Approaching Disruptive Innovation in Uncertain Times

All markets adhere to cyclical patterns, influenced heavily by investor sentiment, macroeconomics, and the geopolitical backdrop. The private market is no exception.

However, as evidenced by recent advancements in artificial intelligence, technology and innovation can play an equally important role in disrupting the market status quo.

Today, many of the world's most widely adopted technologies, including the seven largest listed US companies, developed out of the venture capital ("VC") ecosystem and either disrupted existing businesses or created entirely new markets. As the next wave of innovation advances, many of these now incumbents will find themselves at risk of disruption, particularly those facing innovator's dilemma, a concept brought to light by Clayton Christensen which implies that incumbents sometimes fail by not embracing disruptive innovation.

For investors, this innovation cycle presents both challenges and opportunities.

While periods of increased market volatility and macro-uncertainty can further complicate matters due to capital constraints, slowdown in capital markets activity, valuation pressure, etc., the fact remains that VC-backed companies drive global innovation, perhaps more than ever before given how private companies continue staying private for longer. Furthermore, it is typical during these more challenging periods to find pockets of dislocation that discerning investors can optimize.

Having spent nearly two decades in the venture-backed private market, I've seen this game play out before.

Investors' inclinations to sit on the sidelines amid market volatility is natural. However, in these environments, investors would be better served continuing to strategically deploy capital into the private innovation economy at what are often dislocated prices, while remaining highly selective and exercising extreme discipline. Historically, some of the best performing vintages for public and private market investing can be linked to periods of increased volatility and macro-uncertainty.

Let me elaborate. The protracted low-interest rate environment over the past 15 years enabled many VC fund managers and companies to raise capital. However, many are failing to, or perhaps have already failed to, demonstrate long-term viability. As a result, we're experiencing a heavily bifurcated market, meaning there's a wide dispersion between high-performing managers and businesses and those that will, in all likelihood, just go away. However, this environment has also led to significant dislocations in the pricing of high-performing, private innovation companies, particularly later-stage assets typically generating hundreds of millions to billions in revenue that are at or approaching profitability.

For the most discerning investors, this is where the opportunity exists. Our investment team has continued actively deploying capital over the past couple of years, with a heavy overweight towards secondary transactions at highly discounted prices, but also new rounds of financing, convertible notes, etc. at what we believe are very attractive terms.

Herein lies the biggest lesson for investors: In periods of market dislocation, there are often attractively priced opportunities to access high-caliber, late-stage private innovation companies exhibiting superior operating metrics, differentiated business models, seasoned management teams, strong investor syndicates with proper governance, and healthy balance sheets. While investing in these market segments requires patience as the underlying assets typically require a multi-year hold to benefit from future capital appreciation and exit activity, we believe it's a small price to pay in exchange for outsized return potential from the next wave of innovators.

Sectors in Focus

Investing in the private innovation economy requires an understanding of technology trends, economic cycles, market dynamics, and aligning portfolio construction with long term goals. While technology pervades all sectors in some capacity, there are three particular areas that we believe have the potential to be highly disruptive to incumbents in 2024:

Generative AI

Generative AI ("GenAI") is a facet of artificial intelligence and machine learning that enables the creation of diverse content ranging from text, music, and art to product designs and business optimizations. As computational power and processing speeds continue improving, the applications of this technology become exponential. Not surprisingly, GenAI has garnered significant attention over the past year due to its disruptive potential to various aspects of both our global economy and daily life, which presents an attractive investment opportunity. In aggregate, over $68.7b poured into generative AI startups in 2023 according to Pitchbook,[1] with several high-profile venture-backed companies receiving significant investment from leading VCs and public technology companies. We believe this technology is in the early stages of development, and while there is significant growth potential beyond current applications, investors would be well-served to exhibit discipline and avoid potential areas that may be overhyped.

