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Conservative Investor's Guide to Picking Real Estate Investments: Part 1 - Portfolio Strategies

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Preserving principal and reducing risk with a deliberate portfolio-matching strategy.

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IMPORTANT COVID-19 UPDATE*: this info was posted* ***before*** *anyone knew we would be facing a* ***global pandemic*** *in the spring of 2020. So it may be* ***missing crucial information*** *necessary to making an effective investment today. Some of the information in it may be* ***dated****,* ***no longer accurate*** *and/or* ***irrelevant****.* ***For***

***information on analyzing investments in this new era, see**: "How will Covid-19 / Coronavirus Affect my Alternative Investment Portfolio?"*

Numerous people have asked me **how I pick** the **conservative deals** in my portfolio. There are many ways to do due diligence, and I've come up with a process that I like for myself. My process is **ruthless** and **starts with thousands of deals** in my inbox each year. In the **end, maybe 2 to 4 survive** that I invest in.

This series details exactly **what I look at and why**. I welcome the feedback of other conservative investors, and will add ideas I like to the articles. And aggressive investors should also find this helps them better appreciate and gauge the bigger risks they end up taking. (If you're a non-accredited investor, a lot of this info doesn't apply to you. Check out this non-accredited investor guide instead).

Why "Going Big or Go Home" May Send You Home Early

Warren Buffett, who's one of the most successful investors of all-time, has 2 rules for investing. First: "**never lose money**". Second: "**never forget rule #1**".

This risk-averse mindset **works** because **investing losses always hurt returns much worse than gains** help. For example, if I lose 50% this year, I have to make back twice as much next year (100%) just to break even.

So I believe that the **best long-term returns** come from focusing on **preservation of capital and reduction of risk** (even if it may not always produce the best short-term return in any one year).

Unfortunately, **finding conservative deals** that meet this criteria **isn't easy**. But it is possible, and **here's how** I do it.

The 4 Steps of Analyzing A Deal

This might sound strange, but I **don't look deeply into a deal until late** in the process. If I did property level deep-dives on every deal that crossed my desk, my family would never see me. And there are much easier and time efficient ways to weed out deals before that point. So here's how my process works:

1) **Portfolio Matching** (takes a **few seconds per deal**): Before I look at any deals, I've already thought about my own portfolio and what needs to go into it next (which includes keeping an eye on the real estate cycle). Then when I see a new deal I immediately throw it out if it doesn't match (which weeds out 75% of the candidates run off the bat). I talk about that here in Part 1 which covers **balancing a portfolio, gauging timing, understanding risk versus reward** and **combining it into a coherent strategy**.

2) **Sponsor Quality Check** (**15-45 minutes per deal**): Then I look at the most crucial aspects quality about the sponsor. This weeds another 90% of the investments that are left. This is covered in part 2 where I talk about

getting deal flow, analyzing the sponsor experience, track record and skin in the game.

3+4) **Property level due diligence** (**takes minutes to weeks to months per deal**): Only here do I do a deep dive at the property level and legal documents. This also weeds out about 99% of the investments that are left. This is covered in Part 3 where I talk about **"pro-forma popping", sensitivity analysis and "Stall and See"**. And it's also covered in part 4 where I talk about **recession stress testing, legal document analysis,** etc..

At the end, I have an investment (and a sponsor) that I've put through the ringer, but that I'm **very happy to put in my portfolio.**

Okay, let's talk about **portfolio matching**.

How Much Real Estate do you need?

Most investors throw themselves **randomly** into whatever new crowdfunding or syndication investment happens to cross their desk that they like. The result is an **unbalanced, improperly diversified portfolio** with much **higher risk than necessary.** In my opinion, it's vital to instead take a step back first and have a plan.

The very first step is deciding **what percent** of my total portfolio belongs in real estate, and then **sticking with it.** If you haven't thought about this, you can get more information here: How Much Real Estate Is Ideal for My Portfolio.

I'm currently comfortable with 20 to 45%. But I know people who are about 90%, and others who are 10% and everywhere in between. I don't think there is a single right or wrong answer, because it depends on the person's unique financial situation. The important thing is to understand the risk/rewards and go with what's best for your portfolio.

After choosing a real estate allocation, the **next** step is to look at is **timing**.

Timing Is Everything

Paul Kaseburg, who has sat on both sides of the table on a **$1.7 billion of real estate deals**, says **timing** is one of the two **most important** things in **successful long-term real-estate investing**. (Along with staying power: the ability to keep an investment going if the cycle turns on it, even while others are crashing out). And academic **studies** have shown that as long as a sponsor is competent, **timing** is the most important factor in determining **which deals are successes** and which ones aren't.

