



Helping Clients Determine Risks in Alternative Investments

One of the keys to their success with alternatives lies in differentiating between perceived and actual risks.

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Alternative investments constitute a growing [\\$7 trillion industry](#) and more than [10,000 hedge funds](#) have money in alternative platforms. Yet, most retail investors are just learning about these lucrative asset classes.

That may change soon. Michael Piwowar, acting U.S. Securities and Exchange Commission chairman, recently [proposed eliminating](#) the “accredited investor” distinction, which he believes puts at a disadvantage the smaller investors the commission is supposed to protect. If the change goes through, it would expose a much larger group of investors to alternatives.

If more people gain access to investments they were previously ineligible for, your clients will need help to understand how risk varies among opportunities. As you explore new and ever-expanding options with them, remember that one of the keys to their success with alternatives lies in differentiating between perceived and actual risks.

To illustrate the difference for clients who may not be familiar with alternative investments, ask them to imagine this scenario. A successful real estate flipper has bought and sold 25 properties in five years. After finding a great deal on a house in foreclosure, he applies for a bank loan to purchase it. The bank declines, spooked by four open mortgages he holds on current projects.

He’s never defaulted, but the bank still judges him as overleveraged because his loan-to-value ratio is 50 percent. It doesn’t fit into the bank’s rigid evaluation box, which has become even more stringent after the 2008 financial crisis. The perceived risk is much higher than the actual risk.

Then, he approaches an alternative lender who sees he's willing to put his own money into a property in a desirable neighborhood and to offer a personal guarantee. The decision comes down to actual risk. Can this property fall in value by 50 percent in nine months? Will the borrower flip it in nine months for a handsome profit? By understanding the data and the flipper's borrowing track record, the lender concludes that he will flip the house and fronts the capital.

Investing in alternative asset classes or specialty finance investments may be considered to carry higher risk, as the market "perceives" risk to be higher as it does not fit into the box. Let's understand why. As this example shows, alternative investing doesn't mean throwing caution to the wind. Alternatives should be scrutinized just as traditional products are, but with all the available data that will objectively outline "actual" risk for the lenders.

Coming to Sound Conclusions

The next time a client asks whether an alternative investment is too risky, start by differentiating between *actual* and *perceived* risk before anyone jumps to conclusions.

The key to investing in alternative assets, or any asset, is to understand credit quality, timing, the repayment stack and risks. Asking the following questions can help your clients evaluate whether an opportunity is worthwhile and aligned with their financial goals.

1. What's the loan-to-value ratio? LTV refers to the ratio of money borrowed to asset value. If a borrower takes a \$5 million loan on a \$20 million asset, the LTV is 25 percent. High ratios indicate greater risk, as the sale price on the depreciated item may not cover the principal investment if the borrower needs to sell the asset.
2. Where do you fall on the repayment stack? The repayment [stack](#) is the order in which lenders receive their money. Knowing where you rank helps determine the likelihood that you'll recover your investment. If you fall far down on the list, you'll have to gauge whether the projected return is worth the increased risk.
3. What is the default risk? Default risk indicates the chances that a borrower will not repay the loan principal and interest. Look to the recovery rate or debt service coverage ratio to determine how much you can expect to recoup if this happens.
4. Does the investment decrease your concentration risk? Concentration occurs when all of your investments focus on one region, industry, or product type. If someone offers you an in on a real estate project and you already have money in three other properties, you might want to seek other options. If real estate stagnates, you'll likely want to earn in other sectors until it picks up again.
5. Can you recover the principal? Here, you're looking at liquidity: Will you be able to sell the asset for a reasonable price? Treasury bonds represent a highly liquid asset class, while the liquidity of real estate and commercial loans can vary on the basis of market conditions and asset maturation.

The alternative investment boom is great news for retail investors. Of course, they should vet all opportunities to help ensure they're making wise decisions, but with your guidance, they may be able to find more stability through alternatives in sectors that are not stock market-dependent rather than through traditional products.

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