source of the response.

Table 27: Willingness to use COIN Again

	Respondents to COIN mailing	Respondents to main survey	Total
Would use COIN again	7	2	9
Would not use COIN again	3	7	10
Registered with COIN, but have made 0 investments	4	0	4

These results show that satisfaction was mixed. One respondent to the COIN mailing did not complete the questionnaire, but wrote as follows:

> "After filling out already two questionnaires for Coin and paying the $250 for their services (0 contacts, 0 recommendations during one full year), it was the last thing I wanted to receive an other [sic] form to complete from COIN. If you wish please look at the previous forms."

On the other hand, half of those respondents who had used COIN were willing to use COIN again.

Further insight arises from analyzing respondents' ratings of COIN vis-a-vis other potential sources of investment leads. The questionnaire asked investors to respond (on a 5-point scale where 1=not often, 5=very often) about how frequently they had employed each of 11 possible sources of investment leads. Figure 2 presents the means of the responses to this question. It shows these responses for the 18 investors who had used COIN and for 95 investors who had not used COIN. (Not all respondents answered this question.) From these data, active personal search, lawyers or accountants, business associates, and friends were all used more frequently than COIN. This is true of both sets of investor respondents and is fully consistent with previous research findings.

The questionnaire also asked investors which of these sources had been the most useful means of generating leads. Respondents cited business associates most frequently (by 59 investors). They cited active personal search second most frequently (29 investors). As the most useful source of leads, none cited COIN. In view of Ackerlof's and Chan's arguments about the need for a filter in the marketplace, these findings ought not be surprising. There are no real listing requirements for COIN; thus, COIN fails to provide protection against 'lemons'. Business associates, however, may provide informally a review of projects, reviews which are essential to preserving the integrity of the marketplace.

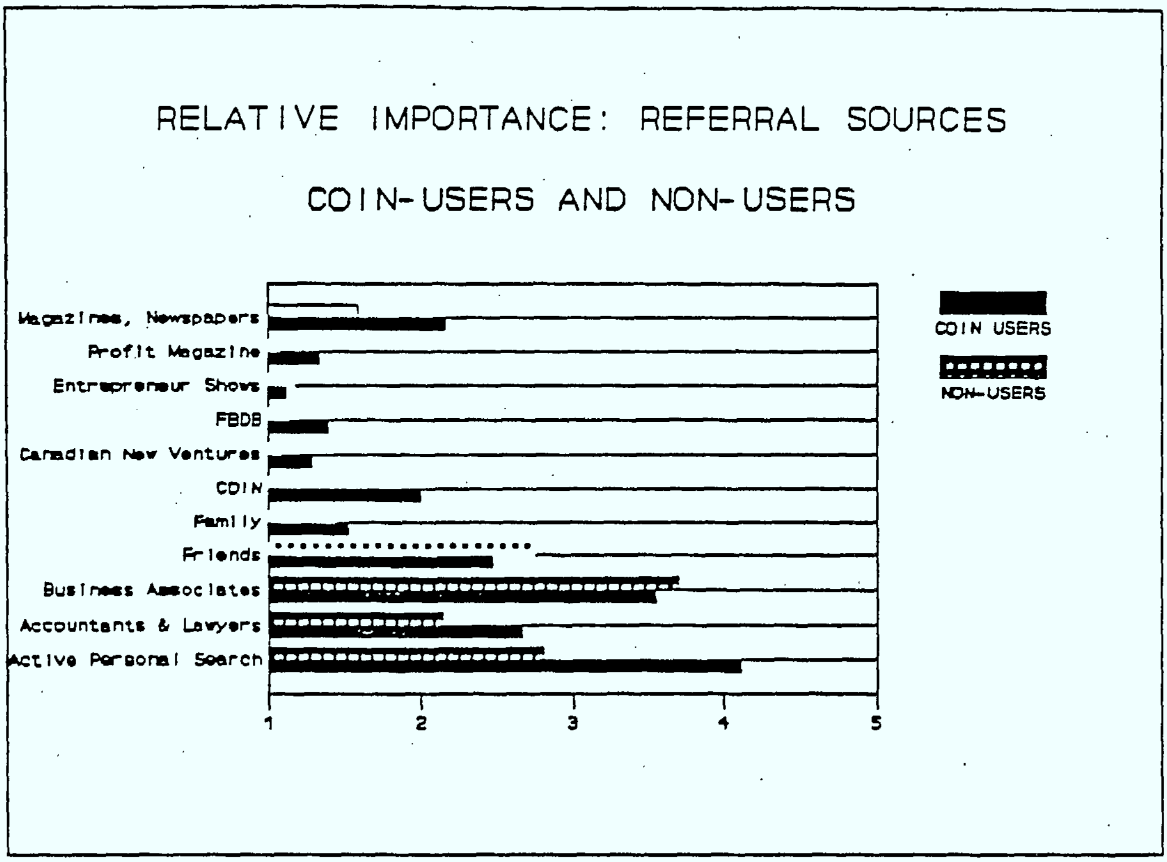

Figure 2: Relative Importance of Investment Leads

COIN does not appear to have facilitated the search for good investment opportunities. Sixty percent of the investor respondents perceived that, compared with five years ago, it was now more difficult to find high-quality investment opportunities, COIN notwithstanding. Among the forty percent of respondents who reported that it was now easier to find such opportunities, only one cited the availability of exchanges and databases (e.g. COIN) as a factor in the perceived improvement. From the investors' viewpoint, then, the problem with the informal market for risk capital is not an inability to make contact. Rather the problem they report is a scarcity of high-quality opportunities.

A further indication that COIN was not meeting the needs of the informal marketplace has been the formation of alternatives. Table 28 provides a listing of such alternatives with a short description of each.[27]

[27] A more detailed listing can be found in Williamson (1992).

Table 28: Alternatives to COIN

Investment Matching Service of Alberta	Operated by the provincial department of Economic Development and Trade, the service provides business-investor introductions. (2 offices)
FACE Business Opportunity Database	Business opportunities are listed with the Foundation for the Advancement of Canadian Entrepreneurship and published in FACE's Venture Source magazine.
FACE Enterprise Funding Board	After professional review of business plans, opportunities with sufficient merit are presented to FACE's Funding Board. Those accepted by the Board are provided intermediation assistance.
The Market Place Bulletin	Published by the Ontario Ministry of Industry Trade and Technology, the bulletin lists certain types of Ontario business opportunities. The bulletin is distributed to about 9,000 Ontario business executives.
British Columbia Investment Matching Program	Operated by the B. C. Ministry of Economic Development, Small Business and Trade, the program provides a listing of business opportunities in each region of the province. It provides matchmaking services and also aids with joint ventures, etc.
Ontario SBDC Program	The program attempts to match a profile of an entrepreneur's company with listed SBDC's (PVCC's).
The Investment Exchange, Calgary	A private sector initiative, the exchange claims to have more than 550 potential investors on its computerized database. Onus is left to the entrepreneur to contact potential investors.
Entinex Inc.	Provides (at a cost) a computerized listing of Canadian business opportunities.
Locating Investors for Niagara Companies (LINK)	Publishes a bulletin and helps Niagara-based manufacturing firms locate investors.
Investment Opportunities Project, St. John's Board of Trade	The IOP provides not only a matchmaking facility; it assists with the negotiation process and provides advocacy.

In addition, a number of venture capital clubs are also in active operation.[28] While the extent to which such clubs invest on behalf of their members is legally problematic, such clubs provide points of contact and ongoing educational opportunities. It is striking that in every case, these alternatives are local in nature.

In summary, investors do not report COIN to be an essential, or even important, element of their investment sourcing. Investors use alternative leads to potential investments more frequently than they use COIN, even investors registered with COIN. The importance of local leads and referrals may be one explanation of why COIN has failed to achieve financial self-

[28] The Venture Capital/Entrepreneur Club of Montreal, the Toronto Venture Group, and the York University Venture Capital Showcases and Forums are among these groups.

sufficiency and has been unable to approach its targeted number of participants. The deterioration of COIN as a marketplace is fully consistent with Akerlof's and Chan's predictions.

7.5.3 Some Lessons From the IOP

The Investment Opportunities Project (IOP) initiated operations in January of 1989. The project is operated under the auspices of the St. John's Board of Trade and has been funded by the Atlantic Canada Opportunities Agency (ACOA henceforth) and by the Economic Recovery Commission of the Province of Newfoundland. In the September 1988 proposal for funding to ACOA, a bi-focal purpose was advanced for the project.

- "[To] identify, through in-house research, investment opportunities in key industrial sectors of the province."

- "[To] encourage potential investors to capitalize upon these opportunities."

In the November 1989 rationale for an extension to the project, the objectives were expanded as follows.[29]

- "To identify specific investment opportunities in the province with the intention of matching these opportunities to [several alternative categories of] investors."

- "To build a database of informal investors..."

- "To organize investment forums on a regular basis, at which selected entrepreneurs will make presentations ... to investors."

- "To promote within the Venture Capital Community an awareness of Newfoundland and Labrador" including possible sponsorship of the 1993 ACVCC (Association of Canadian Venture Capital Companies) Conference in St. John's.

- "To produce ... new materials for promoting the province as an attractive place to invest."

The objectives relate primarily to establishing an infrastructure: a marketplace in which the objectives of capital investment and job creation are facilitated. However, it does not always

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[29] It is understood that portions of the last two of these objectives have been deleted by the Management Committee. The promotion of Newfoundland and Labrador to the venture capital community and the production of new materials which promote the province are both activities that are being carried out by the Department of Development.

follow, even in the most efficient markets, that all opportunities (even 'good' opportunities) get taken up. Nevertheless, without a market infrastructure, investors may never become aware of opportunities that they would finance. Without a marketplace, investments that do get made are unlikely to be properly priced. The costs that investors face are ultimately reflected in higher costs of capital to entrepreneurs. Expenditures include costs of searching for alternative investments and of evaluating proposals. The higher these costs, the fewer investments made. In the end, the marketplace deteriorates.

Accordingly, *the* crucial issue is the effectiveness with which the IOP has or has not established a functional marketplace for informal investment capital. Ot is important to examine the extent to which the infrastructure established by the IOP has been of benefit to entrepreneurs, investors, and the economy. These groups are the primary stakeholders.

Establishment of a Database of Informal Investors

Data for this aspect of the analysis had been collected from investors by the St. John's Board of Trade as part of the national survey of informal investors. Ninety-seven completed questionnaires were received: 48 of the 97 respondents were identified as informal investors.[30] The 48 business angels reported having invested in 172 investments, 148 of which (86 percent) were located in Newfoundland/Labrador. These 172 investments represented a total stake of more than $17 million over the 1986-1991 period, an average of approximately $59 thousand per investor per year.

The two primary means by which Newfoundland informal investors learned about investment opportunities were by active personal search and through business associates. This is the norm in all informal investment markets in North America and in Europe. However, of the 48 informal investors, 16 had also used the IOP by 1991. Of the 32 who had not used the service, only six were unfamiliar with the IOP.

These results need to be viewed in context. The annual budget proposed for COIN for the years beyond 1992 was approximately $900,000 per year. In spite of COIN's budget and its Canada-wide catchment area, COIN appeared to have approximately 50 investors listed in its database. COIN's financial statement data for the 1986-1991 period are consistent with a *maximum* of 100 investors in any of these years. Compared with COIN, therefore, the IOP has performed extremely well in the development of a database of informal investors!

Moreover, the level of satisfaction of informal investors who have used the IOP is high, compared to those who had used COIN. Of the 16 investors who had used the IOP, nine

[30] The other respondents included four professional venture capitalists, 17 entrepreneurs (people who had made only one investment and who were actively involved in the management of that business), and 28 people who had not invested at all in small businesses (non-investors).

expressed willingness to use the service again; none of the other seven respondents stated an *un*willingness to use the service. They simply had not responded to this particular question. This result lies in stark contrast with the (dis)satisfaction of COIN's investors.

Most informal investors in Newfoundland expressed a willingness to pay a fee for use of a referral service. Of the 39 people who responded to the question about a method of payment for a referral, 23 cited a percentage of the investment as appropriate. A minority (nine) preferred a straight fee. Only two respondents did not support a fee, while five were comfortable with either a straight fee or a percentage of the investment. The high level of willingness to pay a fee communicates that investors place a tangible value on the need to maintain a market infrastructure. This infrastructure, however, goes beyond simple matchmaking. It embraces the intentional development of investment opportunities before they are exposed to investors.

The Development of Investment Opportunities

A second objective of the IOP was "to identify specific investment opportunities in the province with the intention of matching these opportunities to [several alternative categories of] investors." Before matching entrepreneurial endeavour with investors, considerable development work was often necessary.

One basic requirement of the IOP is that the business must be able to present a potential investor with a proper business plan. Thus, the identification and development of presentable opportunities often require consultations and assistance with business plans. These steps necessarily precede the matchmaking function. To assess the usefulness of this activity, questionnaires were sent to more than 170 business owners and potential entrepreneurs (61 responses were received). The questionnaire was designed to elicit commentary on each of several facets. [31]

From among the 61 responses to the mailed questionnaire, 12 reported having had consultations with the IOP. Three additional respondents had experience with the IOP by virtue of receiving assistance with their business plans. The respondents rated the IOP's performance on these aspects on a seven-point scale where "1" signified that the assistance was "useless" and a "7" corresponded to "extremely useful." Table 29 presents the breakdown of the responses on these aspects.

