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Risk Versus Reward

We have all heard the term "Risk versus Reward," but I often wonder if this concept is really understood as it relates to a "typical investor." Everyone looks at the risk of an investment a little differently depending on individual circumstances. There appears to be quite a difference between how a multi-millionaire and a low income earner view the investment of $1,000 in a specific stock. To the individual with large amount of funds to invest and regular substantial earnings, a $1,000 investment in highly speculative stock with the possibility of a huge return versus the likelihood of a total loss may not be a big deal. However, to the person whose total savings it may represent, it would be viewed a huge risk.

Appraisers must attempt to view the 'investment' they are appraising "as if" it were contemplated by a "typical" investor. Generally, the standard of value used dictates the view of the hypothetical seller and buyer we consider as we prepare the appraisal.

Let's consider the following possible scenarios illustrating risk versus returns. What these scenarios indicate is that a "typical" investor would be equally comfortable with $1,000 in one year as the amount shown as "Amount Now" in cash – based on the described risk:

Amount Now	Amount in One Year	Probability of Receipt/Type of Investment	Meaning
$998	$1,000	Bank savings or money market account - Certain – 0.2% interest rate	Interest is less than the rate of inflation, but viewed as "safe"
$990	$1,000	Money tied up in a bank certificate of deposit – Insured by the FDIC – 1% rate	Interest on CD of one percent – less than the rate of inflation
$975	$1,000	Money invested in AAA Corporate Bonds – 2.5% rate for 10 year bond	A little higher return due to the little higher risk
$924	$1,000	Money invested in Good Quality Corporate Stocks – 8% rate	A higher return due to increased risk, but the investment is still liquid
$887	$1,000	Money invested in commercial real estate – 12% rate	A higher return is required due to less liquidity and higher risk
$708	$1,000	Money invested in a small business – 35% rate	The increased risk requires an increased reward

The risk rates illustrated in this table include the differences in liquidity of the funds as part of the risk. Also included in the risk is the possibility that the return will not be received at all as well as the risk that the principal may be lost as well. Since interest rates have remained unusually low for many years now, this risk table is skewed – investors keeping their funds in the bank are actually losing money each year as the rates paid are less than the rate of inflation. In times like this, investors looking for real returns on their investments must be willing to take on additional risks of possibly losing their principal in an attempt to receive returns on the investment that exceed the rate of inflation.

Another factor that must be considered in the appraisal of specific business or real estate interests is the likelihood of future price appreciation and the likely holding period of the investment. Each of these criteria can, and does, affect the "risk versus reward" return.

The result of an appraisal (whether of a business, real estate, or anything else) should be the point where the buyer and seller would just as soon take the investment described or the amount of cash shown as the value. They should be ambivalent as to which they would take, as they should consider them to be of equal value.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**

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