Rewiring Goals-Based Investing with Equity Crowdfunding

By Jamie McIntyre, CIPM

The syzygy of crowd-empowering technology, the surge in fintech, and regulation changes present an opportunity for advisors to change clients’ perspectives on wealth and value creation. As access to quality portfolios has become commoditized, advisors are moving beyond analytics for deeper connections with clients. The adoption of goals-based planning has upgraded advisor-client conversations and resulted in wealth management advice that's hewn more closely to core individual and family needs. As basic life goals are satisfied, new impactful objectives emerge. These extensions of goals-based investing can deepen value and catalyze change.

This article addresses the following:

- How reward-based crowdfunding has tapped into collective demand and set the stage for new markets
- Regulation changes that have redefined public and private security offerings
- How early stage investing incorporates a goals-based framework based on Maslow’s hierarchy of needs
- Why the next generation’s first investment will be in a private security

Why are these things important?

- Robo-advisors are offering extremely low-cost diversified portfolios directly to consumers. Advisors’ value-add increasingly will be tied to how they can connect and serve the needs of clients above and beyond a commoditized portfolio.
- Millennials are not connecting with current wealth management offerings. They desire more purpose behind their investments of time and money, and they are keeping more than 50 percent of their assets in cash (Robinson 2016).
- Entrepreneurs who have sold their businesses and retirees have pent-up intellectual and financial capital that advisors can channel in a high-value and intrinsically meaningful manner.

The Corruption of Market Intent

Our markets have foundations in the provision of capital to further innovation and growth. Investors have been rewarded for taking risks in funding the advancements of the companies and industries they invest in and participating in the upside of the growth. But today, investing and wealth management have strayed from this initial premise.

An overwhelming share of individual assets is deployed in vehicles in which the investor has little or no awareness of the underlying investments. These include mutual funds, exchange-traded funds, hedge funds, private equity funds, and separate accounts. One of the most powerful modes of advocacy and support that an investor can have is off-loaded to multiple third parties that have no concept of how an individual’s desires are reflected in the investments. As advisors and money managers we have to ask ourselves, did we do this by design? Does the disassociation between clients and their money make us more important? More needed?

As an industry, our clinical treatment of money and wealth has obfuscated investments to the point that people don’t know how their money is being used or where it is deployed. We inundate investors with charts and graphs and theories of asset-allocation-powered Monte Carlo simulations that create distance between clients and their wealth. This, in turn, has clients dutifully abdicate responsibility for the deployment of funds to teams of professional advisors and money managers. The purpose of clients’ money is distilled into a tool solely to fund future money. Today’s investors are not apathetic; they just never learned to raise the question. This is about to change.

Crowdfunding—Chomping at the Bits

Crowdfunding is the use of small amounts of capital from a large number of individuals to finance a new business venture, and it’s done most often through the Internet. Its initial objective was to provide exposure and encouragement in the arts. One of the first crowdfunding projects, ArtistShare, was founded in 2001 as a way for fans to back musicians’ creative works. This paved the way for reward-based crowdfunding portals such as Indiegogo in 2008 and Kickstarter in 2009. These sites have become sources of initial capital for new businesses that can pre-sell a product before creating any inventory.

Kickstarter alone has provided for more than 12-million people to spend almost $3 billion among more than 100,000 projects.¹ This money is donated, and the project owner has no legal obligation to complete the project. Crowdfunders are investors who are funding passions and dreams, and their returns are the resulting accomplishments of the crowdfunded. This type of crowdfunding flips the supply-demand construct and has a company focus on what is important today—breaking through the noise and creating a market for its product or service before starting any manufacturing. This process weeds out myriad ineffective offerings; 65 percent of Kickstarter product campaigns fail to reach their funding goals and therefore never risk the capital of backers.²
Here are a few examples of how a powerfully engaged crowd can bankroll a new business:

- Pre Apple-Watch, a group of entrepreneurs in Palo Alto, California, created a digital customizable wristwatch that runs apps. The team sought $100,000 in pre-orders to warrant further development of the watch. When the campaign ended two months later, it had raised $10,266,845 from more than 68,000 backers. The Pebble smart watch set records for what was possible in donation-based crowdfunding.

- A re-ensvisioning of the card game UNO with cartoon pictures of cats in various forms of distress would be a tough business proposition using traditional retail methods. Exploding Kittens re-wrote the rules of social marketing to entice more than 220,000 backers to spend almost $9 million on a deck of cards not yet produced.

