The Relativity of Risk Assessments in Investment Decisions

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The Subjectivity and Relativity of Risk Assessments in Investment Decisions

It is a widely accepted belief that risk is an important factor in investment decisions. The income method of valuation stipulates that the price an investor is willing to pay for an investment is a function of the future expected cash flow, discounted by a rate that reflects the risk associated with receiving this expected cash flow. The Ibbotson build-up, Black/Green, and Schilt are three widely used methods valuators use to determine a specific discount rate to be applied to projected cash flows in valuing closely held companies.

The Ibbotson method utilizes historic rates of return on publicly traded investments, combined with risks associated with the specific industry and company being valued. The Shilt method derives a discount rate by adding various risk premia to the risk-free bond rate. Ranges of premia are specified according to risk factors, such as earnings stability, depth of management, competitiveness of the industry, and the size of the company being valued. Black/Green takes a similar, but more detailed, approach.

Despite differences, all three methods falsely assume that only the inherent risks in operating the business need to be considered in the valuation process. I contend that the unique characteristics of potential investors have profound effects on how risk assessments are made in real-world investment decisions. Not all potential investors have the same subjective attitudes towards risk. Not all potential investors have the same depth of financial resources, business experience, and management acumen. These subjective and relative aspects of risk have a great bearing on how risk assessments are made. Their variability makes the risk of owning and operating a business a relative, rather than an absolute, quantity.

All three of the standard methods of developing a risk-related discount rate assume that the expert valuator analyzes the inherent risk associated with various operating characteristics of a closely held business. Based upon this analysis, the valuator develops a discount rate that will be used in capitalizing the projected future income stream and developing a fair market value.

However, in trying to model the behavior of potential investors in small closely held businesses, it is the attitudes of those potential investors toward risk and not the attitudes of CPA/CVA valuators that matter. As a group, CPA/CVA valuators do not necessarily have the same attitude toward risk as potential small business investors, who therefore may not make the same quantitative assessment of
risk as a CPA/CVA valuator. Based on my experience with small business owners, I would predict that CPA/CVA valuators are more risk averse than most small business investors are.

Of course, not all small business investors have the same attitude toward risk either. Certain investors will largely ignore the risk of an investment if they perceive the potential return to be very high. Furthermore, many small business investors have non-monetary motivations for investing in small businesses. For such investors, the inherent risk associated with receiving a future cash flow may not be assessed as it is for a passive investor seeking only a future cash flow.

Some advocates of the income method concede that certain investors do not view the risks of a particular investment as they do. Some proponents of the income method claim that investors who do not pay sufficient attention to the inherent risk of an investment, or who fail to give the same weight to various risk factors as expert valuators, are irrational. This view implies that CPA/CVA valuators are the arbiters of what constitutes rational investment conduct. While as a class we may be more risk averse than other groups of people, who is in a god-like position to claim that being more risk averse is equivalent to being more rational?

Let’s turn to now to the relative aspects of risk. Everyone would agree that walking across a high wire without a net is a risky proposition compared to walking across a living room floor. Nonetheless, the degree of risk associated with walking across a high wire without a net is not absolute: it depends on who is doing the walking. Clearly, if a trained high-wire performer does the walking, the activity is less risky than if an untrained person attempts the feat. In this sense, the risk of walking on a high wire is a relative phenomenon. A similar situation exists in any particular line of business.

Most of us would agree that there is more inherent risk in an industry sensitive to business cycles, like construction, than one where demand for the service is relatively constant, such as tax preparation. However, a buyer who has previous experience operating a construction business faces less risk than a buyer who has never run such a business. Likewise, if a potential buyer has a great deal of capital and access to lenders, that buyer will be able to weather the inevitable cyclic downturns better than a perspective buyer who lacks these assets. The simple point is that different potential investors in closely held businesses are in a position to change the inherent risk of operating a business. Some investors can decrease the inherent risk of operating the business while others can increase the risk.

This point may be overlooked, because advocates of the income method fail to recognize that the investment contexts of publicly traded and closely held companies are dramatically different. An investor buying a few hundred shares of Microsoft is not going to have an impact on the operational performance of that company. An investor buying a controlling interest and becoming intimately involved in the day-to-day management of a closely held company is going to have a significant impact on the operations of that company.

Another relative aspect of risk involves diversification. As modern portfolio theory points out, the degree of diversification associated with a portfolio of assets has an impact on the risk associated with holding any particular asset. If a potential investment in a closely held company represents nearly 100% of an investor’s holdings, that investment is judged as much riskier than if it represents only 5% of the investor’s holdings.

Clearly, risk assessments play a role in real world investment decisions, but the nature and extent of that role is vastly more complicated than implied by the risk measurement approaches used in the income method of valuation. In the real world, differences in subjective risk tolerances will affect investor decisions. In the real world, investors have the ability to change the inherent risk of operating specific closely held businesses. In the real world,
the risk of investing in a particular closely held business will depend on an investor's ability to diversify his or her total portfolio of holdings. By failing to take into account these relative and subjective aspects of risk, all variants of the income method give us a greatly oversimplified and inaccurate account of how investment decisions are actually made.

Michael Sack Elmaleh, CPA, CVA, is an adjunct instructor at Columbia Union College and Central Michigan University where he teaches math, statistics, and cost accounting. He has also taught economics and corporate finance at other institutions. He has a BA in psychology and philosophy and MS in accounting, and an MA in philosophy. He also has twenty years of "real world" experience running his own CPA firm in Madison, Wisconsin and as a principal in a local CPA firm.

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