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[31] Among the 61 respondents to the questionnaire were 16 respondents who replied that they were unaware of the IOP. This was, at first, a surprising result in that the mailing was generated from the IOP's list of contacts. However, it is rationalized by three potential explanations: the person responding from a particular firm was different from the person in the firm who had made contact with the IOP; the ownership of the firm had changed hands in the interim; the respondent identified the IOP with the St. John's Board of Trade.

Table 29: Satisfaction with IOP's Advocacy Role

	BUSINESS PLAN ASSISTANCE	CONSULTATIONS
1 = USELESS	0	1
2	0	0
3	0	0
4	0	0
5	1	3
6	0	1
7 = EXTREMELY USEFUL	2	7

In addition, 14 respondents who had employed the IOP's matchmaking assistance reported on the usefulness of the IOP's feedback about their business plans. Ten of these respondents stated that the IOP's feedback had been useful. Two responded that the feedback had not been useful, while for two others it was too early to tell. It is evident, then, that the IOP's advocacy function is highly regarded. This is an important function that serves the necessary task of 'lubricating' the operation of the marketplace.

The IOP's investment matchmaking service had been used by 23 respondents. Of these, 18 respondents identified how much capital they had been seeking. Half of these were attempting to raise less than $200,000; two were looking for between $200,000 and $400,000; five were trying to obtain between $400,000 and $800,000. Two respondents sought more than $800,0000. Table 30 details their perceptions of the usefulness of this service on the same seven-point scale as used above.

Table 30: Satisfaction with IOP's Matchmaking Role

Level of Satisfaction with Matchmaking Service	Number of Respondents
1 = useless	0
2	3
3	4
4	7
5	4
6	1
7 = extremely useful	3

Clearly, the experience on this dimension is mixed. There have been some successes; but there also have been some poor experiences. It is likely that a poor experience is a reflection of an inability to raise the capital being sought. In this context, the negative responses to this question tended to come from those respondents who had been seeking the largest amounts of capital (more than $500,000). The positive comments are concentrated among respondents seeking less than $500,000 of capital.

Three of the respondents had been able to raise the capital they had been seeking. Two of these credited the IOP with a role in raising this capital. As a result, a total of 14 jobs had been created. The other firms had also benefited through their contact with the IOP. For five of these firms, it was too early for them to respond definitively to some of the queries on the questionnaire. However, most of the firms that had been trying to raise capital reported positive experiences with the IOP.

In response to the question "Have you or has your business benefited from your experience with the IOP", 14 of 19 respondents replied "YES". Only three responses were negative; for two other respondents, it was too early to tell. Moreover, 12 of 19 respondents reported that the IOP had facilitated establishing contacts who could potentially be of help to their businesses. When asked, 15 of 17 respondents reported that they would be willing to use the IOP again; only two respondents replied in the negative.

On balance, the findings of this section are positive. The clear majority of business owners or entrepreneurs who had experience with the matchmaking facility were satisfied. The IOP has provided considerable advice and feedback on business plans and has been involved with related consultations. This activity has been perceived to have been constructive. Survey respondents have acknowledged the role of the IOP in providing the advocacy which is required to prepare an opportunity for potential financing. In so doing, the IOP has identified, and has played a role in the development of, opportunities in Newfoundland.

In a few cases, this has translated into actual financing and job creation. At first glance, the actual number of matches that have been reported might seem to be disappointing. It would be incorrect to conclude this. As an external benchmark, in the absence of agencies such as the IOP, informal investors reject an average of 39 out of every 40 opportunities to which they are exposed. Moreover, the time required to conclude a successful deal is best measured in months or years once a potential match is identified. A "hit rate" of three 3 deals among approximately 20 respondents (with several potential deals still, apparently, under negotiation) is extremely high in comparison with the national and international experience!

The results reported here may be only the minimum case. Consideration must be accorded to the probability that the respondents to the questionnaire represent the *population* of business owners and not a *sample* of entrepreneurs to whom the questionnaire had been mailed. If this is true, then it would be appropriate to extend the results to this population. Consistent with this extrapolation would be a conclusion that the IOP has facilitated between six to ten matches with the attendant creation of 18 to 30 jobs. (Extrapolation can be somewhat heroic when small samples are involved! However, this estimate coincides with the IOP's files which record 7 known matches and less tangible indications that the IOP played a role in additional matches.) On the basis of this experience, the IOP is an effective investor-entrepreneur matchmaking program, especially on a dollar for dollar basis.

The Organization of Investment Forums and Seminars

Since 1989, the IOP has organised five seminars/forums. These assemblies fulfil at least three roles. First, they provide media by which some of the information necessary to maintenance of the informal market infrastructure can be disseminated. Second, they acquaint potential market participants (investors as well as entrepreneurs) with the IOP. Third, they allow potential investors to become better acquainted, and to learn from each other in informal discussion. This may be extremely important in view of the frequent use of syndication reported earlier.

To assess the IOP's performance on this dimension, two sets of data were accessed. The first data were the sets of evaluation forms that participants of each of the five seminars had been asked to complete. The second data set comprised the 61 entrepreneurs who had completed and returned the mail survey associated with this appraisal. In both cases, the assessments of the IOP were strongly positive.

The IOP has organised five gatherings that relate to its objectives. These were:

April 1990	Investment Forum
September 1990	"Investing in Entrepreneurs"
October 1990	Investment Forum
May 1991	"Acquisitions and Divestitures"
April 1992	"Raising Venture Capital"

After each, participants were invited to complete an assessment of the activity. In the last four of these, participants were asked to rate the quality of information as well as the quality of the presentation(s) on a five-point scale. Table 31 summarizes the percentage of respondents from each seminar or forum who had rated the forum as either a "4" or a "5" (where "5" corresponds to excellent on the five-point scale).

Table 31: Satisfaction with Forums and Seminars

	Quality of Information	Quality of Presentation(s)
Investment Forum (April 1990)	73%	64%
Investing in Entrepreneurs (September 1990)	67%	93%
Investment Forum (October 1990)	93%	80%
Acquisitions & Divestitures (May 1991)	92%	100%
Raising Venture Capital (April 1992)	64%	70%

These results convey a high level of satisfaction among participants. In every case, a significant majority of respondents pronounced that both the quality of information and the quality of presentation(s) were at a high level.

Confirmation of this high level of satisfaction arises from the survey of business owners and entrepreneurs. Of the 61 respondents to the mailed questionnaire, 26 reported an awareness of the IOP from its seminars. Of these, 23 had reported experience with the seminars. Question 3 of the mailed instrument asked respondents to report their level of satisfaction on a seven-point scale. On this scale, a "1" corresponds to "useless" and a "7" corresponds to "extremely useful". Figure 3 breaks down the responses. Seventy percent of the respondents reported the seminars to be "useful", to a greater or lesser extent. At worst, seven respondents (30 percent) were neutral. No one reported the seminars to be on the "useless" side of the scale.

To summarize this section, all indications are that the seminars and forums that the IOP has organized were successful in the sense that participants consistently report positive experiences.

Summary

The findings suggest strongly that the IOP has met or exceeded the objectives advanced in its 1989 proposal. Through its consultations and advocacy, the IOP has played a useful role in the identification and development of specific investment opportunities in Newfoundland. It has built a database of informal investors, a database that is comparable in size to the national COIN program. Early indications are that with the IOP's assistance, the rate at which investors take up opportunities has been significantly improved. The IOP has improved the matching of opportunities to investors. The investment forums and seminars have been well-received.

The IOP serves the informal market in a manner similar to that in which the Toronto Stock Exchange and the Ontario Securities Commission serve the formal market. The IOP

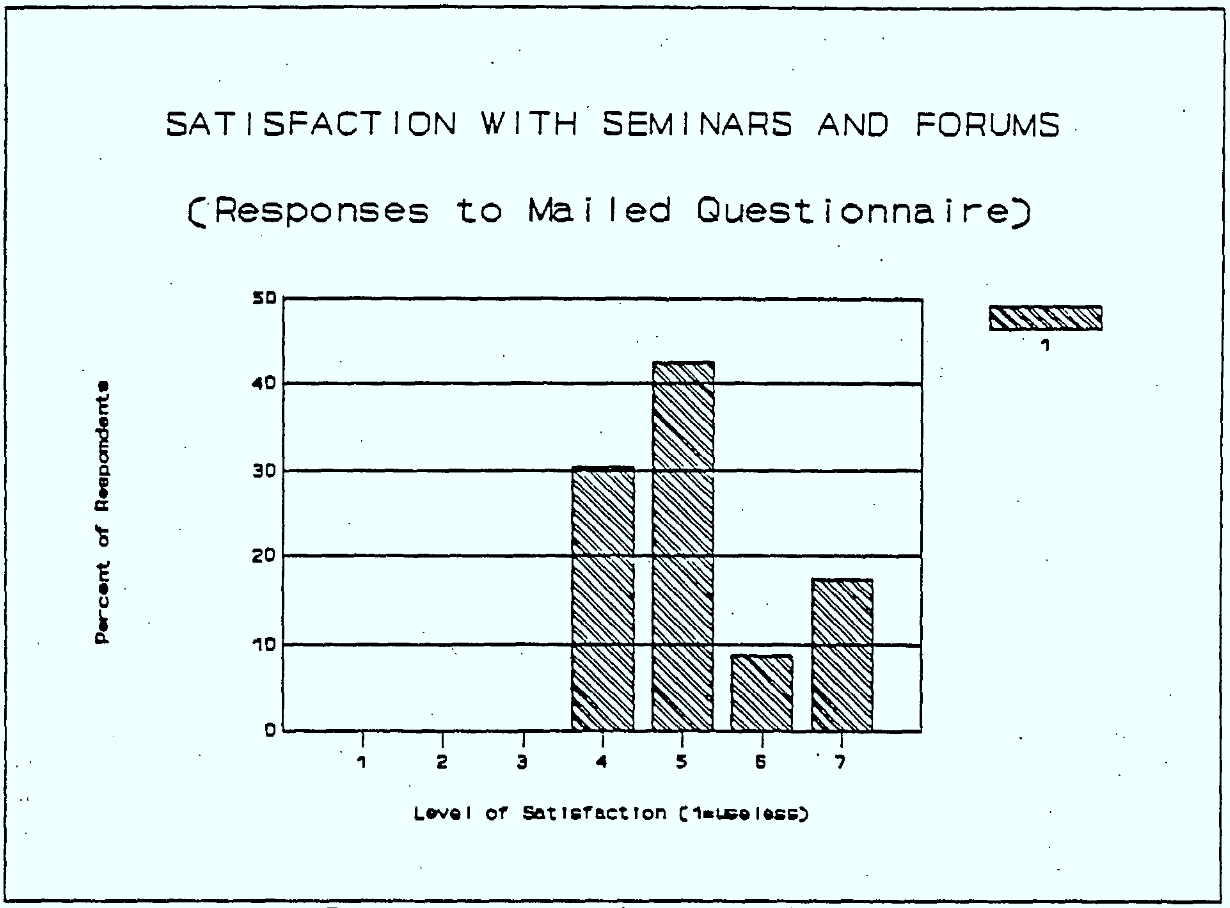

Figure 3: Satisfaction with Seminars and Forums

provides a venue in which investment can occur. Moreover, the IOP provides investors with confidence that the opportunities have met some minimum standards. Investors must, of course, perform their own due diligence. However, by commenting on and assisting with business plans, by regular investment forums, etc., the IOP provides the Newfoundland market for informal capital with the information base necessary for the lubrication of this market.

The IOP has not reached financial self-sufficiency. (Unless this term is defined very broadly: the savings to society of wasted searching for investors by entrepreneurs, and vice versa, the new jobs created, the impractical ideas that may have been detected early all have a tangible benefit to society and to the principals involved.) Establishing and maintaining a market infrastructure may not be a for-profit (or even a break-even) proposition. The institutions which fill this role are routinely financed externally. The Ontario Securities Commission (OSC), for example, is not expected to be financially self-sufficient. Without the OSC, however, the integrity of the Toronto Stock Exchange would be forfeit. By the same token, financial self-sufficiency for intermediaries such as the IOP is unlikely.

7.6 Recommendations for Intermediation

On the basis of these findings, several recommendations are advanced. The viability of the marketplace depends on continued involvement by informal investors. Investors will abandon the marketplace if they are not presented with good quality investment opportunities. It follows that an intermediary must be discriminating in the selection of opportunities to advance. These opportunities must be accompanied by a proper business plan, a plan which communicates the financial rewards inherent in the investment as well as the challenge of the project, the opportunty for affiliation, and the competence of the principals. In a real sense, the intermediary must act in the same way for the informal market that listing requirements act for organized stock markets.

It is also appropriate that venues such as Boards of Trade and local economic development agencies be involved in the intermediation process. These institutions maintain the respect of the business community. This respect goes hand in hand with the need for a market-maker of high integrity. The emphasis needs to be at the local level. In particular, the presence of individuals respected by the community and known to be persons of integrity is crucial. Such people, by their own involvement in a deal, lend credibility to the opportunity. Other investors are then willing to follow. These individuals need not be 'lead investors'; indeed, they may simply play the role of advocate. In several communities, such a role is evolving.

