

the investor's paradigm

About

With investor's paradigm, we aim to promote a culture of entrepreneurship in the general public. We will question the under-representation of small and medium-sized enterprises (SMEs) in the common man's investment portfolio. And we will challenge the way startups and SMEs are traditionally financed.

Over the years, we have been confronted many times with this subject. In three roles, to be exact: during university, researching the importance of SMEs for the overall economy, three times from the perspective of an entrepreneur seeking funding, and lastly, as investors in SMEs having had the luck twice to gain access to interesting startups through our personal network.

Trigger for investorsparadigm.org were eventually the findings from a survey on investment behaviour which we co-initiated, wanting to challenge our views on the subject with the opinions of a broader sample of the population.

Investor's paradigm is meant to be an open platform, inviting everyone interested in this subject to discuss and analyze related problems and to brainstorm innovative methods for their resolution.

If you wish to get in touch, contact us on authors@investorsparadigm.org.

Note: This is a print version of the blog investor's paradigm. Visit us online for the latest articles at investorsparadigm.org.

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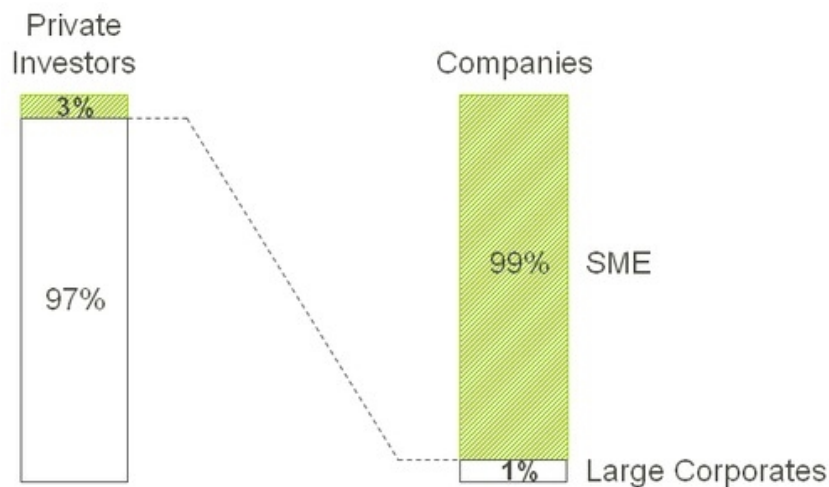
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Outlining the Problem

The paradigm, part 1: Introduction

It is widely known that 99.6% of Swiss enterprises are small or medium sized. In this respect, Switzerland is no exception. In almost every OECD country, SMEs comprise of more than 99% of enterprises. These SMEs, among other things, offer and create the vast majority of jobs and apprenticeships and thus form the backbone of our economy.

Few people seem to be aware, however, that only 3.1% of Swiss private investors (1.4% of the Swiss population) directly or indirectly hold equity in these small or medium sized companies. The number of private individuals providing debt to SMEs is insignificant. This implies that approx. 97% of Swiss private investors in search for private sector investment opportunities choose among shares, bonds and funds of large quoted corporates only. Again, the figures for other OECD countries look pretty much the same.



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Whereas "large corporate" investment opportunities are easily accessible to everyone, the asset class called "alternative investments", which includes investments in innovative ventures and growing SMEs, is (with some exceptions) mostly available to a few qualified investors only. We refer to this asymmetry as the „investor’s paradigm“.

This paradigm was widely perceived as a manifestation, firstly, of the objective distribution of risks associated with SME vs. large corporate investments and secondly, of the objective differences in the ability to understand and manage risks among different investors:

institutional or [accredited private investors](#) vs. non-sophisticated private investors. As with all paradigms, there was a particular set of shared values and beliefs that no doubt have contributed to the way our economy was shaped over the past decades.

We strongly believe that this paradigm is about to shift. Due to the recent turbulences on our financial markets, risks associated with traditional investments appear in a different light, and it is not surprising that policy makers in many countries have now invigorated their efforts to address the much discussed SME equity gap.

Read part 2 on the investor's paradigm: [Stuck in Havana](#).

The paradigm, part 2: Stuck in Havana

Today, the situation private individuals in search for direct SME investments are facing, reminds me a lot of my visit to Havana in the early Nineties. Grocery store shelves were mostly empty, and Cubans needed to show a special permit in order to gain entrance to exclusive stores that used to cater for the needs of the Cuban elite, diplomats and foreigners.