- Palmer Luckey, age 18, has a vision, duct tapes some screens together, and creates a marketing video selling the future of virtual reality. His still-not-invented product generates $2.5 million in pre-sales. Years later backers finally got their goggles, but with no participation in the budding company’s upside. Oculus was sold to Facebook for $2 billion dollars.

The third example has some backstory: At the time, an average investor had no ability to participate in Oculus’ gain. Securities laws prohibited any kind of equity participation from a non-accredited investor and general solicitation of a private offering to accredited investors was not allowed. But increased regulation and expense has made it unattractive for budding companies to use the public markets for funding. In fact, the majority of gains in some of the most coveted companies are occurring in the private markets as public offerings continue to be postponed beyond their primary growth spurs (see figure 1).

**Equity Crowdfunding or Democratizing Investing**

In response to a challenging economic climate for small businesses, lawmakers in late 2011 introduced legislation that became the Jumpstart Our Business Startups Act (JOBS Act). Initially envisioned as an economic accelerator and a fix for tightened traditional bank financing, the JOBS Act ultimately may lead to a democratization of our equity markets. The most groundbreaking aspects of the bill are Titles III and IV, which address crowdfunding and small-company capital formation, respectively, and allow unaccredited investors to invest alongside accredited investors in private and “mini” public offerings. For the first time, anyone can invest in early stage startups that align with their interests and passions and participate in the potential growth.

The JOBS Act paved the way for fundraising disruption; the U.S. Securities and Exchange Commission (SEC) formulated regulations to enable each of the provisions and protect consumers (see table 1). In 2013 Title II, which addresses access to capital for job creators, came online. Before that, seed-level funding for companies was based on who you knew and where the company lived; local angel investment clubs would hear pitches, conduct their own due diligence, and invest in local startups.

Title II allowed online portals such as SeedInvest, CircleUp, and AngelList to openly solicit private investment deals across the Internet. Building on the same crowd-based infrastructure that powers reward-based platforms, companies exposed new investors to radical new opportunities. Crowdnetic’s CrowdWatch platform analyzed the private offerings from the 16 leading Title II platforms for the first three years since implementation. Its data show more than $1 billion of equity and convertible debt raised over the period. Of 6,000 offerings, 1,500 were deemed successful. The high failure rate represents the crowd collectively culling offerings to find those with enough merit to warrant investment. Over the three years, the number of new attempted raises has decreased dramatically and the success rate and average per successful issuer has increased. Today’s

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**Table 1: The Path to Equity Crowdfunding**

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<thead>
<tr>
<th>Date</th>
<th>Event</th>
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<tbody>
<tr>
<td>April 5, 2012</td>
<td>President Obama signs the JOBS Act into law</td>
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<tr>
<td>September 23, 2013</td>
<td>SEC IMPLEMENTS TITLE II Private offerings can be solicited publicly for the first time in 80 years (accredited investors only)</td>
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<tr>
<td>March 25, 2015</td>
<td>SEC PASSES TITLE IV – REG A+ Private companies can publicly raise up to $50 million from accredited and non-accredited investors</td>
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<tr>
<td>October 30, 2015</td>
<td>SEC PUBLISHES RULES FOR TITLE III Private companies looking to raise $1 million per year from small investors</td>
</tr>
<tr>
<td>May 16, 2016</td>
<td>TITLE III COMES ONLINE Investment portals enable small businesses to sell equity directly to retail investors</td>
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equity portals have learned to put money behind the businesses that will successfully fill a round, ultimately creating more protections for the investor.

The companies that are taking advantage of equity crowdfunding today are vanguards. It's too soon and there isn't enough data yet to effectively model this democratized version of early stage investing as an asset class. The closest proxy is venture capital, which can include later-stage investments. However, even after substantial fees and carried interest, the return potential is compelling: Over the past 30 years, early stage venture capital returned 22.65 percent compared to 9.93 percent for the S&P 500 and 6.57 percent for the Barclay’s Credit Bond Index (see figure 2).

The connected technology that has enabled this new type of exposure to private investing outdates modern portfolio theory. Attempting to delineate a new slice in a mean-variance-optimized portfolio will fail due to errant assumptions of expected risk and return. Relying on risk versus return as the sole determinants of optimization ignores the attributes of intention, innovation, and purpose found in seed-level investments. To discover how we can articulate these attributes better, we can investigate how one of the pioneers of motivational psychology updated his own models.