Second, an intermediary matchmaking service ought to incorporate well-known minimum 'listing requirements'. Studies in classical financial economics (e.g., Akerlof, 1973; Chan, 1983) have identified the need for an intermediary which filters out the 'lemons' from the spectrum of investment opportunities. In the absence of such filtering, investors exit the market and the market degenerates. In a very real sense, this is part of what a 'lead investor', mentioned above, also accomplishes.

Third, consideration could to be given to amendments to the legislative environment. In the U.S., entrepreneurs do not need to comply with costly prospectus requirements if investors qualify as 'sophisticated' investors under the terms of "Regulation D". This regulation identifies sophisticated investors in terms of their personal qualities, education, and experience. No such provision exists in the provincial securities acts. While there are conditions under which entrepreneurs can avoid prospectus preparation, these conditions are much more restrictive than are those in the U.S.

Matchmaking systems such as the Venture Capital Network originated by Wetzel for the New England area have operated with greater success. Such systems, however, have remained more local in scope, have operated in a less restrictive legal setting, have usually been associated with small business research centres or incubators (or universities), and have incorporated greater advisory capability than is permitted under Canadian laws. A matchmaking service, one with well-known minimum 'listing requirements', can then, under such circumstances, become an useful adjunct to ease syndication and investment.

7.7 Summary

The data from the informal investment survey could not determine, definitively, whether or not a "capital market gap" exists. By definition and design, the survey examined only the supply side of the equation. However, the data does indicate that the potential supply of informal capital is extremely large and that the amount actually in play is at least as large as that invested annually by the institutional venture capital industry. The rates of return demanded by investors are not exorbitant.

From the investors' perspectives, the gap in the informal marketplace is more a shortage of attractive investment opportunities. Non-investors were seen to be discouraged primarily by the perception of riskiness associated with informal investing. The manner in which the informal market operates was documented and found to operate at a surprisingly high level of efficiency.

Finally, the performance of two intermediaries in the informal market were examined. The findings of this examination led to several recommendations about the intermediation process, recommendations based on the local and personal nature of the marketplace.

8. The Character of the Informal Investor: A Personality Profile

8.1 Introduction

The existing research literature allows a profile to be developed which describes superficial attributes of informal venture capital investors, but a profile that remains incomplete. From this literature, informal investors are typically men in their mid- to late-40's with post-secondary education and incomes that are higher than usual (i.e., $100,000 to $250,000 per year). Investors tend to have had previous investment experience and they are attracted to investments which offer a elevated potential for a high rate of return and capital appreciation. Angels in the U. S. typically invest less than $50,000 and plan to liquidate any one investment within 3 to 7 years. They prefer to invest in high technology manufacturing firms.

Beyond such demographic characteristics, however, information about this group of informal investors has generally been limited. Given the critical need for financing of new venture start-ups, it is important to learn as much as possible about individuals who choose to invest in the informal market. This study seeks to expand understanding of informal investors by gathering information about their character and their attachment to work. Specifically, this study compares informal investors to formal investors with respect to 12 characteristics that were suspected to be important from anecdotal evidence, focus group discussions, and the literatures of finance, economics, and organizational behaviour. These characteristics were:

(1) locus of control,
(2) need for achievement,
(3) need for affiliation,
(4) need for dominance,
(5) need for autonomy,
(6) levels of intrinsic motivation,
(7) levels of work involvement,
(8) job satisfaction,
(9) investment satisfaction,
(10) perceived stress,
(11) perceived control, and
(12) types of coping mechanisms used to deal with stress (i.e. work harder, escape, support from others, seek help and cope by investing).

8.2 A Taxonomy of Personality and Psychological Characteristics

In this section, the personality-based and psychological characteristics listed above are defined.

Locus of Control theory suggests that people will behave differently if they perceive that the outcomes of their actions and behaviours are controlled internally rather than externally. People who perceive internal control feel that they personally can influence their outcomes through their own ability, skills or effort. Employees who perceive external control feel that their outcomes (i.e. rewards, punishments) are beyond their own control. Individuals with high internal locus of control are generally more satisfied with their jobs, more likely to be in managerial positions, better performers, and more satisfied with participatory decision making than are individuals who have external locus of control.

Need for Achievement is the desire to do something better or more efficiently, to solve problems, or to master complex tasks. People high in need for achievement like to put their competencies to work; they take moderate risks in competitive situations; they are willing to work alone; and they are content with the success of a task serving as its own reward.

Need for Affiliation is the desire to establish and maintain friendly and warm relations with other people. People with very high need for affiliation prefer to work with others rather than on their own and pay a good deal of attention to the feelings of others.

Need for Autonomy is the desire to be able to work independently. People with a high need for autonomy prefer to be their own boss, work alone, control their own work pace and activities, and do things on their own regardless of the opinions of others or of rules and regulations that hinder their freedom of choice.

Need for Dominance is the desire to control other people or external events, to influence their behaviour, or to be responsible for them. People with a high need for dominance seek an active role in the leadership of a group, try to influence the opinions of or to direct the activities of those around them, and try to gain control over external events.

Intrinsic Motivation has been defined as the extent to which an employee is motivated to perform because of subjective rewards or feelings he or she expects as a result of performing well. A person who is intrinsically motivated performs a task because of self-administered rewards such as feelings of competency, personal development, and self-control.

Extrinsic rewards, on the other hand, are externally administered (i.e. by the organization). They are valued outcomes such as benefits, job security, verbal praise, or money, given to someone by another person.

Work Involvement is conceptualized as a psychological response to one's current work role or job, the degree to which a person is identified psychologically with the job, and the importance of the job to the person's self-image and self-concept. Individuals who are highly committed to and involved with their work, spend time and energy in this role.

Job Satisfaction is the degree to which employees have a positive, affective orientation towards employment by the organization. Satisfaction can be measured globally or dimensionally. Global measures refer to general satisfaction (or dissatisfaction) with the organization whereas dimensional measures refer to satisfaction with specific features or "facets" of the work. A "facet"-specific measure of job satisfaction was used in this study. Investment was included as one facet of interest.

Although work can be a source of satisfaction and self-esteem, it can also foster dissatisfaction, depression, and despair. Research has shown a negative relationship between job satisfaction and work conflict, absenteeism, intent to quit, work-family conflict, and mental and physical health. A positive relationship has been found between job satisfaction and organizational commitment, marital satisfaction, morale, and life satisfaction.

This concept is extended to that of **investment satisfaction**. Investments, too, can be a source of satisfaction and dissatisfaction. For some, investments are a part of work itself; however, it seems important for this study to consider this aspect of overall personal satisfaction separately.

Perceived Stress refers to the extent to which one perceives one's situation to be uncontrollable and burdensome. Stress has been found to be related to various psychological outcomes including job dissatisfaction, anxiety, and depressed feelings, among others. Behavioral outcomes of stress include smoking, drug use, drinking, decreased work productivity, absenteeism, and staff turnover. Excessive stress can also produce dysfunctional outcomes in the work and family domains.

Perceived Control is the degree to which an individual perceives that they have power over their environment. Research has found that an individual's perception of control over their environment, their work, stressful events, etc., is a key factor in their ability to cope successfully with stress.

Coping, or the use of **coping mechanisms**, is the ability to deal with troubles or problems successfully (Burke *et al.*, 1979). Individuals who are exposed to stressors may not necessarily perceive the situation as stressful. Personal resources significantly affect the way people interpret the environment and respond to stressors. Effective coping (e.g., by modifying the stressful environment by working harder or seeking help) and the mobilization of social support from the work or family domain can also reduce perceived stress and can directly improve well-being. The use of escape mechanisms to cope with stress has been found to be an ineffective way of relieving stress.

8.3 Methodology

To measure respondents' levels on the characteristics listed above, well established measures were employed. Both investors and non-investors were asked to respond on Likert scale formats in all cases. These scales, all of which have been pre-tested and employed in other studies, were used to operationalize the twelve constructs of interest here. F tests were used to determine if investors differed from non-investors on the characteristics of interest. For all scales, benchmark data on what constitutes responses of other people are available from the psychological literature. Hence, the responses from this survey permit investigation of how investor respondents might differ from non-investor respondents. The responses also allow comparisons of both sets of respondents with the general population. The details of the various psychometric measures are discussed Appendix C.

8.4 Empirical Findings

The empirical findings of this aspect of the investigation are summarized by Tables 32 and 33. Table 32 presents the mean scores of the personality variables of interest here for investors and non-investors and reports the F-statistic that compares investors with counterpart non-investors. Table 33 does likewise for the variables that reflect the outcomes of investors' and non-investors' life activities.

Table 32: Personality Variables

NAME OF VARIABLE	INVESTORS	NON-INVESTORS	F STATISTIC	LEVEL OF SIGNIFICANCE
Locus of Control	4.89	4.85	.160	.689
Need for Achievement	5.73	5.57	2.780	.096
Need for Affiliation	4.88	4.87	.008	.929
Need for Autonomy	4.64	4.44	3.997	.046
Need for Dominance	5.54	5.14	13.726	.000
Intrinsic Motivation	6.40	6.26	1.899	.169
Work Involvement	5.60	5.43	3.224	.073

Table 33: Outcome Variables

NAME OF VARIABLE	INVESTORS	NON-INVESTORS	F STATISTIC	LEVEL OF SIGNIFICANCE
Job Satisfaction	5.38	4.96	11.076	.001
Investment Satisfaction	4.75	4.53	1.658	.199
Percieved Stress	4.39	4.42	.190	.664
Percieved Investment Stress	3.65	3.16	6.041	.014
Percieved Control	5.54	5.49	.611	.435
TYPES OF COPING: Work Harder	4.25	4.26	.002	.967
Escape	2.09	2.09	.004	.950
Support from Others	3.29	3.20	.569	.451
Seek Help	2.24	2.01	.653	.420
Cope by Investing	3.10	2.38	8.507	.004

Several important observations follow from these results. First, the data in Table 32 indicates that both the investors and the non-investors surveyed in this study tend to have internal locus of control. This suggests that informal investors feel that they can influence their investment outcomes by doing their homework (i.e., check the business plan, investigate the owners, the industry, etc.). The data in Table 32 also indicates that both the angels and the non-investors who took part in this study have very high needs to achieve. This finding is consistent with the demographic data presented earlier (40% have post-graduate university degrees). Angels display a higher need to achieve than non-investors (the difference approaches significance). It may be that these individuals are attracted to informal investment opportunities because they find it a challenge.

Table 32 also indicates that both the angels and the non-investors have moderate needs for affiliation and autonomy. However, the need for autonomy was significantly higher for angels than for non-investors. This suggests that angels may be attracted to invest their money informally (rather than formally) because they perceive that such forms of investment increase the amount of control that they have over how their money is being employed.

The data also indicates that informal investors have a moderately high need for dominance. The need for dominance is significantly higher for angels than for non-investors. This finding is compatible with the high needs for achievement and autonomy noted earlier, and consistent with the idea that informal investors are attracted to this type of investment opportunity by the higher level of involvement it offers. It would appear that angels need to feel that they can influence the way that their money is being used.

Informal investors have very high levels of intrinsic motivation (6.4 on a 7-point scale). The non-investors included in this study also demonstrate high levels of intrinsic motivation; it may be that the lack of difference between the groups is partially due to how the sample was selected (both groups were successful business men and women). The high levels of intrinsic motivation found in the angel group are consistent with the internal locus of control data discussed earlier. The data suggests that the challenge of deciding where to invest and how best to control one's investment is as motivating to the informal investor as the money to be earned from the investment.

The results from Table 32 shows that angels have moderately high levels of work involvement. The levels of work involvement observed in this group are higher than those observed for the non-investor sample (the difference approaches significance). It would appear that angels identify strongly with both the work that they do and the investments that they make. Being successful at work and making successful investments is important to their self-esteem. Again, this is consistent with the fact that angels have a very high need for achievement.

Angels are significantly more satisfied with their jobs than are non-investors (Table 33). They are also more satisfied with the performance of their investments than are non-investors, although this difference is not significant (Table 33). The higher levels of job satisfaction observed for angels are consistent with the high levels of need for achievement, autonomy and dominance, work involvement, and the fact that they are intrinsically motivated by their work. It is likely than angels who found themselves in unsatisfactory jobs changed jobs. It is also likely (given the education data) that angels are more likely to be found in the more satisfying jobs at the top of the organizational hierarchy.

Both groups examined in this study display relatively high levels of perceived stress (see Table 33). This is consistent with the fact that both groups have a high need to achieve, a trait that is often associated with being a "Type A" individual. Type A personalities have been found to be more susceptible to higher stress levels. The data suggests that worry about their investments' performance makes a significant contribution to the perceived stress levels of approximately half of the informal investors. This is significantly higher than was observed for the non-investor group. This data suggests that a significant proportion of angels find informal investment activities stressful.

The informal investors and non-investors in this study both perceived moderately high levels of control over their environment.

The data in Table 33 indicates that, with one exception, angels and non-investors cope with stress in similar ways. Both groups react by working harder (consistent with their high need for achievement, autonomy, and dominance), a positive way of coping with stress. Neither group uses avoidance tactics, seeks support from friends or colleagues, or seeks professional help.