Cybersecurity

Cybersecurity relates to solutions that seek to protect computers, networks, devices, applications and data from digital attacks. Given the digitalization of our global economy, this presents a massive addressable market with multiple sources estimating annual cybercrime to surge over the next four years from $9 trillion to nearly $14 trillion by 2027.[2] Unfortunately, the sophistication of skilled hackers often seems to outpace the effectiveness of cybersecurity apparatus, further compounded by a significant shortage of qualified cybersecurity professionals. As a result, many public and private sector organizations continue increasing budgets while seeking the most robust cybersecurity solutions, which increasingly incorporate elements of AI/ML. Yet again, this results in a significant investment opportunity for the venture capital industry with key areas of focus involving network security, endpoint security, identity and access management, application security, security operations, and data security. Given the inherent fragmentation across the cybersecurity landscape, we also expect to see increased consolidation of vendors in this space.

Space Economy

The global space industry, once predominantly government-driven, has transformed into a private-sector ecosystem that is projected to surpass $1.8 trillion by 2035.[3]

[1] Pitchbook (2023)
[2] Statista (2024)
[3] World Economic Forum and McKinsey & Company (2024)

Demand for space access continues outpacing supply with backlogs spanning multiple years, and while we expect to see improvements as more launch providers come online, it will take time. Some of the more popular space economy ventures involve launch capabilities that leverage reusable and 3D-printed rockets to make space travel more cost-effective and sustainable, while others focus on advanced communication networks, microgravity applications for manufacturing and research, security and defense systems, geospatial intelligence, and diverse data collection. Notable companies like Axiom Space and SpaceX continued to secure substantial funding in 2023 and into the beginning of 2024, emphasizing the importance of robust business models, effective leadership, and overall product vitality. With increasing strategic initiatives from private and public sectors around the world, we believe the space economy represents one of the most attractive investment opportunities within the venture capital industry.

Summary

In the face of challenging market conditions and shifting cyclical patterns, many private investors have encountered difficulties in recent years. Nevertheless, we suggest that investors remain steadfast in seeking ways to access the private innovation economy, albeit while exercising extreme discipline and optimizing dislocations. With many signals pointing to a positive shift in sentiment as we move into the secondary quarter of 2024, including the Russell 2000's recent run up, a strengthening macro environment could lead to an opening of the IPO window, increased M&A activity, improved valuations, and an uptick in capital deployment across the VC ecosystem.

Christian Munafo

Christian Munafo is Chief Investment Officer of Liberty Street Advisors, Inc. and a portfolio manager to The Private Shares Fund.

The Private Shares Fund Top 10 Holdings* as of 3/31/24

GrubMarket
Space Exploration Technologies
nanotronics
Tradeshift
Axiom Space
Motive Formerly KeepTruckin
Contrast Security
NextRoll
Lookout
Betterment

*Represents 33.16% of Fund holdings as of March 31, 2024. Holdings are subject to change. Not a recommendation to buy, sell, or hold any particular security. **Current and future holdings are subject to risk.** The Fund's website updates top holdings and total holdings frequently. For a list of the Fund's current holdings, please visit the Fund's website: https://privatesharesfund.com/portfolio/

Important Disclosures

As of December 9, 2020, Liberty Street Advisors, Inc. became the adviser to the Fund. The Fund's portfolio managers did not change. Effective April 30, 2021, the Fund changed its name from the "SharesPost 100 Fund" to "The Private Shares Fund." Effective July 7, 2021, the Fund made changes to its investment strategy. In addition to directly investing in private companies, the Fund may also invest in private investments in public equity ("PIPEs") where the issuer is a special purpose acquisition company ("SPAC"), and profit sharing agreements.

Investors should consider the investment objectives, risks, charges and expenses carefully before investing. For a prospectus with this and other information about The Private Shares Fund (the "Fund"), please download here***, visit the Fund's website at*** PrivateSharesFund.com ***or call 1-855-551-5510. Read the prospectus carefully before investing.***

The investment minimums are $2,500 for the Class A Share and Class L Share, and $1,000,000 for the Institutional Share.

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