Even in the world of Private Equity, it takes a special permit to enter its exclusive stores. If you happen to be a wealthy individual, someone private bankers consider to be a "high or ultra high net worth individual", you can declare yourself as a ["qualified"](#) or ["accredited investor"](#). Among other requirements, a high net worth and salary are the paramount preconditions for any membership in business angel networks or exchanges. In [Switzerland](#), in order to qualify as angel, individuals need to declare an individual net worth of >\$1m (can be joint with spouse) and an annual income of >\$200k (or >\$300k if joint with spouse). In addition, the invested sum per individual investment has to be \$100k at the minimum. Once accepted as a member, you can directly tap into a flow of investment opportunities: many angel networks and exchanges have excellent connections with local university incubators and maintain close ties with its international sister organisations. 2006 figures indicate 290 individuals organized in Swiss business angel networks.

Qualified business angel or not, the majority of direct investments on the part of private individuals originates from family, friends or personal business contacts. This is what Cubans call the "economía sumergida" - it works, but not very efficiently. Far from being a reliable source of deal flow, this situation clearly indicates a lack of liquidity and transparency in this market. Consider yourself lucky, if you're among those who were personally approached with a high-quality SME investment opportunity that meets your needs.

Elite aside, like most Cubans, ordinary investors like myself can't help the feeling that what's on offer for ordinary people is not only limited but also just not exactly what we are looking for. Let's look at the few SME products that made it onto the shelves.

If you don't care whether to lend debt or invest equity, you could use an existing online lending service (aka social funding or crowdfunding). The first generation of lending services however was mostly focusing on people-to-people lending (aka peer-to-peer lending) - among those are Prosper, Zopa, and Lending Club. In addition, services tailored to the funding of charitable and development projects were launched - among those are Kiva, Fundable and MicroPlace. There are, however, some new kids on the block, dedicated to facilitating lending to businesses, such as [40billion](#). So far however, only a few people have gained experience with online lending, given the limited number of providers and a restricted regional and product scope.

Which leaves us with indirect options of investing equity. Private individuals can buy shares of (globally around 250) listed private equity firms (LPEs), such as 3i Group, Blackstone or KKR. They can invest in private equity funds, offered by companies such as the Carlyle Group or Partners Group. And last but not least, they can invest in funds of funds, managed by players such as Pantheon or Conversus. The portfolio of SMEs they invest in, however, is entirely in the hands of the respective asset manager.

Read [part 3](#) on the investor's paradigm, addressing common arguments on why direct SME investment possibilities are limited.

The paradigm, part 3: Legitimate concerns or inefficient markets?

The previous two posts on the investor's paradigm raise an important question. If we take into consideration our findings (a) that today, only a small fraction of investors in OECD countries engage in the SME segment and (b) that in today's private equity markets only a few offerings are available for ordinary private investors, we need to ask: why not more?

This question on demand and supply breaks down to the following aspects. Firstly, does the number of current SME investors reflect the number of people with a clear motivation to invest in SMEs? Secondly, if this should not be the case, what are the concerns on part of investors keeping them from doing so? Thirdly, is there a shortage on supply of quality investment opportunities? Lastly, if we allow for the possibility of this being an imperfect or inefficient market, what market distorting factors, regulatory and non-regulatory, can be found?

Let's start looking at investors' motivation. We are currently conducting a [survey on investment behavior](#) and while it is still ongoing, we already published some interesting preliminary [findings](#). The bottom line is: approximately 40% of survey participants with money to invest would consider investing in ventures and SMEs. And more specifically: in comparison with the few investors already experienced with SME investments (approx. 3% of total investors), more than double (8.4% of investing participants) are clearly motivated to do so. These participants not only indicated an interest in SME investments but also stated that they would accept the associated risks and would be prepared to invest the time it takes to make informed decisions. On top of this, the vast majority of those also has relevant skills and significant experience with investments in other asset classes.

On average, investors participating in our survey indicated a degree of concern over all crucial aspects an SME investment involves - but no concern was seen to be irresolvable. Primary concerns mentioned were: (1.) Comprehensiveness and reliability of information provided on the investment target and (2.) Trust in the capabilities of the management. Fraud risks, concerns related to the liquidation of investments and post-investment monitoring/control were secondary. Surprisingly, the perceived general risk of such investments ranked only second last among all possible concerns. In short: investors' concerns do play an important role and any approach aimed at promoting SME investments needs to find ways to adequately address them. Survey participants, however, believe all of those could be allayed. Watch out for our detailed survey findings on investor concerns soon to be published.