While angels are more likely than non-investors to indicate that they actively seek new investment opportunities as a way of coping with stress, the majority of the informal investors surveyed indicate that they do not cope in this way. Many, in fact, cope with stress by reducing their levels of informal investment. This is not surprising given the data presented earlier indicating that the performance of their investments may be a significant source of stress for many informal investors.

8.5 Conclusions

The data collected in this study are consistent with regard to the picture it presents of the typical informal investor. Angels are most likely to have internal locus of control, very high needs for achievement and dominance, and moderately high needs for affiliation and autonomy who are intrinsically motivated, highly involved with their work and their investments, very satisfied with their jobs, and moderately satisfied with their investments' performance. Angels report relatively high levels of perceived stress (a significant proportion of which may be attributed to the performance of their investments) and cope with this stress by working harder. This profile suggests several strategies that could be used by entrepreneurs to maximize their chances of attracting informal risk capital.

First, entrepreneurs who are seeking capital should present the investment as a challenge. Make it known that the angel will be encouraged to take an active role in the running of the organization and that their actions will have a direct bearing on the ultimate success or failure of the organization. Angels have high levels of confidence in their own abilities to succeed and a high need to equate successes with their own efforts. Investments that offer them the opportunity to satisfy these needs will be more likely to attract them then ones that do not.

Second, informal investors must be offered some formal type of leadership position in the organization. Spell out their level of control over how the investment money is to be employed (perhaps make it a participatory process between organization and investor) and formally include the informal investor in the decision-making process.

Third, make sure that investors are offered non-monetary incentives to invest (i.e., learning opportunity, media attention). These types of incentives should appeal to their internal locus of control, high levels of work involvement, and intrinsic motivation.

Finally, informal investors must be kept advised on an on-going basis of the progress of the investment and provide opportunities for the angel to give more than money. Stress levels increase for angels who do not feel that they have enough control over their informal investments and many cope by decreasing the amount of money that they invest. Involving these investors, on the other hand, might encourage them to work harder to make the investment a success rather then withdraw their support.

9. On Public Policy Initiatives

9.1 Introduction

Among the central concerns of this research was the evaluation of historical public policy initiatives and the generation of ideas for further potential initiatives. Accordingly, respondents were asked to comment on particular existing initiatives and, by means of an open-ended question, to suggest further ways in which governments might be able to encourage informal investing and the attendant job-creation and economic development. This chapter details the analyses of these responses.

9.2 Federal Policy Incentives

This section reports on the results of an analysis of responses regarding the present lifetime capital gains exemption, an exemption designed to encourage informal investment. Capital gains are associated with informal investments because the return on investment is most often in the form of a capital gain upon exit. This evaluation is based on the responses to two questions, Q33(b)i and Q33(b)ii of the questionnaire:

33 (b) i. *"The Federal government has provided an exemption from income taxes on the first $100,000 of capital gains income. Did this exemption encourage you to undertake informal investment activity?"*

33 (b) ii. *Would you be more likely to undertake [more] informal investment activity if this exemption were increased?*

Respondents answered either 'yes' or 'no' to both questions, or they did not respond at all. Of 220[32] respondents, only 69 (31.4%) admitted that the exemption *encouraged* them to undertake informal investing. The remaining 151 respondents (68.6%) stated that the exemption did *not* prompt their decision to take on informal investing activity. A majority (170 of 220) of investors replied that an increase in the capital gains exemption would increase the amount of informal investment activity. However, this number should be interpreted with caution because people usually want to have more money than less.

[32] Analysis of federal incentives will not include responses from Newfoundland angels because the Newfoundland version of the questionnaire did not include these two questions.

Before proceeding to further analsysis, it is useful to split the sample of respondents according to their answers on Question 33(b) i. An investigation of the subsequent questions will offer more revealing recommendations for tax reform and determine whether or not those respondents who were encouraged by the capital gains exemption differed from those who were not.

Therefore, respondents were classified into one of two groups, and the answers in each group were considered separately. First, the 69 respondents who replied that the $100,000 capital gains tax exemption encouraged them to invest informally are referred to as *Investor Group 1*. Since these investors considered the incentive to be an encouragement, their responses regarding the subsequent open-ended questions on potential tax reforms may be taken as being representative of informal investors currently in the market. Their opinions on subsequent questions about how tax-based incentives might be improved are considered appropriate for increasing the investment activity of those investors currently in the market.

The 151 investors who were *not* attracted to the market by the capital gains tax exemption incentive are categorized as to as *Investor Group 2*. Responses from this group are examined separately because this particular incentive did not seem to be useful to them.

Perspectives on the informal market of these two groups of investors are constrasted with each other and with the views of non-investors in Table 34. Here, it is clear that the risk tolerance of non-investors is considerably less than that of either group of investors. For all respondents, risk is perceived as a disincentive to investing, yet it seems to affect non-investors more (95% level of significance). No statistically significant differences between aspects of risk capital investing were found between the two groups of investor respondents. Note that, although not statistically significant, tax considerations are less a disincentive to Investor Group 2 than to those in Group 1, the group that was encouraged to undertake informal investment by the lifetime capital gains tax exemption. When investor groups were collapsed and compared to non-investors, risk continued to be considered a greater disincentive by non-investors than investors (99% significance; see Table 34).

Table 34: Attitudes Towards Selected Aspects of Risk Capital Investing

Aspect:	Non-Investors n=74	Investor Group 2 n=151	Investor Group 1 n=69
Few opportunities	2.58	2.67	2.68
Tax considerations	3.14	3.38	3.53
Risky	2.25***	2.59**	2.44***
Lack of liquidity	2.44	2.44	2.32
Investment required is often too high	2.48	2.42	2.32
Time required to search for deals	2.53	2.59	2.68
Time required to manage the company	2.42	2.32	2.57

** 95% significance; *** 99% significance (between all investors and non-investors)

It is instructive to return to the responses to Question 33 (b) ii in light of the split sample. Of the 69 respondents who stated that the lifetime capital gains tax exemption encouraged them to invest informally, 65 (i.e., 94.2 percent) also replied that they would be more likely to increase their level of informal investing if the ceiling on the exemption were to be increased. Only 54 percent of the second group of investors stated that an increase in the exemption would encourage them to undertake more informal investment. Again, the caution that 'more is better than less' may well apply to these answers.

Investor respondents were also asked the following open-ended question:

Q33(c): *"Can you suggest policy incentives you would like to see enacted?"*

Most (196 of 220) respondents took the time to complete this section. The responses to the open-ended question potentially provide more precise indications of what informal investors seek in the way of policy initiatives. Analysis of the responses to this question used a methodology based on the thematic evaluation of qualitative data collected from angel respondents. Two data analysis procedures were employed.

The first technique was a two-stage categorization of the transcribed open-ended responses; first into broad themes, and then into more specific topics. This process grouped the responses into descriptive and precise incentives. To avoid researcher-specific biases, two researchers independently categorized the data. Discrepancies between the interpretations of the two researchers were considered jointly until consensus was obtained. The incentives are reported according to aggregate findings of each of the two groups of investors.

The second data analysis procedure used here segmented the data according to the characteristics of the individual investor respondent regardless of group affiliation. Specifically, the incentives were grouped according to the investor's age, since prior research has suggested that investment decisions differ according to the age of the investor (Dal Cin, 1992). Age categories were: 35 and under, 36 to 50, 51 to 65, and 66 and over. The recommended incentives must address and reward intelligent, patient capital with the hope of increasing this investment activity.

The database contained 196 investors who made a total of 257 suggestions or comments on tax reform regarding new venture investing. These comments and suggestions were compiled into categories that contained frequencies of 2 or more suggestions. Thus, 249 usable suggestions were sorted into eleven categories. Table 35 is a compilation of the suggestions made by the two investor groups. This table is followed by a short interpretation of each of these categories. Note that there does not seem to be much difference between the two groups regarding their views on potential incentives.

Table 35: Frequency of Incentive Directions Made by Investors

Tax Suggestions	Frequencies		
	Investor Group 1	Investor Group 2	Total
Corporate Tax-Related	17	35	52
Capital Gains-Related	22	29	51
Personal Tax-Related	7	26	33
Write-off Losses against Income	8	20	28
More Government Involvement	15	19	34
Less Government Involvement	7	10	17
Simplification of Tax System	2	10	12
Indexation of Returns (Gains)	2	3	5
Additional Deductions	0	3	3
Minimum Holding Period	4	3	7
Employee-Related	2	2	4

The category of incentives most frequently recommended by investors was that which related to changes in corporate taxes. Examples of specific recommendations within this category included:

- the creation of tax holidays for new businesses for a specified time period;

- reductions in tax rates for small businesses;

- accelerated capital cost allowances for assets acquired by SMBs.

These recommendations are interesting because they do not affect individuals' tax liability. Rather, they impact the probability of success for the new venture and the probability of an ultimate cash flow to owners and investors in new businesses.

Reduced corporate taxes for large corporations were also mentioned because this would help private investors attract corporations as strategic partners. In this context, Macdonald (1991) outlined elements of strategic support that a large corporation could provide. These included capital infusions, improved credibility, rapid market penetration, economical high-quality manufacturing, and R&D support. For example, a large corporation as a co-investor would not only provide financing, but also an asset base for the new organization. This infrastructure would save the new SMB from dispensing precious resources for these necessary disbursements. Moreover, large corporations often provide an exit for individual investors.

The incentive most frequently mentioned regarding the capital gains tax exemption incentive was the suggestion that capital gains taxes on returns from investments in SMB's be reduced or eliminated. Capital gains-related incentives are very relevant to informal investment since returns are usually obtained in the form of a capital gain and only upon exit. Taxing these gains removes from the marketplace funds that would normally have been re-invested in other new endeavours.[33] Moreover, Hatsopoulos (1989) claims that the tax treatment of capital gains is crucial to international competitiveness. He argues that in a high-wage country such as the U.S. (or Canada), the key to competitiveness is being innovative and investing in long term investments. For the Canadian situation, Doyle (1990) also argued that the Department of Finance's taxation policies should encourage risk-taking.

Another frequently-voiced suggestion, one that is related to the tax treatment of capital gains, was the idea that there be no capital gains taxes on investments held for a minimum number of years (3 - 5 years were mentioned). This incentive is one that would reward patient and intelligent investment .

Issues mentioned that related to the treatment of personal taxes included:

- reducing personal taxes,

[33] It should be recalled in this context that most informal investors are 'repeat players', and re-invest the proceeds of prior informal investments. Wetzel (1983) describes angels as former founders of successful companies. The success of their venture allows them to buy into participation of other new ventures. Canadian angel investors have similar backgrounds: 48.5% of those interviewed have experience as senior management members of a small business. Thus, investors are often former entrepreneurs who have successfully developed a business and who are seeking to reinvest the proceeds they have realized from liquidating their historical ownership in earlier firms.

- reducing the marginal tax rate for the higher level tax brackets, and
- allowing interest from a mortgage to be tax deductible.

The reasoning behind decreasing personal tax rates is that private investors invest personal income in new ventures. Moreover, it is almost exclusively the high income earners who undertake these types of investments. Again, decreasing their tax liability would release more capital for investment.

A specific recommendation that was also frequently mentioned was to allow capital losses to be claimed against income in determining taxable income by individuals. A total of 28 investors made this suggestion. Currently, capital losses may be claimed against capital gains. Investment losses may also be claimed against other income under the terms of the Available Business Income Losses (ABIL) clause. However, it appears that many respondents were either unaware of ABIL or, more likely, that the terms of compliance with ABIL were restrictive. Implementing this suggestion could involve, therefore, an expansion of the terms of qualification for ABIL. This step would make new venture investing less risky: a loss would be less expensive in terms of after-tax income. It would afford investors additional protection against down-side risk in recognition of the job-creating expansion of the tax-base that results from successful enterprise development.[34]

Suggestions of further government involvement generally involved the establishment of additional front-end tax incentives. Examples given were tax credits in the range of 20-50% of new investment. This type of incentive would make risk financing more attractive by the potential return on investment.

Less government involvement generally referred to the elimination of front-end incentives, to the creation of a less distorted marketplace for capital. According to one respondent: "[there should be] No tax driven incentives, [they] raise the wrong kind of money." Another comment was that "Government should not try to give incentives ... [an incentive] distorts the system." Even though many such incentives have been eliminated, there remains a perception that such incentives constitute a policy tool. Such comments reflect that informal investors are not primarily motivated by financial returns, especially when those returns are based solely upon tax relief. Investments should be made on their own merits, not on the basis of tax-driven incentives. Petitions for less government involvement also included comments that referred to a desire for stability of taxation regulations. Since angel investing is patient capital, unstable tax regimes make it difficult for investors to be able to plan on the magnitude of future after-tax cash returns. In essence, *the inherent instability of Canadian tax law adds an element of risk to an already risky investment market.* Indeed, some investors went so far as to state that their returns are virtually tax dependent. The frequent changes to the treatment of capital gains taxes over the last ten years was an often-cited example.

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[34] Somewhat related to the cumulative net investment loss tax rule, search costs incurred cannot be claimed as a deduction unless the investment is undertaken. This rule makes it more expensive to undertake this sort of investment activity.