**Maslow’s Hierarchy Redefined as Goals-Based Investing**

In the 1940s and 50s, psychologist Abraham Maslow studied top performers to understand what motivated them. This was revolutionary at the time because his peers were focused primarily on researching mental illness and symptomatic diagnosis. His findings often are represented in the pyramid recognized as Maslow’s Hierarchy of Needs.

Ashvin Chhabra (2015) used Maslow’s hierarchy as the foundation of his Wealth Allocation Framework, which buckets portfolio risks for an individual investor. Chhabra asserts that every individual or family needs a framework that delivers on the following three objectives that correspond to Maslow’s hierarchy (see figure 3):

- **Safety**: The certainty of protection from anxiety and poverty
- **Stability**: A high probability of maintaining your standard of living
- **Aspire**: Enhance lifestyle
- High risk, illiquid, high alpha investments
- **Stability**: Maintain lifestyle
- Diversified, global, strategic, market participation, passive and active investments
- **Safety**: Preserve lifestyle
- Capital preservation, inflation protection, insurance, annuities, primary home, portfolio protection investments

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**Figure 2: Venture Capital Returns vs. Stocks and Bonds, 30-Year End-to-End Pooled Returns as of March 31, 2016**

Data from Cambridge Associates LLC, March 31, 2016. U.S. Venture Capital Index® and Selected Benchmark Statistics Report. The Early Stage Index includes pooled end-to-end return, net of fees, expenses, and carried interest; past performance is no guarantee of future returns.

**Figure 3: Psychology and Goals-Based Hierarchies**
• Aspire: The possibility of achieving upward wealth mobility and creating the potential to meet your aspirations

This type of solid construct around why a portfolio is developed and the purpose of each asset class within it provides a foundation to guide clients through irrational behavior that can lead to financial mistakes. By bucketing investments in alignment with the client’s core needs, advisors can guide clients through turbulent markets because client loss aversion is constrained to the portions of assets aligned with appropriate market risks.

Welch (2015, 15) described the advantages of designing portfolios using a goals-based approach such as the Wealth Allocation Framework:

1. The portfolio has been built to address specific investor objectives.
2. The portfolio is proposed and reported on in the same intuitive way the investor thinks about his/her money rather than in advisor-centric MPT-speak.
3. From a reporting perspective, the focal point of advisor/client communication moves away from client-irrelevant market benchmarks and individual manager performance and more toward a client-centered progress-to-plan approach.

Maslow (1943) defined the peak of the hierarchy as the need to “self-actualize”:

*It refers to the person’s desire for self-fulfillment, namely, to the tendency for him to become actualized in what he is potentially.*

Later in life, Maslow noticed something missing in both himself and his hierarchy that was beyond self-actualization. He decided that his original model was incomplete and he created a new stage deemed “transcendence” (Maslow 1999, 117): “the greatest attainment of identity, autonomy, or selfhood is itself simultaneously a transcending of itself, a going beyond and above selfhood.”

Maslow's definition of transcendence can be broken into two parts:

1. Transcendence seeks to further a cause beyond the self to service to others, devotion to an ideal (e.g., truth, art) or a cause (e.g., social justice, environmentalism, the pursuit of science, a religious faith)
2. Transcendence seeks to experience a communion beyond the boundaries of the self through peak experience. The person experiences a sense of identity that transcends or extends beyond the personal self (Koltko-Rivera 2006).

Even though goals-based portfolios align with the core motivations of clients as defined in Maslow’s original hierarchy, the investments often are not deployed in accordance with this elevated need. Most portfolios are designed with investments used as opaque tools that obfuscate the underlying securities. This can lead to many portfolios unaligned with the clients’ undiscovered intentions. Platforms do exist to screen investments for criteria, socially responsible or otherwise, but a disconnect remains as to what an investor can achieve with direct purposeful funding of investible causes.

Chhabra allows for some transcendent goals in his aspirational bucket, but the innovation is in creating a discrete fourth bucket dedicated to transcendence, the purpose of which is to catalyze change. The subject of that change is deeply personal and its discovery can involve multiple conversations that strengthen the advisor-client relationship. The front lines of change—where an investor can have the most impact—are in helping to power early stage companies and their passionate entrepreneurs. By utilizing crowd-curated investments, investors are immediately part of a community that shares a common transcendent purpose in alignment with their own personal gain.