When it comes to supply, a differentiation of investment opportunities is crucial. While a small percentage of SMEs in need for capital are outnumbered by interested institutional and other accredited investors 10:1, the vast majority of startups and SMEs struggles to find capital. There is general [agreement](#) that this "equity gap", mainly in the space of seed and early stage innovative SMEs ("ISMES") which are (in the words of the OECD) "economically significant" and could use this capital "productively", has largely to do with market inefficiencies in the formal capital markets. The entrepreneur's perspective thus is important to fully understand the complications of the investor's paradigm. For that matter, we will focus on the different types of seed, early stage and growth SMEs and discuss related market inefficiencies in part 4 on the investor's paradigm.

If we wrap up the following interim results: (a) almost double of today's non-sophisticated investors are qualified and motivated to invest in SMEs, (b) these investors articulate a number of concerns over SME investments, but none of them is seen to be insurmountable,

(c) there is no shortage on quality SME investment opportunities, then we are mainly dealing with a problem of market inefficiencies.

Let's start our analysis on market inefficiencies with a look at potentially distorting regulatory interventions. First and foremost, regulators intend to protect "non-qualified investors" based on the assumption that those are not able to understand and manage risks associated with certain investments. Point taken. A closer look at existing regulations, however, reveals that policy makers settle for damage containment rather than problem-solving. As discussed in the [previous post](#), regulators define a "qualified investor" mainly depending on a person's salary and wealth. Their logic goes "if rich investors fail, at least they survive".

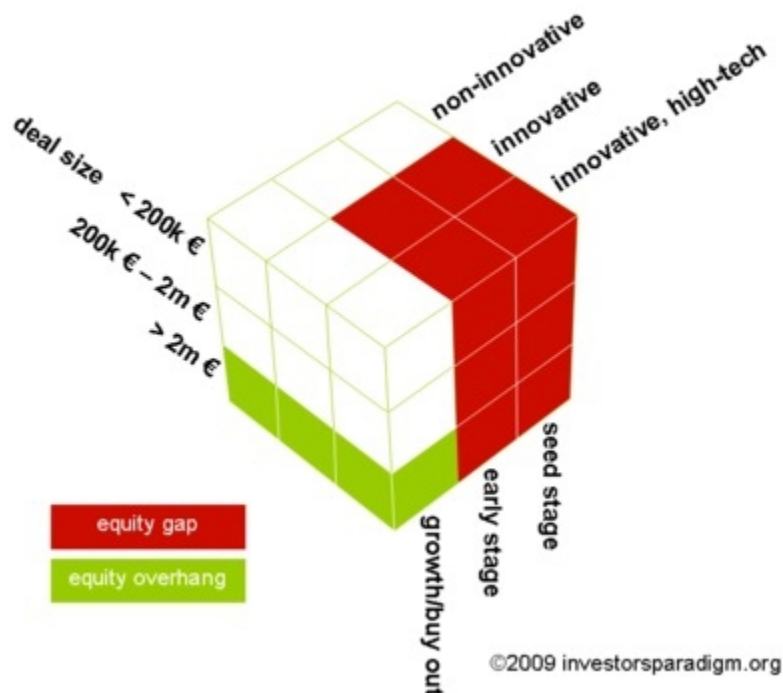
The real problem, however, is not one of definition. Instead, the trade-off between investor protection and promotion of SME financing seems out of balance. Many [Swiss business angel networks](#), for instance, grant membership only to "qualified investors" - voluntarily. In other countries, e.g. the UK, business angels are requested by law to sign an official document certifying their capacity as "qualified investors". For better or worse, our preliminary survey findings underline that many people are qualified and keen to invest long before they make their first million: see our post ["A different take on small investor interests"](#).

Last but not least on non-regulatory market distortions. As mentioned before, the supply side is clearly characterized by market inefficiencies. Formal players (VCs, private equity firms and banks) are not willing to invest in high-cost, high-risk ventures requiring less than €2 million in equity. The OECD therefore acknowledges the need for informal venture capital, especially for innovative companies in their seed and early stages.

In summing up, it's high noon for governments to not only acknowledge the general importance of informal venture capital, but also the specific importance of private investors not qualifying as business angels, often referred to as friends, family and fools ("FFFs"). Our market study indicates that the last "F" comprises not only fools, but many individuals that are by all means capable to invest. According to our calculations, Swiss business angels made up for only 7-10% of venture capital provided by private individuals in 2008. So with 90-93%, other private individuals (incl. founders) already provided the lions share – despite [limited investment possibilities](#). Let's make sure they provide even more.

Read [part 4](#) on the investor's paradigm.

The paradigm, part 4: Equity gap or overhang?



