Getting a handle on the true risk of your investments

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People of all kinds are investing in deals every day without ever understanding their true risk. Usually, one thinks the higher the return, the higher the risk, yet most investors don't realize the risk they are assuming is far greater than their potential return. What is the true risk of the investment?

Let me illustrate this with an example.

If I were to loan someone money, and I decided it was a big risk to do so, I might charge a high interest rate to compensate for that risk. Sounds sensible, right? I decide to charge 100 percent interest, thinking this will make up for the risk I am assuming. Yet setting the interest rate at 100 percent on a loan that I will most likely never get my principal investment repaid doesn't solve my problem. I could charge 1,000 percent, and it still wouldn't be a good investment. When you look at my true risk, which is the return of the principal, my risk is far too great for the potential return.

Let's look at some other scenarios in real estate.

What about vacant land? There were numerous deals going on with vacant land four to five years ago. You could buy into first trust deeds at low loan-to-values (what ended up being a facade of protection) and get a return of 9-15 percent on your investment. The problem is if that type of investment goes bad, not only will it be a hassle to foreclose and manage the asset, but the asset will become an expense with no potential of income. None. To exasperate the problem, the vacant land investment may not be sellable for multiple years, and until sold, it will continue to be an expense.

When one examines the return of 9-15 percent on a deal like vacant land you can see it was a little like charging the 100 percent interest on a high risk loan. It was not enough for the risk.

What about commercial real estate? Commercial is at least income-producing. I own a couple of commercial buildings here in town. When I built my first one, I thought this was the way to go. It seemed easier to manage than single family residences, produced steady income, and I expected long term appreciation. My return was in the 7-10 percent range, and that seemed appropriate.

The challenge with commercial real estate is that it's not a necessity. In other words, there are times you can't even give it away to someone for free. I have spaces that once commanded $2,500 a month that now get only $500. Look at some of the spaces around town that have sat vacant for years. This is because when the economy tanks so do the businesses that can afford to rent those properties.

Is the amount of risk you take with commercial buildings appropriate for the potential return? It depends. Commercial buildings are better than vacant land, but investors will have to be able to ride out the storms of lack of cash flow for extended periods of time with vacant buildings or units.

What about single-family residences? They are a pain to manage. Tenants are in and out, there are repairs to deal with, skipped rent, calls in the middle of the night, etc. They are income producing, so what kinds of returns can an investor expect? Usually 6-10 percent. Is the risk appropriate for the hassle and return?

The answer is yes, if done properly, and here is why: The big difference with single-family residences as compared to commercial and vacant land is single-family residences are always income producing and usually do not experience large fluctuations in either rent or vacancy. People always need a place to live, and in the tough times the rents will generally increase because the demand is higher.

However, there is one important key that you can never lose sight of with single-family residences. The risk-to-reward scenario only works when the rent is sustainable for the property. The rent must be a positive cash flow and the investor's expected return cannot be based solely on appreciation. It doesn't matter how tempting it may appear. Don't violate that rule.

One last example outside of real estate is a Certificate of Deposit in a bank. While CDs are usually extremely safe with almost no downside risk (other than inflation), the return on investment is minuscule. Ok, so it's a safe investment, but literally, if inflation is greater than the return, then one's money is losing buying power daily. It should be called a Certificate of Disappointment in today's market.

What would happen if risk verses reward could be flipped to produce more return than the risk involved? This scenario is rare, but it does happen. This is how savvy investors become rich.

I believe we have found that exact scenario in single-family residences lease-to-owns. We have been able to provide the safety of a savings account yet have very lucrative returns. In fact, our lease-to-owns are all single-family residences yet when compared with a regular rental of a single-family residences they are almost the double the return with far less risk.

In investment terms, this phenomenon is known as an alpha, or as I like to call it, "excess returns." An alpha is defined as being the spread between your upside return on investment and the expected downside risk for that return. By benchmarking the spread against other similar investments, an investor is able to compare the amount of potential risk to the potential return.

Understanding the risk verses the potential return is crucial to smart investing. Unfortunately, too many times investors take on more risk than appropriate. When searching for investments, be demanding and only accept those investments that have "excess returns."

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