The work done by Chhabra (2015) and Welch (2015) can be extended by applying the framework of goals-based investment criteria to the new bucket (see table 2).

### The Next Generation’s First Investment Will Be Private

Young, high-income earners are the highest adopters of fintech applications (see figure 4). This demographic is using mobile phones to transfer assets into robo-advised investment portfolios with no custodial paperwork or in-person conversations. These platforms will continue to innovate rapidly as they compete for market share. Hedgable, a robo-advisor that specializes in alternative investments, offers equity crowdfunding exposure through funds from many of the leading platforms such as AngelList, CircleUp, OurCrowd, and the startup accelerator Y Combinator.

<table>
<thead>
<tr>
<th>Table 2: Sample Investment Criteria for a Rewired Goals-Based Framework</th>
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<tr>
<td><strong>Wealth allocation framework</strong></td>
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<tr>
<td>Preserve lifestyle</td>
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<tr>
<td>Stated investment goal</td>
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<tr>
<td>Defined time horizon</td>
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<tr>
<td>Desired rate of return</td>
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<td>Acceptable loss</td>
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<tr>
<td>Liquidity</td>
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<tr>
<td>Benchmark</td>
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<tr>
<td>Dollar allocation ($10 million)</td>
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The same social virality that has propelled reward-based crowdfunding campaigns is being retooled to reach non-accredited investors. It is easy to imagine the next generation of investors tinder-swiping seed-capital private deals and matching up their diversified portfolios against their friends’ portfolios. Companies will embolden investors as participatory evangelists to help them expand. At the same time, platform companies are investing in technology to remove some of the most common obstacles, as shown in the following examples:

- In October 2016, SeedInvest launched auto-investing, which slashed minimums in individual companies to as low as $200 and provided much-needed diversification for early adopters.
- On November 15, 2016, Indiegogo, a top reward-based crowdfunding portal, launched equity crowdfunding in partnership with MicroVentures. Indiegogo provided its suite of proven social-solicitation tools to millions more backers worldwide.
- At the end of 2016, Overstock.com raised a $10.9 million Series A offering with 20 percent of the shares sold on a blockchain platform, effectively creating its own market. The use of crypto technologies such as blockchain can accelerate development of secondary markets and create liquidity for crowdfunded securities.

For stock exchanges, brokers, and central securities depositaries, the Overstock.com offering was the initial shockwave of crowdfunded investment. Blockchain is a distributed ledger that verifies every transaction across a network of computers; it is fully transparent and without a centralized authority. Computers complete a set of complex calculations to validate that the ledger of recorded transactions should be part of the master chain. Blockchain was designed as the foundation for Bitcoin, the digital currency that has no backing institution, bank, physical good, or country—but does have an aggregate market cap of more than $20 billion.³

Skeptic’s question a digital currency, but financial institutions are embracing the power of the blockchain technology to move money and, in Overstock.com’s case, securities. Bitcoin and blockchain were introduced by an anonymous author in a paper in 2008 and deployed in January 2009. So, in fewer than eight years, a company that was started to liquidate merchandise from failed companies is issuing, trading, and settling securities on the first SEC-approved alternative trading system. Watch out Wall Street.

Millennials and their descendants may be the earliest adopters, but advisors also need to explore this asset class with boomer clients. As boomers sell businesses or retire, many of them are confronted with difficult questions of “what’s next?” A study by the Institute of Economic Affairs shows that retirement increases the risk of clinical depression by 40 percent because retirees are doing less problem solving and contributing less to society (Sahlgren 2013). An introduction to early stage companies in need of guidance as much as capital can be intrinsically fulfilling and potentially fiscally rewarding for boomer clients.

The role of a wealth advisor itself can be transcendent. The fiduciary advisor directly services others and their hierarchies of needs while creating a community of clients whose combined goals enrich society. As advisors look to differentiate themselves from thousands of peers, the opportunity to purposely connect clients with their invested wealth yields strong relationships and impactful gains.

Jamie McIntyre, CIPM, is founder and chief executive officer of Rewire Capital, which funds startups that leverage technology to disrupt their industries and rewire legacy inefficiencies. He is a founder of both Lydian Wealth and Fortigen. He earned a BS in computer science with a minor in mathematics from Virginia Polytechnic Institute & State University. Contact him at jamie@rewirecapital.com.

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### Endnotes
2. See https://www.kickstarter.com/help/stats.
7. See https://www.coindesk.com/price/.

### References