An entrepreneur in need for capital might be confused. In the finance industry as well as the media, two buzz words make the round: “equity gap” and “equity overhang”.

Equity gap and overhang are not two sides of a coin. In general, the term “equity overhang” refers to the gap between funds raised and funds invested and thus to a problem institutional investors are facing. The term “equity gap” is used in reference to the gap between funds required and funds invested and thus relates to a problem entrepreneurs are facing.

Based on these definitions, a first answer to the question raised in the title of this post is: both! Depending on a company’s industry, stage within the company life cycle, and amount of capital required, today’s capital seekers find themselves in one of three clusters of the graph shown on top.

The red cluster of our “private equity cube” indicates which companies typically suffer most under the equity gap. According to the [OECD](#), these are mostly seed and early stage innovative SMEs (“ISMES”). While figures are difficult to obtain, in the U.S., this gap is said to be around \$40 billion. Within this red cluster, first and foremost, entrepreneurs requiring between 200k € and 2 m € are affected, as these amounts are too large for informal players such as business angels but too small for VCs and private equity firms (corresponding to the

medium layer of the red cluster). Currently, the only cure for these young and innovative SMEs are business angel syndicates and publicly backed funds, such as [CTI Invest](#) in Switzerland or the "[Enterprise Capital Funds](#)" in the UK. But the volumes provided by these players are still way too small.

The green cluster, on the other hand, indicates which companies in need for capital are most fought over: expanding or turnaround companies requiring >2m € capital. Only players of the formal private equity industry, such as venture capital firms ("VCs") and private equity funds, or funds of funds respectively, play in this field. As of April 2009, [current figures](#) for the U.S. indicate an aggregated overhang of \$400 billion. While the numbers differ, this situation applies globally: VCs are sitting on loads of cash but for two reasons hesitate to invest - due to the economic slowdown and due to a tendency of increasing minimum deal sizes in the formal private equity industry.

But what if an entrepreneur finds himself in the white cluster? First of all: he or she will have to rely on his own funds and capital from informal investors. And three rules of thumb apply: (a) the bigger the required capital, the more difficult it will be to find FFF or angel money; (b) the riskier the business model, the more difficult; (c) the earlier in the business lifecycle, the more difficult. Thus, even white cluster companies are confronted with an equity gap, just less severe than red cluster companies.

In wrapping up posts 1 to 4 on the investor's paradigm, it seems that market inefficiencies are the overarching problem: from an entrepreneur's perspective, if your business does not match the preferences of formal VCs and private equity firms, and from an investor's perspective if you do not happen to qualify as an "accredited" or "qualified" investor. In other words: the majority on both sides relies on the quality of their personal networks.

Survey on Investor Behavior

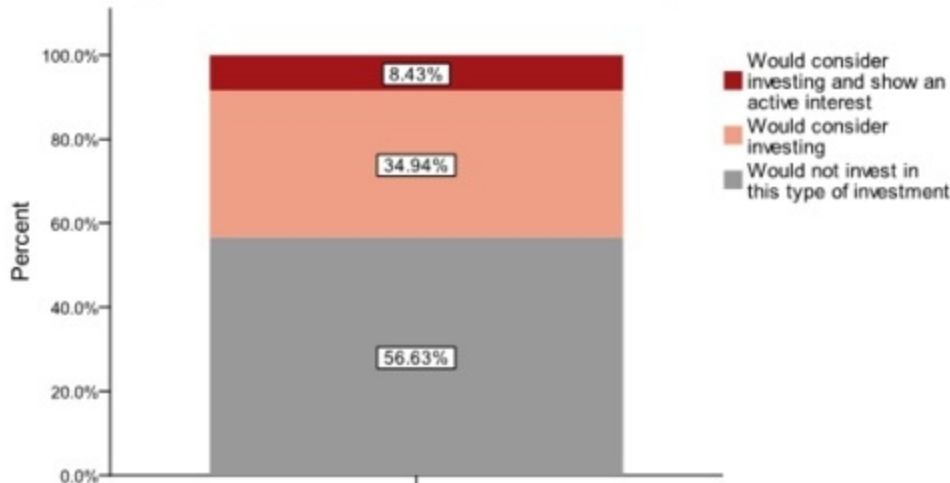
Survey findings, part 1: A different take on small investor interests

Private equity is for affluent individuals with an attitude, as many people see it. And this notion clearly reflects in the portfolios of small investors. Further is it fortified by some recommendations of business journalists and bankers to their readers or clients respectively, to stay away from this kind of investments. Last but not least: under the banner of investor protection, regulators do their best to maintain the status quo.

