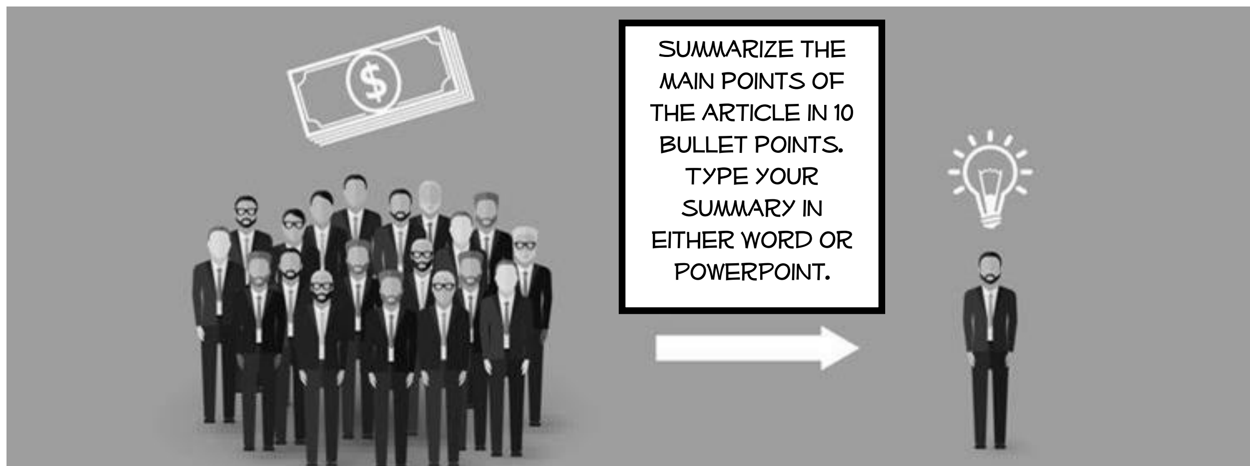
Equity Crowdfunding: Cool Concept, But Should You Invest?



Crowdfunding is a cool concept: Regular folks lending each other money when the big guys with big bucks just aren't interested. In some developing countries, it has helped lift small-business owners out of poverty. It has also made its way into the investment world stateside, giving average investors a chance to participate in the launching and funding of new companies.

Now, if you have a few bucks to spare, you can invest in that nifty new business your friend is starting and, theoretically, share in its success when it takes off. This may sound like a win for investors and startups alike, but you should think carefully before taking part.

JOBS ACT RULES

The Jumpstart Our Business Startups Act, passed in 2012, provides a pathway for startups that aren't publicly traded — and aren't attractive to venture capitalists — to seek capital from smaller investors. This lets many more people take part in an investment opportunity once reserved for the deep-pocketed elite.

In late 2015, the Securities and Exchange Commission finalized the rules that will govern equity crowdfunding. Starting in May, anyone can invest in startups that register for crowdfunding with the SEC. The agency's rules affect investors and startups by:

Restricting startups to raising $1 million through crowdfunding in a 12-month period

Limiting maximum investments by people who make $100,000 or less per year to $2,000 or 5 percent of their annual income or net worth (whichever is less) in a 12-month period

Limiting maximum investments by people whose annual income and net worth are $100,000 or greater to 10 percent of annual income or net worth (whichever is less) in a 12-month period

Capping the annual amount anyone can invest in one or more startups through crowdfunding at $100,000

KEY CONSIDERATIONS

But just because you can engage in crowdfunding as part of your investment portfolio, does that mean you should? The answer, of course, is that it depends.

Equity crowdfunding does have some advantages for small-scale investors. It can make it easier to be socially conscious in your investing. For instance, you could invest in a company that builds and distributes low-cost water-purification units in developing countries. It can also let you gain an equity stake in the startup you think is the next big winner. There's always the chance that you'll pick the next Facebook.

Still, investing in startups is risky. Even if you follow the SEC's rules, there are other important factors you should consider before plunging into equity crowdfunding:

Startups have a high failure rate. The vast majority of startups fail, many within the first few years of operation. If the startup you've crowdfunded becomes one of these, you'll likely lose every penny of your initial investment.

Startup financials may not be transparent. Companies that opt for crowdfunding bypass traditional investment banking processes, including in-depth auditing that's intended to uncover major potential problems. Investors who crowdfund may not know what they're getting into, meaning the risk of loss may be greater.

Estimated valuations may be wrong. Companies that crowdfund also bypass traditional investment valuation. Instead, investments in them are priced at "estimated fair values." When prices are not readily available, these values are often determined by a general partner or sponsor who is involved with the company. These best-guess estimates may not reflect the actual amount that would be realized in a sale.

FIRST, ASK YOURSELF THESE QUESTIONS

Risk is a factor in virtually any investment. You should always consider your ability to weather potential setbacks before you invest — especially in crowdfunding.

To decide whether you are really prepared, ask yourself these two important questions: Am I mentally, emotionally and financially ready to lose this entire investment? If I lose my money, how long will it take me to rebuild this portion of my portfolio — and do I have the time?

Even very smart venture capitalists with the wherewithal to scrutinize every aspect of a startup before they invest often end up losing their investments. They have deep pockets and can usually afford the loss. Will you be able to say the same? And if the startup you invest in succeeds, it could still take years before you see a return on your investment. Will you be able to wait that long?

Many financial planners recommend that you limit your speculative investments — such as a crowdfunding investments — to 5% to 10% of your total investment portfolio if you're a smaller investor. And this is assuming you can truly afford to lose the entire investment. If you have a conservative risk tolerance or lack the time to recover from a complete loss, you should probably avoid speculative investments altogether.

If you do decide crowdfunding is for you, ask your financial planner how you can do it correctly. For instance, you won't want to neglect savings in your employer-sponsored retirement savings vehicles first. And as with any investment tool, crowdfunding should never be done in a silo, without considering your overall financial picture.