There's 2 steps to timing real estate successfully. First is **awareness of the real estate cycles**. And second is **portfolio planning to reduce risk,** based on the position. Let's talk about the first step...

Cycles

There are **two** different cycles in real estate: **physical and financial**. And investing in the **wrong strategy** at the **wrong part of the cycles** can be **catastrophic** to your portfolio. So it's important to **understand** them, as well as keep on top of financial news, so you can strategize accordingly. (If you're unfamiliar with the cycles, you can learn more here).

I personally feel that we're **very late in the physical cycle**, but only **midway through the financial cycle**. Others may have a different opinion. The important thing is **understand** that there are cycles, **watch** the market closely, and **adjust** if and when your opinion doesn't sync up with reality.
Once a person understands real estate cycles, the second part of **timing** is **portfolio planning to reduce risk**. Let's talk about that now.

Newbie Recap

First, I'm going to take a step back for a second, for any newbies. There's so much variety in real estate investments that it can be overwhelming. But 90% of the variety is made up just **4 things**.

And if you're a **newbie**, then I really recommend that you **DO NOT invest in ANY individual deals, until you understand ALL the below concepts**, and particularly the **risk/reward trade-offs**. **Otherwise** you'll almost certainly be *taking much more risk than you realize.*

1. **Strategies** (core, core+, value-added, opportunistic) *(More info...)*

   Note: watch out because **many** crowdfunding **sites** and sponsors **mislabel strategies** as something that's **more conservative than it really is**. A supposed "core+" fund may actually have much riskier leverage at 75%, or have a strategy with much more execution risk like value-added. So it's important to double check the details.

2. **Capital stack choice** (debt, equity... and more exotic variants and blends) *(More info...)*

3. **Residential versus commercial** (residential versus commercial) *(More info...)*

4. **Specialized asset subclasses** (multi family, office, retail, mobile home parks, medical, industrial, etc.) *(More info...)*

In my opinion, a prudent **conservative** investor **favors different strategies, choices and options depending on the stage** of the cycles. And the way to do that is through **portfolio planning**.

My Portfolio Planning

I believe we are late in the physical cycle, but midway through the financial cycle. If that's right then the next downturn is coming sometime in the next several years. And if so, a conservative investor is hitting the brakes, rather than pumping the gas.

So I'm defensive. I'm overweight in leverage-free debt funds and debt-free equity (while underweight in debt-financed equity). These don't have the high projected returns as highly-leveraged equity an might seem too boring to a more aggressive investor. But I'm happy with that since the returns are still fine and they harden my portfolio against the two biggest threats that blow-up investments in a downturn: the risk of defaulting on debt, and the risk of not being able to refinance.

I do invest in a *little bit* of debt-financed equity. but when I do, it needs to be low leverage and an extremely experienced and high quality sponsors.

Even though I believe we're only midway through the financial cycle and not near the end: no one knows for sure. It's been a 50/50 chance of the last six physical cycle recessions. So since I'm conservative, I plan as if the financial cycle downturn is coming too, anyway.

This means I avoid all equity deals with medium-term, 3 to 5 year debt. If we do have a financial cycle downturn, many of these will be at risk of blowing up because they won't be able to refinance (just like in the Great Recession). Again, I like to think that the next recession will not be that bad, so this could end up being overkill. But I "plan for the worst before hoping for the best". This happens to also be really handy for filtering right now, because it lets me throw out alot of crowdfunding deals right off the bat.

I'm also holding a lot of cash, to hopefully take advantage of distressed opportunities in the next downturn. As the stage of the cycle, I generally like the safety of lower execution risk core and core + over higher execution risk value-added. I won't touch opportunistic now, which to me is too risky.

How My Portfolio Planning Will Change

After the next downturn comes and then we recover, I'll be doing a 180° in many ways. When that happens, I'll be maximizing the timing by "hitting the gas".

I'll go overweight in leveraged equity then (although not highly leveraged since I'm conservative). I'll move more aggressively into value-added and even a touch of opportunistic. And I'll be adding deals financed with medium-term 3 to 5 year debt, as well. But for now, I'm being very patient.

That's my strategy. You may have a different view on the cycles, or you may be a less or more conservative investor. In that case your strategy will be different. But regardless of your strategy, the important thing is to have

a strategy, and remember to stick to it.

Bottom Line

So this **portfolio matching strategy weeds out 75% of new deals in just a few seconds,** because they obviously aren't a match for me. On the other hand, if they do match, then I move on to the next step.

Next Steps

Part 2 of this article talks about the **sponsor quality check:** getting deal flow, analyzing the sponsor experience, track record and skin in the game.