An ongoing market study we are conducting sheds a new light on small investors' interests in this regard. Our preliminary findings show that over 40% of investors (defined as someone of minimal wealth) have indicated that they would consider a direct private equity investment in an SME or startup and that they would value improved access to such investment opportunities. This is roughly eight times of what reality is showing today.

Even under more restrictive criteria, requiring not only a clear interest but also preparedness to invest time and accept associated risks, 8.4% of investors or roughly 3.64 million people in Germany, Switzerland and Austria would invest part of their money in new ventures or SMEs. This portion includes individuals already invested in private equity today (currently roughly 3%, [read here](#)) and, to a large extent, individuals with an entrepreneurial background or advanced investment track record, in the sense that they have invested in more than one asset class.

Figure 1: Investor Demand for SME and Startup Investments



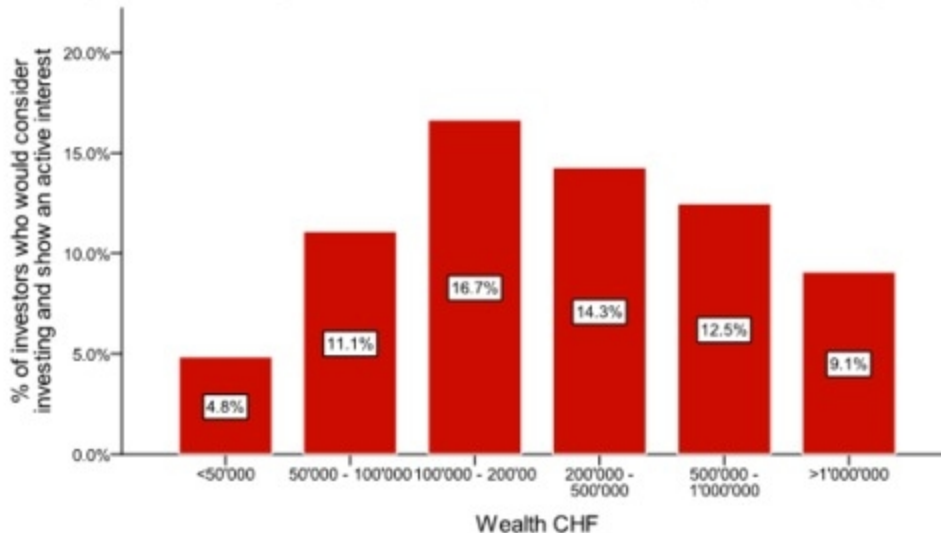
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Note: 56% stated that they would not invest in this type of investment (including a few participants that gave ambiguous answers).

Interested SME investors are almost exclusively in jobs entailing “independent and qualified” or “highly demanding” tasks (job level categories 1 and 2 out of 4 of the Swiss Federal Statistical Office), with a focus – but not predominantly – on economic, finance and law backgrounds. Men are more likely to invest than women whereas the marital status and family situation do not play a significant role.

While it is not surprising that wealth and income play a role in people’s interest to invest, the study shows that there are many people below the threshold of the so-called accredited investor (according to the SEC, a net worth in excess of \$1 million or income of >\$200k) that are likely to invest. Figure 2 shows the percentage of investors likely to invest by wealth group, increasing sharply and peaking at 16.5% for individuals with of wealth between \$100k and \$200k. Declining interest with higher net worth could potentially relate to further alternative investment offerings accessible to these individuals.

Figure 2: Percentage of Investors with Active Interest by Wealth Group



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The apparent demand clearly raises the question of why no corresponding offering for small investors can be found in today's markets. We will approach this question from a number of perspectives in subsequent posts, including investor concerns (see [Survey findings, part2](#)) as well as regulatory and non-regulatory aspects of the market. (See blog [the paradigm, part 3: Legitimate concerns or inefficient markets?](#)). Should a corresponding offering emerge, it will be even more interesting to see how many of the 34.9% already considering SME or startup investments today, will take a more active interest.

At this point however, we simply note that the percentage of investors who are likely to invest in private equity is significantly higher than the percentage invested today. It will be an interesting discussion to lead, how and to what extent this additional source of private funds can contribute to funding a larger portion of startups and SMEs in need for financing - today, more needed than ever. Governments are currently evaluating a myriad of options to support this. However, it will be challenging for them to strike the right balance between their mandates to protect small investors and letting small investors take an active and responsible role.

