5 Factors Physicians and Other High-Net-Worth Investors Should Consider Before Investing in Alternative Investments

By Jeff Larson, Financial Advisor and Partner at 25 Financial

Alternative Investments are investment opportunities that do not fall in the traditional categories of stocks, bonds or cash. Some examples may be private equity, hedge funds, limited partnerships and commodities. Our industry might call these “racehorse” investments as their intention is to out-perform traditional stock and bond investments (the “workhorse”). We believe that both the racehorse and workhorse investments are important to a well-diversified portfolio. Alternatives are not directly correlated to the public markets, and as a result, they can offer more diversification to high net worth individuals during times of volatility. Keep in mind that investors must meet the SEC’s definition of an accredited investor in order to participate in the majority of alternative investments. These investments carry more risk as they are not liquid and do not have the same regulation oversight as the traditional market. Investors should consult with their advisor or they can contact a 25 advisor to determine if they are eligible to participate.

Simply knowing that alternative investments are important in a portfolio is not enough. In fact, these investments can be detrimental to a portfolio without proper due diligence and compliance oversight. In addition to a scrupulous due diligence review of each investment, there are some general considerations that will help investors weed out the “bad apples.”

We have listed 5 key topics accredited investors should inquire of any alternative investment before further consideration of investing their hard-earned money. None of the following 5 factors are necessary nor sufficient on their own. But collectively, they will help guide investors to a better decision. The following 5 points are intended to educate accredited investors as they explore which alternative investments are best suited for their portfolio.

Full Cycle

In the words of “Mr. Wonderful” on Shark Tank: “Are you an Entrepreneur or ‘Wantrepreneur’”? With alternative investments, this happens when a fund “fully cycles” meaning the entire fund has been purchased and liquidated and all capital and appreciation has been returned back to investors. Investors should look for the purchase price, purchase date, sale price, and sale date of each asset in the fund to determine the internal rate of return of the fund.

Do not confuse fund with asset. A fund is generally made up of several assets which adds more diversification. Investors invest in the fund and an asset is simply one investment in the fund. Some companies like to highlight a specific asset going full cycle but this is not usually their black eye. One or two winners might not make up for the four assets that failed.

If a company is asking for investor capital but has not proven that they can deliver results, they might still be “wantrepreneurs” and investors should proceed with caution.

Whose Money

“Put your money where your mouth is” before asking for mine. What dollar amount and percent of the fund is made up of internal dollars (meaning, the Company, CEO, Owner, Principal, or any other relevant title)? The investor should be one of the last to put their money into a fund. Let the sponsoring Company invest their dollars first, purchase a few assets, generate some cash flow, and then investors know they are not the only ones with “skin in the game.”

Proprietary

“If all that you have is a hammer, everything is a nail.” Some investors will be approached by their financial advisor to invest in their company’s fund as the only option. Not only does this possibly give rise to a conflict of interest (especially if the advisor also has ownership in the fund directly or indirectly through ownership of the financial firm that owns the fund) but it is also unlikely that the Company’s one option fits all investors. Also, diversification among alternative investments is helpful to reduce risk and impossible when there is only one option from which to choose. Investors would do well to ask their advisor if there are funds available that are not owned by the advisor’s company.

Cash on Cash Return

“Show me the money!” If $50,000 left your bank account as your initial investment, what dollar amount is expected to go back into your account and in what timeframe? This can be confusing, don’t let it be. Some “companies” at this point may talk faster, connect dots that don’t exist and explain details like depreciation that do not make sense. Each company runs accounting differently. It is the companies’ responsibility to explain and not the investors’ to understand. Do not let up on this point – “I invested $50,000 and I only see $30,000 returned to my account in 3 years. When can I expect the remaining $20,000 and how much (and when) will the remaining appreciation beyond the $50,000 be paid to my account?”

Leverage

This final point is very important to understand, especially in the midst of our Covid-19 pandemic. The more debt a fund has, the greater the risk. Some companies increase the leverage (debt) of the fund in order to boost returns. But during a market downturn where assets lose value, banks may require an infusion of cash to keep the loan to value ratio in range. If the payment is not made, the bank may foreclose resulting in a loss of investor capital. If the fund has minimal debt, the values have more room to drop before triggering the potential bank loan call. Also, interest rates may increase which of course apply pressure for the fund to perform profits or even remain sustainable. Debt policy and how well capitalized the company in the event of a downturn or interest rate hikes are very important to understand.

Summary

Alternative investments can be a very powerful part of diversifying a portfolio and may minimize market risk. These five simple takeaways will help lay groundwork as a guide to becoming more knowledgeable of opportunities in the alternative investment world.