High Risk Investing

[Editor's Note: This is a guest post from facial plastic surgeon D. J. Verret, MD, FACS. In it, he describes his experiences with accredited investments. He gives seven tips to help you make sense of this complicated area of investing. We have no financial relationship.]

I read the [December 13, 2015 article on accredited investing] with great interest as I have started using some accredited investments to diversify a part of my portfolio. I have to admit that I have some investments where I have lost everything, some which are progressing nicely, and some which have paid off with over a 100% return in less than 2 years. When I started investing in accredited or high risk investments, it became obvious that there are many different kinds of investments, different methods of investing, and no standard method for evaluating the investments. With that in mind, I'd like to share my thoughts on investing in high risk investments.

1 Only use money that you don't mind losing – completely

When I started practice, I made a plan for investing in retirement. Every year, I stick to the plan and only use money that is available after I have made my retirement investments to invest in high risk investments. This way even if I lose all of the money in high risk investing, I will still be on track for retirement. If some of my investments make money – the retirement timeline will accelerate.

 # 2 Invest and forget

Even if your investments are successful, investments in high risk equities are illiquid. This means that unlike the stock market where you can buy and sell on a whim, you will not be able to get your money out for months or even years, if ever. While I keep track of my investments and interact with the companies in which I invest on a regular basis, I maintain a separate accounting of high risk investments. This way, the money invested is not included in my retirement planning or yearly budgeting.

 # 3 Evaluate the investment for yourself

When you evaluate an investment, don’t assume that anyone knows how to evaluate the investment better than you do. The worst loss that I experienced in high risk investments is one that seemed good and was backed by a physician friend of mine. He sold me that he had previous investments that made him lots of money and that this investment was a ‘no-brainer’. Unfortunately the ‘no-brainer’ quickly turned into a ‘no-gainer’ and I’m still waiting to see my initial investment returned.

High risk investing is high risk because the returns are never guaranteed. Even with the best analysis, there are a million reasons that the investment may not turn out the way that you want. Talking to people with more experience in investing is always helpful. Having a ‘business’ mind examine the potential investment is a great idea. Unfortunately even the best business plan can run into unexpected turbulence. Ultimately you will have to invoke a leap of faith and decide if the potential reward is worth the risk of losing everything, or potentially more.

The evaluation that you will make of an investment will depend on the type of investment that you are making. Real estate investments require a different skill than technology start up investing. Some opportunities will be in successive funding rounds for development or production stage companies. These evaluations will be different than an evaluation of an expansion opportunity in a company with a fiscal track record. Partnering with more experienced industry investors can give a leg up but does not always guarantee success.

 # 4 Stick with what you know

With a scientific background most doctors are best served by investing in scientific endeavors. As a general rule, if you are pitched an idea that doesn't sound right, it probably isn't. If you can't understand a business, then don't invest. While there are many variables that will determine the ultimate success of a business, it all starts with a good idea. In medicine (outpatient surgical centers, imaging centers, urgent cares, free standing EDs etc), you may be able to quickly tell if something is a good idea or not. The rest of the diligence will be a bit more difficult.

 # 5 Assume worst case scenarios and if you can live with it,

do it

Always assume the worst and if the best happens you will be pleasantly surprised. If you make an investment that is limited to the amount of the investment and will not require additional capital investment, then if you can lose that amount of money consider the investment. If there is any doubt that you can do without the money, skip the investment. There will be another one right around the corner.

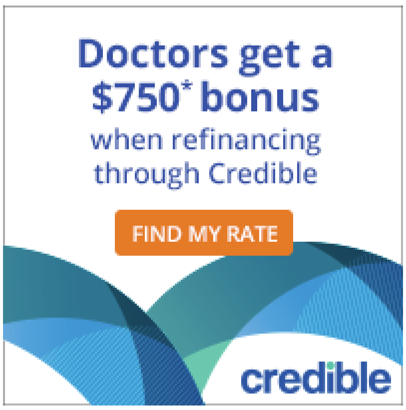
In some investments, like real estate, there may be added unexpected expenses. The returns on a commercial real estate property look great if the property is completely rented and the tenant is responsible for all expenses, a "triple net" situation. But what if you lose a tenant and have to replace the roof on the building so the remaining tenants will stay with you and pay for the finish out for a new tenant. Those costs can quickly add up. Always calculate your financial responsibility in an investment assuming worst case scenario. The last thing you would want is to lose your stake in a long term lucrative real estate venture because of a short term liquidity problem.

 # 6 Talk to an attorney

Most investment documents are not negotiable but there is no such thing as a standard investment so you will want your attorney to look over any document before you sign anything or invest any money. Investments are full of potential liabilities depending on the nature of the investment. Even limited liability partnerships can be ripe for taking advantage of the limited partner. While you think you may be investing a set amount in a company, the investment documents may require additional capital investment or allow the company to take on additional loans that you are responsible for. If you are considering investing $10,000 or more in a company, the couple of hundred dollars an attorney will charge to review documents is well worth it – just consider it part of the investment and calculate the cost into your investment return calculation.

 # 7 Diversify

Just like any investment, high risk investing is best done with diversification. Because most investments require significant capital outlay and are illiquid, meaning you can't readily get your money out of the investment if you need it, it may take several years to diversify a portfolio. Look for 'fund of fund' opportunities. Programs have sprung up across the country that take startup companies and provide on the job business education, funding, and connections. Some of these programs, called incubators, look for 'mentor investors' who not only provide capital which is then invested in a number of the sponsored startup companies like a mutual fund but also provide industry expertise to help the companies become successful. Other crowdfunding websites have been developed that not only allow for investment in individual companies but also into funds which are run by the website sponsors and invest in multiple investments featured on the sites. While you may not have as much control over the specific company investments, you will have a more diverse portfolio that is being vetted by a more dedicated diligence team.



While this article may seem to put a negative spin on accredited investing, I am a strong proponent of maintaining a portion of your investment portfolio in accredited investments. Consider that from 1928 to 2014, the S&P 500 produced a compound rate of return of 9.8%. But according to a report by the Kauffman foundation, angel investors they studied had an overall 2.6 times return on investment within 3.5 years although 52% of the investments lost money. The take home message – you will likely be successful if you are cautious and diversify. With those numbers, the rate of return for the accredited investor is 3 times the return for the S&P 500!!!! In future articles, we will look at how to maximize the probability of success in high risk investing.

What do you think? Do you invest in accredited investments? How have they worked out for you? Was it worth the additional risk, hassle, and illiquidity? Comment below!