Investors also suggested that a simplification of the tax structure would affect their investing pattern. Simple taxation rules would make it easier for investors to evaluate opportunities and would also lessen the administrative burden on small companies. Indexation of returns has particular relevance for angel investing again because patient capital is required.[35] Employee-related suggestions refer to such recommendations as the elimination of taxes on stock options bought by employees of SMBs. This step would not only encourage employee performance, but could also provides SMBs with alternative, internal sources of equity financing: its employees.[36]

9.3 Provincial Initiatives

Currently, the most common incentive offered by provinces in support of informal investing are programs such as Ontario's Small Business Development Corporation (SBDC) program. Collectively, these are known as Provincal Venture Capital Corporations (PVCC's). In general, these programs provide a tax benefit linked to the magnitude of an investment in an SMB. Knight and Ferguson (1984) in their evaluation of the Ontario SBDC program identified one major concern: they found that SBDCs were established with the intent of investing in only one particular investment. They noted that this practice is contrary to the intent of the SBDC program: the program had been established with the intent that SBDCs would continually monitor and evaluate new opportunities. The authors contended that the program has failed in this aspect because individual SBDCs do not promote themselves. They concluded that SBDCs prefer to have investments referred to them by someone who would pre-screen investments.

The use of the SBDC program by the informal investors in this study was measured by means of question 29, which asked investor respondents to specify the number of investments in which other individuals, institutional venture capital firms, economic development agencies, and PVCC's had been involved. It was found that 75% of investments were co-financed by other individual investors. However, less than 3 percent of the deals reported by the informal investor respondents involved PVCC's. The national breakdown of the responses to Question 29 was reported in Table 24, and is repeated here for the convenience of the reader.

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[35]A numerical example will illustrate the need for indexing. An investor invests $10,000 in 1980. He cashes out 10 years later for $20,000, resulting in a $10,000 capital gain. If he would have chosen an alternative investment, a bond for example, with a 10% coupon annual rate of return, paid annually he would also have $20,000 at the end of 10 years. Yet he subjected himself to considerably more risk and had to wait 10 years to receive his return on investment. Furthermore, discounted cashflows are required to show a truer picture. Assuming a 10% discount rate for the 10 years, the present value of both investments, after tax, is $3000 for the bond and $2380 for the risky investment. His original investment actually resulted in an opportunity loss vis-a-vis a less risky alternative.

[36]Macdonald (1991) also realizes the value of employee participation in financing new ventures. She recommends that the $500,000 capital gains exemption for small business investors be extended to employee investors. Currently, the exemption is more useful to outside investors than to employees.

Table 24: Co-Financing of Informal Investments*

Type of Co-Financier	Canada	Eastern Canada	Quebec	Ontario	Western Canada
Other individuals	75.0	71.1	90.3	78.6	73.1
Venture capital firms	8.8	9.5	4.2	10.1	7.1
Economic development agencies (e.g. FBDB)	5.2	13.9	1.4	3.2	5.7
SBDCs	2.7	2.0	-	4.0	0.1
Other**	8.8	3.5	4.2	8.3	16.2

*Totals may not equal 100% since different co-financiers may be included in financing the same venture.
**Other co-financiers included pension funds and companies (through joint-ventures).

The finding that informal investors have made such infrequent use of PVCC's is surprising at first glance. This is especially true in view of the significant amounts of capital investment that can be documented for provincial PVCC's. PVCC's appear to offer investors tax benefits for activity in which they are already involved, so it seems odd that so many investors seem to be passing on these benefits. Discussion with investors, however, has revealed that there are very real, and not insignificant, costs associated with being able to use a PVCC. First, the PVCC's often require that professional legal and accounting information be supplied as part of the establishment process. The average informal investment is of the order of $100,000. Professional involvement is, relative to this total, expensive. Moreover, anecdotal reports from investors cite that PVCC's also involve costs in the form of considerable administrative time and attention. Thus, the establishment of a PVCC vehicle for an informal investment may only be justified for relatively large commitments of capital. In support of this contention, it was found that PVCC's were set up by only seven investors for investments of less than $100,000.

These findings may provide direction to provincial governments. It seems very likely that a simplification of the PVCC process could provide impetus to informal investment. Further reduction of bureaucracy and savings in administrative burden may be relatively easy ways of further stimulating use of this potentially valuable complement to the investment process.

9.4 Municipal Initiatives

As reported in previous chapters, it is at the local level that the most effective stumuli to informal investing can be developed. Initiatives such as the Investment Opportunities Project in St. John's are an effective means of stimulating such investment. It is in the best interest of the municipality to undertake activities that promote economic development. New businesses employ area residents, expand the tax base, and attract other new businesses, to name a few societally beneficial spillovers. Moreover, the regions in which the new business settles are the first to have these benefits accrue to them.

Investors cite a lack of confidence in management as the primary reason for rejecting investments. Realizing the economic importance of new venture creation, Krentzman and Samaras (1960) were concerned about the high failure rates among new businesses. They advocate the use of outsiders by small firms to assist in the preparation of business plans, and to help secure financing. Since the municipality benefits directly from new venture creation, it seems logical that it should become involved in assisting entrepreneurs in a marketplace that is inherently local and personal. Efforts at the municipal level should concentrate on informing entrepreneurs of the details of running their own business and assisting them to prepare a presentation to investors.

In support of this position, the work of Chrisman *et al.* (1987) is instuctive. These researchers surveyed entrepreneurs who had been served by regional economic development offices over a three-year period prior to establishing their businesses. Comparing sales and employment tax revenues with the cost of running the pre-venture counselling, their results indicated that returns[37] of $3.77 and $1.50 were realized for every dollar spent in two disparate geographic areas. These results may be a very conservative estimate of the economic benefits generated by this type of counselling because only a 14% response rate was obtained. Yet, telephone listings verified that 75-80% of the firms that obtained pre-venture counselling were still in existence. Further evidence of the success of this program is that respondents rated the value of counselling received as very high (4 on a 6-point scale).

9.5 Summary: Some Public Policy Implications

The evidence provided in this report suggests that the market for informal risk capital is of a significant size and operates at a surprisingly high level of effciciency. The need for this market to operate without distortion has been a recurring theme among respondents to this survey. At the same time, investors also seek tax benefits, benefits tied more strongly to the success or failure of their investments. The job-creation associated with informal investment is one means of enabling economic development while expanding the tax base. For investors, however, this activity is risky, and the instability of Canadian tax regulations contributes to this risk. The incentive provided by the reduction or removal of capital gains taxes on job-creating investments has much to recommend it. Further facilitation of the ability to write off losses resulting from such investments against other income is another way of providing explicit government support for informal investment activity.

A second set of potentially productive initiatives are those that relate to the support of training and advocacy at local levels. These might include the establishment of incentives for cooperative ventures, ventures that might involve the cooperation of universities and colleges, economic development organizations, and boards of trade. Such joint ventures could provide

[37] Return is defined here in terms of new tax revenues.

venues in which the principals of SMB's can upgrade management skills and develop more viable investment opportunities, opportunities that would then be more attractive to potential investors. Advocacy roles of local ventures should not be overlooked as sources of education and screening of new firms. Government's role might then become that of overseeing and coordination of local initiatives.

There is a need to review legislative barriers. Such barriers take the form of prohibitively expensive barriers to investment. For example, the Ontario Securities Act requires a prospectus (cost of at least $400,000) if firms are to sell securities. While there are four provisions for exemptions from this requirement, the legal costs involved remain significant. Consideration of such provisions as the U. S.'s so-called Regulation D might be advised. According to this regulation, an investor is deemed not to require the protection proferred by a prospectus if the investor's personal characteristics (explicitly listed) meet some established standards. Generally, in Ontario, investors are deemed to be exempt from the need for a prospectus if the size of their investment exceeds $150,000. Since the average informal investment is of the order of $100,000, this exemption provides little relief, and expensive legal recourse is required.

There seems to be a strong need to review PVCC's. The data indicate that these vehicles are not of very much help to informal investors. That they have been associated with significant capital formation argues strongly for their value; however, the costs of compliance seem to render these vehicles less useful at the low end of the investment spectrum.

Chapter 10: Summary and Recommendations

Firms that require up to $1,000,000 of equity capital must depend on the marketplace for informal capital. In this marketplace, the supply of capital is provided by informal investors. Informal risk capital is *the* primary source of equity capital for new firms. Accordingly, facilitating access to equity capital would have several benefits. These include: sustaining the expansion of growing firms (and the attendant job creation); enabling entrepreneurs to focus more on the development of the operational aspects of their businesses; incorporating the managerial talents of informal investors; enhancing the competitive bidding process so that the cost of equity capital can be reduced; promoting larger, more viable start-ups.

Predicated on the job-creating faculty of small business expansion, governments have made a variety of attempts to stimulate informal investing. However, research on the informal market is at an early stage. Public policy, therefore, has not had the benefit of a well-developed knowledge foundation upon which initiatives can be based. Therefore, this study attempts to advance knowledge about this important aspect of economic development. In particular, the objectives of this research study included: the identification and evaluation of specific ways in which informal investors differ from otherwise comparable people who do not invest in small firms; the documentation of the processes according to which informal investors make investment decisions; the identification of the criteria behind their choices; the analysis of the marketplace for informal risk capital; the description of psychological characteristics and motivations of informal investors; and the understanding of informal investors' perspectives regarding the barriers and opportunities inherent in the market.

To accomplish these objectives, informal investors and other individuals were surveyed from across Canada. Of 411 respondents, 279 were informal investors. The other 132 respondents provided benchmark data against which the responses of informal investors could be compared. Potential respondents were identified from boards of trade and other intermediary organizations. A very high response rate (more than 40 percent) was obtained. The informal investor respondents reported having made a total of 1,334 investments involving more than $171 million over five years. The number of investments were found to be be uniformly distributed as to size and to embrace all industrial sectors. The natural resource, manufacturing, and service sectors accounted for more than half of all investments. The high technology sector received more than its share of informal capital.

Most investors were male, with an average age of 50. In general, they were highly educated and had previous experience at the managerial levels of new firms. Investors differed significantly from non-investors in their family wealth profiles and their incomes. Informal investors were among Canada's most wealthy people; but many people exhibited the degree of wealth characteristic of informal investors. According to received economic theory, these wealthy investors demonstrated more risk tolerance than did less wealthy non-investors. Nonetheless, investors protected themselves against risk in a several ways. Their risk-reduction strategies included diversifying across markets and industries, investing as members of syndicates, involving themselves closely with the firms, establishing contractual arrangements and covenants with the other owners, and the using hybrid financial investments that often included a secured debt component. Investors expect rates of return that are consistent with those required by other participants in the venture capital arena. Investors provide patient capital: they expect to hold their investment for an average of 6.35 years.

Investors had little use for national matchmaking services or provincial venture capital corporations such as Ontario's SBDC's. On the other hand, local advocacy services were found to facilitate informal capital formation. Investors learn of potential opportunities primarily through personal means and, especially for distant opportunities, from business associates. The references of business associates in this process are important determinants of investment decisions.

The process by which informal investors arrive at decisions may be viewed as a three-stage process. Investors rejected an average of 72.6 percent of proposals out of hand and an additional 15.9 percent following initial investigation. The perceived potential of the product and industry, the perceived backgrounds of the principals, and the anticipated financial payoffs are primary determinants of decisions at these stages. Following due diligence, an additional 6.3 percent of proposals are rejected. Following negotiations, an average of one proposal in 40 ultimately results in consummation of a financing agreement.

The motivations of informal investors were examined to help entrepreneurs to fashion their business plans in ways that might improve their chances of finding equity financing. It was found that three broad factors were involved. These were the perception of financial rewards, the level of comfort felt about an investment, and the degree to which the opportunity provides excitement and affiliation. While the financial and comfort factors were primary, the importance of the excitement and affiliation was significant.

Analysis of the way in which the informal marketplace functions indicated that it works at a surprisingly high level of efficiency. Communications and syndication among investors and other participants occur with considerable regularity. Investors perceive a more than sufficient deal flow without matchmaking services.

From the investors' perspective, the gap in the market is the dearth of attractive opportunities. For investors, the perception that the principals of the firms lack the managerial capability to make the business a success is paramount and pervasive. The need to help entrepreneurs improve their managerial talents and to develop appropriate and professional business plans is crucial.

The potential size of the market is vast, but largely untapped. Potential investors shy away from the market because of the risk they perceive. This risk might be ameliorated if the principals of potential investments were able to demonstrate the managerial talents necessary for success. To be sure, this is not the only component of risk; however, it is one critical dimension. The improvement of the management skills of the owners of growing businesses must be a high priority if the informal market is to be expanded.

Local, personal assistance by intermediaries of integrity addresses this need. Local assistance with business development and business plan fabrication is essential. The screening process implicit in such a process helps prevent investors from abandoning the marketplace and increases the likelihood of a deal. As a result, recommendations for intermediation are advanced.

These include making use of such venues as boards of trade and local economic development agencies to house intermediation services. Such institutions maintain the respect of the business community and fulfil the need for a market-maker of high integrity. Intermediaries or matchmaking services ought to incorporate well-known minimum 'listing requirements'. Without such filtering, investors exit the market and the market degenerates. This is a part of the role of a 'lead investor'.