Along those lines: the financial crisis has taught us that too much trust of investors in the "system" or external advice is not only dangerous for the individual investor, but also eliminating some of the checks and balances for the entire economy - controls that, amongst others, regulations were meant to provide. Maybe some of these checks and balances can be put back in place by letting society vote – by means of investing – not only on large corporates

but on smaller and/or upcoming enterprises, as well. This voting mechanism works well if voters are experience and well informed. The study shows that people who are likely to invest bring this to the table.

>> [Survey findings, part 2: Investor concerns](#)

Check back soon to read additional findings from the market study such as small investors' motivations with regard to private equity investments as well as how much they are prepared to invest.

Survey: N=176, including only participants from Germany, Switzerland and Austria in evaluations; in these preliminary findings, no corrective factors have been applied to eliminate potential bias in the sample population

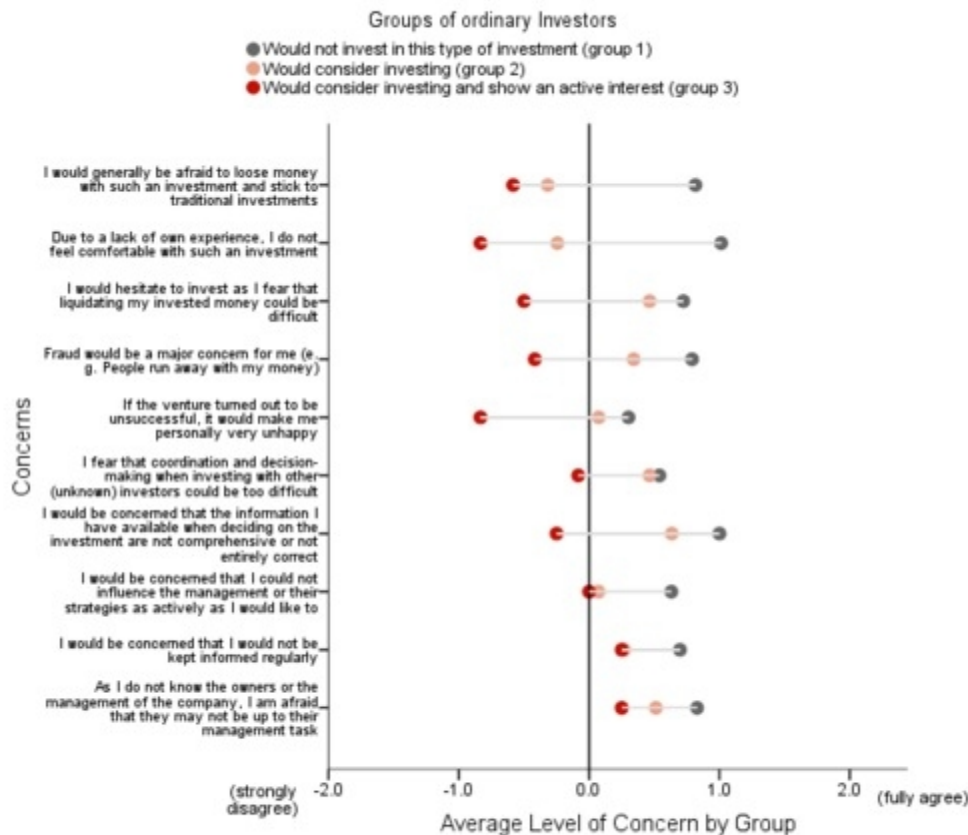
Survey findings, part 2: Investor concerns

As a result of our survey on investor behaviour, three distinct groups of ordinary investors emerged (see post [Survey findings, part 1: A different take on small investor interests](#)). Group 1- individuals who would not invest in SMEs or startups (56.5%), group 2 - individuals with an interest to invest (35%), and group 3 - individuals who are ready to invest, based on interest, risk profile and willingness to invest time (8.5%).

We will be analyzing investors' concerns along these groups. With respect to group 1, we will try and establish key reasons that are keeping people from considering this type of investment (besides other aspects like for instance lack of interest). Regarding group 3 (people who are likely to invest), we will try to find out where they would lay emphasis on in the due diligence phase - given an appropriate SME or startup could be identified. And as for group 2, we will try to assess to what degree and under which circumstances these people would become likely investors in the future.

The chart below gives an overview of concerns along with a rating (strongly disagree to fully agree) for each group. The three groups consistently express different levels of concern throughout all questions. Each group corresponds to a distinct concern profile which we will enlarge upon.

