The venture capital business is inevitably headed for an overdue shakeout, given that investment has outpaced returns for more than a decade. But it’s going to take some time, probably over the course of a few years, before we see large numbers of venture firms kicking the bucket.

While bunches of cash-strapped start-ups will likely shut down this year seemingly over night, venture capital shops can soldier on long after they’re run out of capital to back new companies. This, of course, is because venture funds are typically designed to have a life of at least 10 years, with enough capital in reserves to make follow-on investments.

In fact, the shakeout has been occurring slowly for the past several years. Last summer, VentureWire examined the effect with the help of data from industry tracker VentureSource. We found 844 venture firms investing in U.S.-based companies in 2007, 40 fewer than in 2006. That’s down 30% from the bubble year of 2000 when there were nearly 1,200 active investors.

More telling: that total of 844 included a substantial number of firms - 224, or 27% of the total - which did not back any new companies in 2007. Instead, these firms only made follow-on investments, indicating that the ranks of active investors will continue to thin.

Some of them will hold out for a few years, tend to their portfolio companies, try to score some decent returns, and hope they can persuade limited partners to back them with a new fund.

But in an era of shrinking liquidity, most of these poor performers will quietly wind down - manage out the life of the fund and then close shop once all portfolio companies have exited.

[2] VentureWire reported on one such firm today, early-stage technology investor [3] ArrowPath Partners. The Redwood Shores, Calif.-based firm spun out of E*TRADE Group Inc. in 2003 and has been investing from a fund totaling about $200 million. Around late 2007, ArrowPath’s partners came to a “mutual decision” not to pursue a subsequent fund, encouraged in part by a tough fund-raising environment. About a dozen of the 25 total companies backed by ArrowPath’s fund are still active and could receive more capital, so it will probably take years before we see the ArrowPath name vanish.

Given the private nature of this business, it’s impossible to name with authority all of the firms that will close their doors. A better-known firm, Worldview Technology Partners, which has a 12-year track record and manages close to $1.4 billion under management, shelved plans for a $250 million fifth fund in 2006. While the firm has said it decided not to raise another fund and instead manage out its existing portfolio from its $600 million fund raised in 2001, it hasn’t found the need to adjust its Web site which explains [4] the criteria it uses to make new investments. The San Mateo, Calif., firm is still managing at least 29 private companies, according to VentureSource.

Another veteran of the industry, Sevin Rosen Funds, was rumored to be winding down after it pulled its tenth venture fund out of the market in 2006. At the time, it canceled some $250 million to $300 million in commitments and said the venture industry was suffering from fundamental, structural issues and that Sevin Rosen needed to rethink its investment strategy. Since then, the firm has said it expects to eventually raise a new fund of about the same size as its current $300 million pool, while “opening up the aperture” to do more late-stage deals and possibly move beyond technology investments. Whether or not it will be successful in doing so remains to be seen. [5] Forbes recently unearthed data showing Sevin Rosen’s vintage 1999 and 2000 funds were performing miserably, though a partner from the firm said none of the return numbers “mean anything until the end of the fund.”

So while the start-ups they invest in fall apart around them, and as other financial firms like banks and hedge funds crash and burn almost instantly, venture capital firms continue to trudge along, some moving toward their slow and inevitable death.

(Update: The New Mexico Educational Retirement Board has approved a $30 million commitment to Sevin Rosen Funds’ latest venture fund, according to its latest investment report. Sevin Rosen Fund X
LP aims to raise $300 million.

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