Consideration should be given to amendments to the legislative environment so that prospectus requirements could be waived if investors fulfilled certain well-defined characteristics. Such characteristics would need to demonstrate sufficient sophistication that the requirement for protection is obviated. As an example, in the U.S., investors qualify as 'sophisticated' investors under the terms of "Regulation D". This regulation specifies personal qualities of education and experience that identify sophisticated investors.

The data collected in this study are consistent about the psychological portrait of the typical informal investor. Investors tend to be men with internal locus of control, very high needs for achievement and dominance, and moderately high needs for affiliation and autonomy. They are intrinsically motivated, highly involved with their work and their investments, very satisfied with their jobs, and moderately satisfied with their investments' performance. Investors report relatively high levels of perceived stress and cope with this stress by working harder. This profile suggests several strategies that could be used by entrepreneurs to improve their chances of attracting informal risk capital.

Entrepreneurs who are seeking capital should present the investment as a challenge. The challenge should be one that offers investors the opportunity to satisfy their sense of confidence in their own abilities and their high need to equate successes with their own efforts. Second, investors also should be offered some formal type of leadership position in the organization, and they need to be formally included in the decision-making process. Third, investors need to be offered non-monetary incentives to invest (i.e., learning opportunity, media attention). These incentives should appeal to their internal locus of control and to their high levels of work involvement and intrinsic motivation. Finally, informal investors must be kept advised on an on-going basis of the progress of the investment and be provided with opportunities to contribute more than money. Stress levels increase for angels who do not feel that they have enough control over their informal investments and many cope by decreasing the amount of money that they invest. Involving these investors, on the other hand, might encourage them to work harder to make the investment a success.

Investor respondents were asked to evaluate existing public policy measures and to suggest modifications or additions. It was found that the current exemption from capital gains tax was not particularly effective in prompting informal investment. With an average investment of approximately $100,000, an expected holding period of 6.35 years, and an average required rate of return of 51 percent, the lifetime exemption is used up with one successful investment. Of course, investors would prefer to see some exemption than none.

Investors made a variety of suggestions for improvements to the tax climate for informal investment. These included measures to reduce corporate taxes. This would leave additional funds in the hands of the owners of successful businesses, owners who frequently become investors in the companies of other individuals. Frequent suggestions included the elimination of capital gains taxation on the proceeds of investments in small businesses and expansion of the ability to write off investment losses against income. On the basis of the findings presented here, a strong case could be made for the elimination of capital gains taxes on investments held in Canadian SMB's if those investment were held for a minimum time. Insofar as investors expect (on average) to hold investments for more than six years, a minimum holding period to qualify for exemption from capital gains taxes might reasonably be set at five years.

Two aspects of taxation policy were problematic. One was the instability of tax policy. The frequent changes to tax regimes constitute one dimension of risk in an already risky market. Stability of tax policy is essential. Second, respondents voiced frustration over the perception of tax benefits that distort capital markets, even though most such distortions no longer exist.

With some surprise, it was found that provincial venture capital corporations were seldom used by informal investors. The high financial expense and the cumbersome bureaucratic burden of SBDC creation were significant deterrents, especially for smaller investments. A review of this program is well advised.

Local, municipal endeavours are the most effective means of supporting the informal market. This is not surprising given the market's local and personal nature. In many regions, local intermediation services (often including a matchmaking facility) have evolved. Unfortunately, each is 're-inventing the wheel' as far as facilitating informal investment is concerned. A primary role for government at all levels is the support of such endeavours. One cost-effective and valuable initiative is the organization of a national conference at which all those involved in local matchmaking could learn from each other.

In summary, it is difficult to make the case for a shortage of capital. Nor is there a dearth of innovations or entrepreneurial ideas. The shortage is one of managerial ability. Access to a potentially large supply of informal capital can only be facilitated by reducing the deterrents that investors perceive. The primary deterrent is the risk associated with financing small businesses and start-ups. The primary source of risk is the pervasive perception that the owners lack the managerial skills to convert effectively an innovation or idea into a ***business*** opportunity.

Based on these results, the gap that needs to be addressed is one of training, of converting entrepreneurs into managers.

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May 21, 1993

APPENDIX A: Questionnaire

SECTION 1. BACKGROUND INFORMATION

The following questions are designed to provide a brief bibliographical profile of respondents. Remember that all information is strictly confidential and that only aggregate data will be published. We very much appreciate your participation in this research.

1. (a) What is your sex?
   a. Male b. Female

   1.(b) Which city, province do you reside in? ____________________

2. What is your age? ________ YEARS

3. What is your present marital status?
   a. Married or living with a significant other (hereafter referred to as "spouse")
   b. Divorced → skip to Q.8
   c. Separated → skip to Q.8
   d. Never married → skip to Q.10
   e. Widowed → skip to Q.8

4. What is your spouse's age? _______ YEARS

5. Does your spouse work for pay?
   a. No (please skip to Q.8)
   b. Yes

6. How many /hours a week does your spouse work on his/her job? ________ HOURS

7. Which of the following descriptions best describes most of the work your spouse does? (Please circle one)
   a. Managerial
   b. Professional
   c. Administrative
   d. Clerical
   e. Craft
   f. Service
   g. Other (please specify) ____________________

8. Do you have any children?
   a. YES ______ CHILDREN
   b. NO → skip to Q.10

9. Please answer the following questions concerning your children.

	AGE	SEX (please circle)	LIVING AT HOME (please circle)
CHILD #1	___ YEARS	M F	NO YES
CHILD #2	___ YEARS	M F	NO YES
CHILD #3	___ YEARS	M F	NO YES
CHILD #4	___ YEARS	M F	NO YES
CHILD #5	___ YEARS	M F	NO YES
CHILD #6	___ YEARS	M F	NO YES

10. Do you have any dependants other than your spouse or children living with you?
    a. No
    b. Yes (Please specify) ______________ lives with me

11. Are you self employed? a. Yes → skip to Q.14 b. No

12. How long have you worked for YOUR PRESENT EMPLOYER? _____ YEARS

13. How long have you had YOUR PRESENT JOB? ______ YEARS

14. How many individuals report to you directly? ________ PEOPLE

15. Please circle the letter which BEST describes:

YOUR Educational Background		YOUR SPOUSE'S Educational Background	
		a.	No spouse
a.	High School or less	b.	High School or less
b.	Courses at Community College	c.	Courses at Community College
c.	Community College	d.	Community Colleges
d.	Some university	e.	Some university
e.	A university degree	f.	A university degree
f.	Post Graduate Degree(s)	g.	Post Graduate Degree(s)

16. Have you ever been involved at the top management level (as director or officer) in the start-up of a new venture?
    a. YES   b. NO

17. If YES, have you been employed in a similar business prior to this start-up?
    a. NO   b. YES (please specify) ____________________

18. How many hours a week do you spend working? ______ HOURS

19. What is the population of the municipality where YOU presently reside?
    a. Under 10,000
    b. 10,000 to 100,000
    c. 100,001 to 250,000
    d. 250,001 to 500,000
    e. Over 500,000

20. How long have you lived in this municipality? ______ YEARS

21. (a) How many different salaried jobs have you held since you left school? ______ JOBS
    (b) What is the nature of your past business experience:
    i) senior management of a large corporation?
    ii) senior management of a medium-sized business ($25-$100 million annual sales)?
    iii) senior management of a small business ($500,000-$25 million annual sales)?
    iv) middle management
    v) professional
    vi) other ____________

    (c) What best describes most of the work you do?
    i) managerial
    ii) professional
    iii) administrative
    iv) clerical
    v) craft
    vi) service
    vii) retired
    viii) other ____________

22. Please circle the category which BEST describes, for the current year, *before taxes*:

YOUR INCOME		YOUR SPOUSE'S INCOME	
		a.	no spouse
a.	less than $35,000	b.	less than $ 35,000
b.	$ 35,000 - $ 49,999	c.	$ 35,000 - $ 49,999
c.	$ 50,000 - $ 64,999	d.	$ 50,000 - $ 64,999
d.	$ 65,000 - $ 74,999	e.	$ 65,000 - $ 74,999
e.	$ 75,000 - $ 99,999	f.	$ 75,000 - $ 99,999
f.	$100,000 - $149,999	g.	$100,000 - $149,999
g.	$150,000 and over	h.	$150,000 and over

23. Please circle the category which BEST describes:

Total Personal Assets		Personal Net Worth (Personal assets less liabilities)	
a.	less than $ 50,000	a.	negative or zero
b.	$ 50,000 -$ 74,999	b.	less than $ 50,000
c.	$ 75,000 -$ 99,999	c.	$ 50,000 -$ 74,999
d.	$100,000 -$149,999	d.	$ 75,000 -$ 99,999
e.	$150,000 -$299,999	e.	$100,000 -$149,999
f.	$300,000 -$499,999	f.	$150,000 -$299,999
g.	$500,000 -$999,999	g.	$300,000 -$499,999
h.	$1,000,000 and over	h.	$500,000 -$999,999
		i.	$1,000,000 and over

24. (a) Do you invest any of your personal funds in the following? **Circle as many as apply.**
   i) the stock market
   ii) mutual funds
   iii) bonds
   iv) GIC's and the like
   v) real estate, other than principal residence
   vi) coins, stamps, art and the like
   vii) directly in small business
   viii) other (please specify) ________________

(b) If you do **not** invest directly in small business, is there a particular reason? **Circle as many as apply.** (If you do invest directly in small business, please skip to 24(c).)
   i) lack of suitable opportunities
   ii) lack of information about such investments
   iii) too much risk involved
   iv) too much capital required
   v) other (please specify) ____
   THANK YOU, PLEASE SKIP TO Q.51

*****If you answered "no" to each and every item listed in 24(a), please skip to Question 51. Otherwise, please continue.*****

(c) Approximately what percentage of your annual income derives from these risk capital investments?
   i) less than 2%
   ii) 2% to 10%
   iii) 11% to 25%
   iv) 26% to 50%
   v) more than 50%

*****If you answered "no" to (vii) in 24(a), please skip to question 51. If you do or have invested directly in small business, please continue.*****

SECTION 2: INVESTMENT PROFILE

The following questions are designed to measure the extent and nature of past risk capital investments in young or start-up firms. For purposes of this questionnaire, risk capital is defined as equity or equity-type capital for young or start-up companies.

25. Within the past five years, how many risk capital investments have you made?

_________ *investments in Canada* _________ *investments outside Canada*

26. Of the investments reported in Q.25, how many fell in the following categories which represent the amount(s) of funds personally committed by you?

	NUMBER
a. under $10,000	____
b. $ 10,000 - $ 24,999	____
c. $ 25,000 - $ 49,999	____
d. $ 50,000 - $ 99,999	____
e. $100,000 - $249,999	____

f. $250,000 and over → please specify the appropriate amount for each investment
i. $ ________ ii. $________ iii. $________

27. Of the investments reported in Q.25, how many fell in each of the following categories?

	NUMBER
a. Retail	______
b. Wholesale trade	______
c. Manufacturing-High Technology products	______
d. Manufacturing-Industrial products	______
e. Manufacturing-Consumer products	______
f. Service	______
g. Construction	______
h. Finance/Banking/Insurance	______
i. Transportation	______
j. Natural Resources	______
k. Real Estate	______
l. Other (please specify) __________	______

28. Of the investments reported in Q.25, how many fell in each of the following geographic categories?

	NUMBER OF CASES
a. within 10 miles of your home or office	______
b. beyond 10 miles but within 50 miles	______
c. beyond 50 miles but within 300 miles	______
d. beyond 300 miles	______

29. Of the investments reported in Q.25, in how many cases did the total risk capital financing involve other types of investors besides yourself who also put up risk capital?

	NUMBER OF CASES
a. other individuals	______
b. venture capital firms	______
c. public economic development agencies (ie. FBDB)	______
d. Small Business Development Corporations	______
e. other (please specify) __________	______

30. Consider the total assets of your immediate family. What percentage of these assets is represented by your risk capital investments in young or start-up firms? Please circle.
   a. under 5%
   b. 5% - 10%
   c. 11% - 25%
   d. 26% - 50%
   e. more than 50%

31. Below is a list of ways in which you might have learned about risk capital investment opportunities that you have considered during the last five years. Please indicate how often each source has been used by circling the appropriate number below.

	NOT OFTEN				VERY OFTEN
a. Active personal search	1	2	3	4	5
b. Accountants or lawyers	1	2	3	4	5
c. Business associates	1	2	3	4	5
d. Friends	1	2	3	4	5
e. Family	1	2	3	4	5
f. COIN*	1	2	3	4	5
g. Canadian New Ventures (VentureLink)	1	2	3	4	5
h. FBDB**	1	2	3	4	5
i. Entrepreneurship shows and fairs	1	2	3	4	5
j. Profit (formerly Small Business Magazine)	1	2	3	4	5
k. Other magazines or newspapers	1	2	3	4	5
l. Other (please specify)__________	1	2	3	4	5

* *Computerized Ontario Investment Network*
** *Federal Business Development Bank*

32. (a) Which of the above sources have been the most useful for generating leads or risk capital investment opportunities that you have seriously considered?__________

(b) Do you introduce other potential investors to entrepreneurs requiring financing?
a. Yes   b. No

(c) When you choose not to invest in a particular investment opportunity, do you sometimes refer the entrepreneur or intermediary to another potential investor of your acquaintance?
a. Yes   b. No

33. (a) Have you ever used COIN?
a. Yes   b. No   c. Not familiar with COIN

If YES, would you use COIN again?
a. Yes   b. No

(b) The Federal gov't has provided an exemption from income taxes on the first $100,000 of capital gains income.
(i) Did this exemption encourage you to undertake informal investment activity
a. Yes   b. No

(ii) Would you be more likely to undertake informal investment activity if this exemption were increased?
a. Yes   b. No

(c) Can you suggest tax incentives which you would like to see enacted? Please describe.