Concerns of Small Investors with respect to SME and Startup Investments



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People not considering an SME or startup investment (group 1) share all concerns listed, the top three being:

1. “Due to a lack of own experience, I do not feel comfortable with such an investment”
2. “I would be concerned that the information I have available when deciding on the investment are not comprehensive or not entirely correct”
3. “I would generally be afraid to loose money with such an investment and stick to traditional investments”

This expresses a general fear or hesitation, relating to a lack of experience or a fundamental mistrust in such kind of investment. Based on these fundamental barriers, a more in-depth discussion of more specific concerns would bear no additional insights.

For those ready to invest (group 3), only two concerns are seen to be of some importance:

1. “As I do not know the owners or the management of the company, I am afraid that they may not be up to their management task”
2. “I would be concerned that I would not be kept informed regularly”

Individuals from this group do not share any of the other potential concerns (a value of zero indicating a neutral attitude, this group rates concerns not mentioned above below zero). This of course does not imply that these people deem the majority of concerns as illegitimate, but rather as resolvable. Clear disagreement is expressed, if we are insinuating a lack of experience or fear with respect to such kind of investments. Their concerns are specific to a given opportunity, circling around trust in the management team and post-deal reporting.

Let’s take a closer look at group 3. Strikingly enough, the so-called exit option, the way in which a private equity investment can be liquidated, is not overly high on the agenda of small investors. This finding is particularly interesting, as it is well known to be an important factor for business angels and institutional players, when placing their investments. Typically, the latter are seeking an exit in 3-8 years in order to free up resources – in the case of institutionals also pressed by their own investors, and generally are mostly motivated by purely economic factors. It appears that in this regard, the small investor distinguishes itself through increased patience and potentially different/additional investment motivations – an assumption we will be validating in a subsequent post on the survey results. It is important to note, however, that many small investors are simply not familiar with various aspects of such an investment; this most certainly includes the divestment mechanics.

Also noteworthy is the fact that likely SME and startup investors state, they would not be frustrated if an investment turned out to be unsuccessful. Taking into account the potential high risk associated with an SME or startup investment this is another confirmation of their entrepreneurial mindset.

To complete the picture, let’s cast some more light on group 2 and assess how high a barrier their concerns pose and under what circumstances they would still adopt this type of investment. The group indicates that they would feel quite comfortable with this type of investment and that they would not be afraid of losing money. Nevertheless, as opposed (and in addition) to group 3 (people likely to invest), there are a number of concerns shared with group 1 that would have to be addressed: comprehensiveness and correctness of information, potential liquidation difficulties, coordination with other small investors and fraud risks.

In summing up, we are seeing quite fundamental concerns for group 1, making it quite clear that they would only take the plunge in exceptional cases. Group 2 feels generally comfortable with such an investment. Before they would invest in an SME or startup, however, probably most of them would want to get more clarity around what such an investment entails. Group 3 clearly has the mindset of the entrepreneur and SME / startup investor.

Survey: N=176, including only participants from Germany, Switzerland and Austria in evaluations

Survey findings, part 3: Investor motivation beyond the homo oeconomicus

In [part 1](#) of our survey findings, we presented three distinct groups of ordinary investors. In [part 2](#), we discussed common concerns among likely and less likely SME investors. But what are the main reasons for small investors that would justify investing hard-earned money in alleged risky startups and SMEs?

Not surprisingly, for all survey participants, risk/return as well as diversification considerations are the main drivers for such an investment.

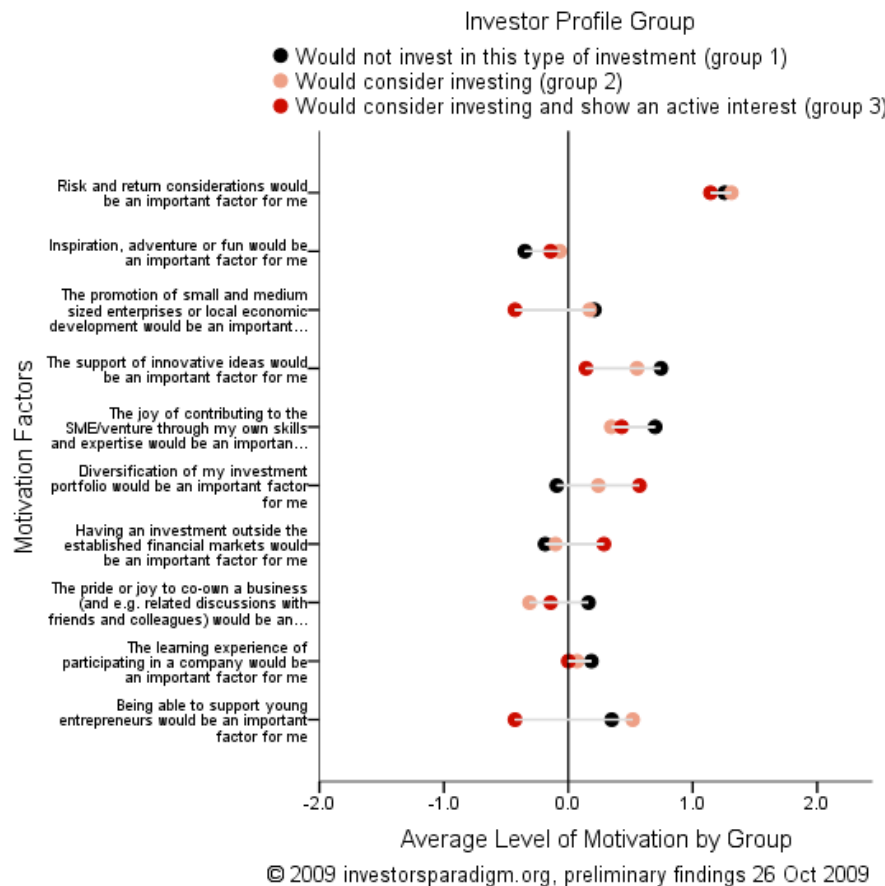
For those individuals who are likely to invest, based on interest, risk profile and willingness to invest time (group 3 = 8.5% of investors), the joy of contributing own skills and expertise to the venture is seen to be another important factor. This non-economic factor, however, is closely related to economic considerations as the majority of this group is confident of being capable of adding value through their personal involvement in business matters (often referred to as “smart money”).

In addition, individuals from this group (as opposed to groups 1 and 2) underline the importance of diversification, indicating that having an investment outside the established financial markets would be an important factor.

Being confronted with other potential non-economic or altruistic motivations, group 3 reacts at best neutral. As if to underline the paramount importance of economic considerations, the average group 3 investor even disputes that the promotion of the local economic development through support of SMEs and young entrepreneurs would be an important reason to get involved.

In short: the majority of group 3 couldn't care less about non-economic factors. Being clear-cut homines oeconomici, they consider SME investments to be yet another investment opportunity economically competing against other offerings. No time for romance.

Motivating Factors for Small Investors with Respect to SME and Startup Investments



Group 2, all individuals with an interest to invest but not belonging to group 3 (35%), also attributes paramount importance to risk/return considerations but their motivational profile is much more complex. So far, all participants within that group indicated at least some degree of agreement with respect to all altruistic and most non-economic factors. In particular, they are more likely to become involved if two non-economic factors are taken into the equation: The average group 2 investor aims to support innovative ideas and young entrepreneurs.

In consequence, there is a huge potential for raising risk capital from an even broader public and beyond the homines oeconomici, if capital seekers succeeded to address two issues. Firstly (and as discussed in our [previous post](#)), the most common concerns of group 2 have to

be dispelled. And secondly, the innovativeness and social relevance of a business opportunity needs to be communicated.

Participants were asked to give answers even if they did not indicate an interest in SME investments. And given the hypothetical nature of this scenario to group 1, results need to be interpreted very carefully. One finding however is noteworthy: altruistic and non-economic factors play an even more important role than for group 2 and 3 participants.

If we take into consideration some of our [previously published findings](#), we can draw some first conclusions on how motivations of small investors differ from those of formal VCs and other informal investors.

1. Small investors are equally focused on the economics of an investment but have more patience/long-term orientation than formal VCs
2. As opposed to formal players, the majority of potential small investors take additional non-economic factors into the equation
3. In comparison with other informal investors in the friends and family space (often driven by friendship and favors), small investors are first and foremost economically minded

Quite clearly, if we want to pinpoint typical behavioral profiles of likely investors, it will be necessary to do a more detailed segmentation based on our data. Come back, we will do that soon – and in the meantime, let us know your thoughts on what could be feasible dimensions to slice and dice groups 2 and 3!

Survey: N=176, including only participants from Germany, Switzerland and Austria in evaluations

Authors



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Steffen has an academic background in Economics and Philosophy ([FU Berlin](#) and [Carlos III de Madrid](#)). Since the mid Nineties, he has researched and worked in the interface of financial markets and private sector development: as founder of two companies (a [technology venture](#) in Berlin and a [dried fruit producer](#) in Uganda), as management consultant (among others [b&m management](#) and [PwC](#)) and as development consultant in Africa ([UNDP](#)).

He is author of various studies on financial markets and small and medium-sized businesses (click [here](#) for latest publication) and currently acts as [Swiss correspondent manager](#) for the [Foundation of German Business](#).

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