____
____
____
____
____
____

SECTION 3. INVESTMENT DECISION MAKING

This section asks questions about what prompts you to invest and about how you make decisions about particular investments.

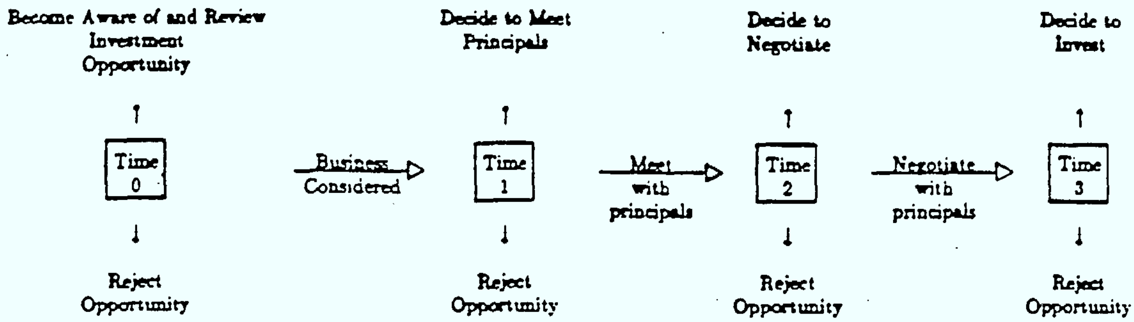

Figure 1 is a schematic of what could happen during the process of making decisions about whether or not to invest in a particular proposal. Please refer to it when aswering questions 34 to 39.

34. a. Out of the every 100 opportunities, what percent do you reject at time 0? _____ PERCENT

    b. What is the most frequent reason for such a rejection?

    ____ REASON

    c. Out of the original 100 opportunities, what percent do you reject at time 1?____ PERCENT

    d. What is the most frequent reason for such a rejection?

    ____ REASON

    e. Out of the original 100 opportunities, what percent do you reject at time 2?____ PERCENT

    f. What is the most frequent reason for such a rejection?

    ____ REASON

    g. Out of the original 100 opportunities, what percent do you reject at time 3? ____ PERCENT

    h. What is the most frequent reason for such a rejection?

    ____ REASON

35. Please recall Figure 1. Below is a list of things that you may consider at Time 0 when deciding whether to proceed to Time 1. Please evaluate how important each of these are to your decision by circling the appropriate number on the scale below.

	NOT IMPORTANT			MODERATELY IMPORTANT			VERY IMPORTANT
	|			|			|
potential of industry	1	2	3	4	5	6	7
potential of product or idea	1	2	3	4	5	6	7
having a business plan	1	2	3	4	5	6	7
realism of business projections	1	2	3	4	5	6	7
opinions of your colleagues about the opportunity	1	2	3	4	5	6	7
background of the principals	1	2	3	4	5	6	7
fit with your own background	1	2	3	4	5	6	7
perceived financial rewards	1	2	3	4	5	6	7
other	1	2	3	4	5	6	7

36. Please recall Figure 1. Below is a list of things that you may consider at Time 1 when deciding whether to proceed to Time 2. Please evaluate how important each of these are to your decision by circling the appropriate number on the scale below.

	NOT IMPORTANT			MODERATELY IMPORTANT			VERY IMPORTANT
	|			|			|
potential of industry	1	2	3	4	5	6	7
potential of product or idea	1	2	3	4	5	6	7
having a business plan	1	2	3	4	5	6	7
realism of business projections	1	2	3	4	5	6	7
opinions of your colleagues about the opportunity	1	2	3	4	5	6	7
background of the principals	1	2	3	4	5	6	7
fit with your own background	1	2	3	4	5	6	7
fit with other investments	1	2	3	4	5	6	7
perceived financial rewards	1	2	3	4	5	6	7
other	1	2	3	4	5	6	7

37. Please recall Figure 1. Below is a list of things that you may consider at Time 2 when deciding whether to proceed to Time 3. Please evaluate how important each of these are to your decision by circling the appropriate number on the scale below.

	NOT IMPORTANT			MODERATELY IMPORTANT			VERY IMPORTANT
	|			|			|
potential of industry	1	2	3	4	5	6	7
potential of product or idea	1	2	3	4	5	6	7
having a business plan	1	2	3	4	5	6	7
realism of business projections	1	2	3	4	5	6	7
opinions of your colleagues about the opportunity	1	2	3	4	5	6	7
background of the principals	1	2	3	4	5	6	7
fit with your own background	1	2	3	4	5	6	7
fit with other investments	1	2	3	4	5	6	7
perceived financial rewards	1	2	3	4	5	6	7
other	1	2	3	4	5	6	7

38. Think of investment opportunities you have rejected. What were the most common reason(s) why you declined to invest? (Circle one or more as appropriate).

a. unfamiliar with the technology or the nature of the investment
b. market potential insufficient
c. lack of confidence in management
d. unsatisfactory risk/return ratio
e. inadequate or unsatisfactory business plan
f. other (please specify)________________________________

39. Is Figure 1 an adequate description of the investment decision making process you use?
    a. Yes
    b. No, (please explain)____

40. Please indicate the extent to which you agree or disagree with each of the following statements by circling the appropriate response below.

I decide to invest directly in a business opportunity because:	Strongly Disagree			Neither Agree nor Disagree			Strongly Agree
I expect large financial returns	1	2	3	4	5	6	7
I value my participation with the individuals involved	1	2	3	4	5	6	7
I understand the nature of the particular business opportunity	1	2	3	4	5	6	7
It is important to me to be a part of creating something	1	2	3	4	5	6	7
I've had previous experience in this kind of business	1	2	3	4	5	6	7
I have confidence in the business's principals	1	2	3	4	5	6	7
I value the sense of excitement associated with my involvement	1	2	3	4	5	6	7
My research indicated the opportunity has potential	1	2	3	4	5	6	7
I value the recommendations about the business made by people whose judgement I respect	1	2	3	4	5	6	7
The business is the "be-all and end-all" of the principals financial future	1	2	3	4	5	6	7
It is more fun than gambling	1	2	3	4	5	6	7
I have confidence in my ability to manage the risks	1	2	3	4	5	6	7
My gut-feeling regarding possible investments is dependable	1	2	3	4	5	6	7
I am lucky in such endeavours	1	2	3	4	5	6	7

Can you please specify other reasons why you invest?

____

41. How large a financial return (after taxes) do you expect on your risk-capital investments? ______ % over_____ years. How long do you expect to hold your investment before cashing out?______ years

42. Do you expect personal representation on:
    a. a formal Board of Directors   b. a Board of Advisors

43. Do you expect to participate directly in the business as an operating principal, i.e., financial officer, sales & marketing, engineering?
    a. Yes   b. No

44. Do you insist on a formal shareholder's agreement?
    a. Yes   b. No

45. Are your risk-capital investments structured in the form of:
    a. straight equity   b. debt only   c. a combination of debt and equity

46. Do you negotiate operating covenants?
    a. Yes   b. No

    If YES, which of the following have you asked for in past investments?
    a. minimum debt/equity ratio
    b. maximum salaries/dividend payouts
    c. minimum working capital ratio
    d. others (please specify)____________________

47. Do you prefer a silent role in the company?
    a. Yes   b. No

48. Do you object to people knowing about your investment in a given company?
    a. Yes   b. No

49. How would you characterize the availability of investment opportunities in which you would seriously be interested?
    a. plentiful   b. adequate   c. scarce

50. Compared with five years ago, is it getting easier for you to find high-quality investment opportunities?

YES

(a) More good companies are forced to seek equity.

(b) More investment exchanges/databases/publications

(c) Quality of management is improving

(d) Involvement of other investors is increasing, reducing exposure

(e) Other________________________________

NO

(a) Tougher economy

(b) Competitive marketplace

(c) Quality of management is declining

(d) Entrepreneur's unwillingness to give up equity, accept investors' conditions

(e) Other________________________________

51. Please rate the following aspects of risk capital investment according to whether they encourage or discourage you from investing.

	Major Disincentive		Neutral		Major Incentive
few opportunities	1	2	3	4	5
tax considerations	1	2	3	4	5
risky	1	2	3	4	5
lack of liquidity	1	2	3	4	5
investment required is often too high	1	2	3	4	5
time required to search for deals	1	2	3	4	5
time required to manage the company	1	2	3	4	5
other	1	2	3	4	5

SECTION 4: PERSONALITY, MOTIVATIONS AND NEEDS

52. Please indicate the extent to which you agree with each of the following statements:

	Strongly Disagree 1	2	3	Neither Agree Nor Disagree 4	5	6	Strongly Agree 7
Like plenty of excitement going on around me	1	2	3	4	5	6	7
Nearly always have a quick answer when people talk to me	1	2	3	4	5	6	7
Like practical jokes	1	2	3	4	5	6	7
Am rather lively	1	2	3	4	5	6	7
Like doing things where you have to act quickly	1	2	3	4	5	6	7
Like getting a party going	1	2	3	4	5	6	7
When making new friends, I usually make the first move	1	2	3	4	5	6	7
Like telling jokes or funny stories to your friends	1	2	3	4	5	6	7
Am usually happy and cheerful	1	2	3	4	5	6	7
Like mixing with people	1	2	3	4	5	6	7
Sometimes get so restless that I cannot sit in a chair long	1	2	3	4	5	6	7
Usually like letting myself go and enjoying myself at a party	1	2	3	4	5	6	7
Like going out a lot	1	2	3	4	5	6	7
Think that other people think of me as being very lively	1	2	3	4	5	6	7
Usually feel sure I can do the things I have to	1	2	3	4	5	6	7
Say the things you are thinking quickly	1	2	3	4	5	6	7
Usually feel if things go badly they will work out right in the end	1	2	3	4	5	6	7
Am slow and unhurried in the way I move	1	2	3	4	5	6	7
Often long for exciting things to happen	1	2	3	4	5	6	7
Very much enjoy talking to people	1	2	3	4	5	6	7
53. I do my best work when my assignments are fairly difficult	1	2	3	4	5	6	7
I try very hard to improve on my past performance	1	2	3	4	5	6	7
I take moderate risks and stick my neck out to get ahead	1	2	3	4	5	6	7
I try to perform better than my colleagues	1	2	3	4	5	6	7
I try to avoid any added responsibilities	1	2	3	4	5	6	7
When I have a choice, I try to work in a group instead of alone	1	2	3	4	5	6	7
I pay a good deal of attention to the feelings of others at work	1	2	3	4	5	6	7
I find myself talking to those around me about non-business related matters	1	2	3	4	5	6	7
I prefer to do my own work and let others do theirs	1	2	3	4	5	6	7
I express my disagreements with others openly	1	2	3	4	5	6	7
In my work, I try to be my own boss	1	2	3	4	5	6	7
I go my own way, regardless of the opinion of others	1	2	3	4	5	6	7
I disregard rules and regulations that hamper my personal freedom	1	2	3	4	5	6	7
I try my best to work alone on a job	1	2	3	4	5	6	7
I consider myself a "team player"	1	2	3	4	5	6	7

	Strongly Disagree			Neither Agree Nor Disagree			Strongly Agree
I seek an active role in the leadership of a group...	1	2	3	4	5	6	7
I find myself organizing and directing the activities of others	1	2	3	4	5	6	7
I strive to gain more control over the events around me	1	2	3	4	5	6	7
I strive to be "in command" when I am working in a group	1	2	3	4	5	6	7
I avoid trying to influence those around me to see things my way	1	2	3	4	5	6	7
When I do my work well, it gives me a feeling of accomplishment	1	2	3	4	5	6	7
When I perform my work well, it contributes to my personal growth and development	1	2	3	4	5	6	7
I feel a great sense of personal satisfaction when I do my work well	1	2	3	4	5	6	7
Doing my work well increases my feeling of self-esteem	1	2	3	4	5	6	7
What I do is more important to me than the money I earn	1	2	3	4	5	6	7
I would be happy if I didn't have to work at all	1	2	3	4	5	6	7
My main interest is to get enough money to do the other things I want to do	1	2	3	4	5	6	7

55. Please indicate how satisfied you are with:	VERY DISSATISFIED			NEUTRAL			VERY SATISFIED
Your work in general	1	2	3	4	5	6	7
The performance of your investments (if any)	1	2	3	4	5	6	7
Your pay	1	2	3	4	5	6	7
The number of hours you work	1	2	3	4	5	6	7
The schedule of your working hours	1	2	3	4	5	6	7

SECTION 5: STRESS AND COPING

These questions ask you about your feelings and thoughts during the last month. Please indicate how often you felt or thought a certain way (although some of the questions are similar, there are differences and you should treat each one separately).

In the last month how often have you:	NEVER			SOMETIMES			ALWAYS
been upset because something happened unexpectedly?	1	2	3	4	5	6	7
felt that you were unable to control important things in your life?	1	2	3	4	5	6	7
felt nervous or "stressed"?	1	2	3	4	5	6	7
dealt successfully with irritating life hassles?	1	2	3	4	5	6	7

	NEVER			SOMETIMES			ALWAYS
felt that you were coping effectively with important changes that were occurring in your life?	1	2	3	4	5	6	7
felt confident about your ability to handle your personal problems?	1	2	3	4	5	6	7
felt that things were going your way?	1	2	3	4	5	6	7
found that you could not cope?	1	2	3	4	5	6	7
been able to control irritations in your life?	1	2	3	4	5	6	7
felt you were on top of things?	1	2	3	4	5	6	7
been angered because of things that happened that were outside of your control?	1	2	3	4	5	6	7
found yourself thinking about things that you had accomplished?	1	2	3	4	5	6	7
been able to control the way you spent your time?	1	2	3	4	5	6	7
felt difficulties were piling up so high that you could not overcome them?	1	2	3	4	5	6	7

57. How frequently do you use the following strategies to cope with stress?

I work harder than usual	1	2	3	4	5	6	7
I just try to forget about it	1	2	3	4	5	6	7
I find some activity to take my mind off things, like going to a movie or playing some sports	1	2	3	4	5	6	7
I go shopping	1	2	3	4	5	6	7
I have an alcoholic drink	1	2	3	4	5	6	7
I take a tranquillizer	1	2	3	4	5	6	7
I take some other kind of medicine	1	2	3	4	5	6	7
I smoke more often	1	2	3	4	5	6	7
I talk things over with my spouse	1	2	3	4	5	6	7
I talk things over with my friends	1	2	3	4	5	6	7
I talk things over with my colleagues at work	1	2	3	4	5	6	7
I talk things over with my supervisor at work	1	2	3	4	5	6	7
I participate in some organized groups or clubs in order to get social support	1	2	3	4	5	6	7
I try to get away from everyone	1	2	3	4	5	6	7
I engage in some religious activity, such as going to church, saying a prayer, or meditating	1	2	3	4	5	6	7
I seek professional help, such as a counsellor or therapist	1	2	3	4	5	6	7

APPENDIX B: SAMPLING PROCEDURES

The following is an account of the sampling procedure for each geographic area. An overall response rate of 42.3% was achieved. (Response rate is defined as the number of participants who responded to the questionnaire to the number of those who were contacted and invited to participate.) *A priori*, the size of the population of informal investors is unknown, given the inherent invisibility of the informal investors.

EASTERN PROVINCES

Newfoundland

The St. John's Board of Trade identified individuals in the community whom they knew to be informal investors. Introductory letters inviting the investors to participate in the survey initiated contact between interviewer and respondent. The interviewer then proceeded to contact the potential respondent by telephone to schedule an interview. If an interview could not be scheduled, the investor was mailed the questionnaire along with a postage-paid envelope. The number of potential investor respondents grew well beyond the initial list through referrals (snowball data collection technique). The St. John's Board of Trade supplied an interviewer from their office to administer the questionnaire. The data collection period extended from April 1991 to August 1991. The overall response rate achieved was 27.5%.

Prince Edward Island

Prince Edward Island investors were sourced by Robert Safrata based on an earlier study of investors. Investors were mailed an introductory letter under Professor Riding's signature and a summary of the study. These investors were then contacted and interviews were scheduled. The data collection period was June 1992, and the response rate was 80%.

Nova Scotia and New Brunswick

Investors in Nova Scotia, and New Brunswick were called personally by Robert Safrata. Those investors who agreed to an interview then called the interviewer to schedule an interview. Additional names were obtained from these investors, and the additional investors were interviewed or were mailed a questionnaire package.[38] The data collection period was October 1992, and a response rate of 53% was achieved.

[38] Questionnaire package: a covering letter guaranteeing confidentially (see Appendix F), an executive summary (see Appendix G), a questionnaire and a postage-paid return envelope.

QUEBEC

For reasons of economy, respondents in the province of Quebec were limited to the city of Montreal and its environs. The initial list of Montreal investors' names was obtained from a variety of sources. Toronto investors interviewed referred the interviewer to some of the Montreal investors; others were obtained from a list published by Profit Magazine's "Canada's 50 Fastest Growing Companies"; others were obtained from an list of investor participants from previous research. Additional Montreal respondents were referred to the interviewer by other Montreal respondents. When time permitted, investors were mailed an introductory letter under Professor Riding's signature. Usually, however, investors were simply telephoned and asked to participate in the study. The data collection period was from August 1991 to July 1992. A response rate of 78% was achieved.

ONTARIO

Central Corridor

The Georgian Triangle Economic Development Corporation asked the former mayor of Collingwood to assist them to compile a list of investors in the area. A covering letter under the signatures of the former mayor and the manager of the Georgian Triangle Economic Development Corporation, an executive summary of the study, the questionnaire and a postage-paid return envelope were sent to these investors. The data collection period was during July and August 1991. A response rate of 30% was achieved.

Eastern Ontario

Kingston — The Kingston Area Economic Development Commission provided a list of local investors. These investors were mailed a package containing a covering letter under Professor Riding's signature indicating how the investors were sourced, an executive summary, the questionnaire, and a postage-paid return envelope. The data collection period was March 1992 . The response rate was 11.5% for this area.

Ottawa — A similar study to the venture capital study had been conducted by Master of Management Studies graduate Dominique Short, in 1986. The list of investors generated by her study formed the initial list of Ottawa area investors. These individuals were mailed an introductory letter under Professor Riding's signature, along with an executive summary of the study. Subsequently, the interviewer telephoned the investor and scheduled an interview. Additional respondents were named by those investors and the Ottawa sample was constructed. The data collection period for this area was from July to October 1992. A response rate of 85% was achieved.

The Ottawa-Carleton Economic Development Corporation also assisted with the data collection in the Ottawa area. It mailed questionnaire packages to investors who had not already approached. (This data collection technique will be referred to as a "Best Efforts" technique.) Packages were mailed in November 1992, and a response rate of 20% resulted.

Metropolitain Toronto

An initial list of potential investor respondents was provided by Robert Safrata who also telephoned the investors and informed them of the study. The interviewer then followed up these calls and scheduled an interview or arranged for a mail package. Those investors in turn referred the interviewer to other investors (often asking that their name not be revealed as the source). The majority of respondents was comprised of referred investors. The investor was usually telephoned (at the office) and asked to participate in the survey and an appointment was scheduled. If an appointment could not be arranged, a questionnaire package was mailed. The data collection phase for the Toronto area occurred between June and September 1991. The response rate was 66%.

Niagara Region

The Niagara Region Development Corporation maintains a matching service, LINC (Locating Investors for Niagara Corporations). The Canadian investors in the database were sent a package which contained a covering letter asking for investor participation under the signature of LINC's manager, a general covering letter under Professor Riding's signature guaranteeing confidentiality, an executive summary of the study's intent, the questionnaire, and a postage-paid envelope. The data collection period was September 1991. The response rate was 28.4%.

Northern Ontario

The Sudbury & District Chambers of Commerce provided a list of local investors. These investors were mailed a package containing a covering letter under Professor Riding's signature acknowledging the source of the investors' names, an executive summary, the questionnaire, and a postage-paid return envelope. The data collection period was January 1992 . The response rate was 24%.

WESTERN PROVINCES

Alberta

The Calgary office of Ernst & Young mailed introductory letters to the area investors with whom they were familiar. The interviewer then proceeded to call the investors to schedule interviews. Similarly, other investors were called personally by Robert Safrata in the hope of scheduling additional interviews for the same interviewer. If meetings could not be scheduled, a questionnaire package was delivered or mailed to the targeted respondent's office. The interview schedule was May 1992, and an overall response rate of 67% was achieved.

British Columbia

An initial list of contacts was provided by Robert Safrata. Other contacts' names were passed along to the interviewer through Vancouver referrals. The interviewer telephoned the contact in the hope of scheduling an interview. The data collection phase was executed during July and August 1991; the response rate is unknown.

COIN

The Canadian Opportunities Investment Network (COIN) mailed the questionnaire to all investors listed on their database. Since the investors were from across Canada, returned questionnaires were categorized according to their geographic location rather than their affliation with COIN. The response rate was 29.2%.

Respondents in Database

Area	Sample Size	Data Collection Technique	Response Rate	% of Total
Newfoundland	97	Best Efforts	27.5%	23.6
Niagara	27	Mail	28.4%	6.6
Collingwood	33	Mail	30%	8
Sudbury	6	Mail	24%	1.5
Kingston	3	Mail	11.5%	0.1
Calgary	20	Best Efforts	66.7%	4.9
Montreal	25	Best Efforts	78%	6.1
Toronto	107	Best Efforts	66%	26
Ottawa	41	Mail and Best Efforts	57%	10
COIN	13	Mail	29.1%	3.2
Vancouver	26	Personal	?	6.3
P.E.I	4	Personal	80%	0.1
N.B and N.S	9	Best Efforts	53%	2.2
Total	**411**		**42.3%**	**100**

APPENDIX C: PSYCHOMETRIC MEASURES

The respondents' **locus of control** was measured using the instrument developed by Rotter (1966). The locus of control score is calculated as the summed average of twenty item scores. A score of 7 on this scale indicates that an individual has an internal locus of control. A score of 1 indicates that the person has an external locus of control. A score of 4 indicates that the respondent displays moderate levels of both internal and external loci of control.

Need for achievement, need for affiliation, need for autonomy, and need for dominance were all assessed using the Manifest Needs Questionnaire (Steers and Braunstein, 1976). The scale consists of twenty questions, five for each of the four needs. In each case, the need score is calculated as the summed average of the five item scores. Items 5, 9, 10, 15, and 20 are reverse coded before the scores are summed. A score of 7 on these scales means that an individual has a high level of need for the motivation being measured. A score of 1 indicates that the person has a low need for the motivation, while a score of 4 indicates that the respondent has a moderate need for the motivation.

Intrinsic/extrinsic motivation was measured using Lawler and Hall's (1970) Intrinsic Motivation Scale. The Motivation scores are calculated as the summed average of the scale items (four questions). A score of 7 on this scale indicates that the individual is internally motivated. A score of 1 indicates that the person is extrinsically motivated. A score of 4 indicates that the respondent displays moderate levels of both intrinsic and extrinsic motivations.

The short form of Lodahl and Kehner's (1965) scale (three items) is used in this survey. Cronbach's alpha of the short scale range from 0.77 to 0.83. There is a seven-point strongly disagree (1) to strongly agree (7) response dimension. Work involvement is calculated as the summed average of item scores. Items two and three are reverse coded before the score is summed. Higher scores indicate greater work involvement.

The "facet" specific measure of job satisfaction developed by Quinn and Shepard (1974) for use in the Quality of Employment survey was used in this study to measure job satisfaction. Employees were asked to indicate how satisfied they were with their job in general, their pay, their work hours, their work schedule and their work tasks using a scale of 1 (very dissatisfied) through 7 (very satisfied). One question: "Please indicate how satisfied you are with the performance of your investments (if any)." was added to the job satisfaction scale to measure investment satisfaction. Job satisfaction is calculated as the summed average of item scores. High scores on this scale represent greater job satisfaction.

The Perceived Stress Scale (PSS) developed by Cohen, Kamarck, and Mermelstein (1983) was used to assess the stress levels of the respondents. The PSS is a 14-item instrument on which respondents rate on a 7-point Likert-type scale the frequency with which they have experienced different feelings within the previous month. PSS scores are obtained by reversing the scores on the positive items (numbers's 4, 5, 6, 7, 9, 10, 12, and 13) and calculating a summed average. Higher scores on this measure indicate greater levels of perceived stress. Population norms indicates that PSS scores of greater than 3.6 indicate a degree of risk for physical and mental health problems. One question, "In the last month how often have you felt anxious about the performance of your investment(s)?" was added to the scale to measure the levels of stress associated with how the respondent invested money. The measure of control used in this study is the summed average of a four question subscale embedded in the PSS (items 2, 9, 11, 13).

The coping measure used in this study was developed by Jackson and Maslach (1983). To determine which coping strategies were used by our respondents, individuals were asked to report how frequently they used each of 17 coping behaviours, using a scale of 1 (never) through 7 (always). Included among the 17 behaviour were items representing four of the seven coping dimensions identified by Burke *et al.* (1979) including Work Harder: "I work harder than usual than usual"; Escape: "I try to get away from everyone; I try to forget about it"; Support from Others: "I talk things over with my spouse, I talk things over with my colleagues at work"; and Seek Help: "I seek professional help." Items 2, 4, 5, 6, 7, 8, 14 and 16 are reverse coded before the coping score is calculated. Higher scores indicate a greater ability to cope with conflict in a healthy fashion. One question, "I actively seek new investment opportunities as a way of coping with stress" was added to the measure to capture the extent to which investors use investment itself as a coping mechanism.

May 21, 1993.

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