The Entrepreneur's Investment

PARADOX

How to change one's entrepreneurial mindset in order to achieve financial independence

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The Entrepreneur’s Investment Paradox

At a certain stage in their business journey, owners of small businesses and micro-businesses reach a critical decision point: What share of their finite financial resources should be allocated toward growing the enterprise, versus meeting personal financial goals?

We call this dilemma: “The Entrepreneur’s Investment Paradox”.

This white paper explores the common challenges that business owners face when it comes to maximizing their financial returns over the long haul. It also examines harmful beliefs and behaviors that prevent business owners from making the best use of their capital, which ultimately prolongs the time it takes to reach financial independence. Finally, it proposes five strategies for securing one’s financial future without jeopardizing the business’ performance.

INTRODUCTION

This paper draws on academic and other research as well as empirical evidence derived from 30 years of business experience. Over a thousand business, financial, and consulting engagements have led me to the conclusion that most US-based small business owners look upon their enterprises as being the primary vehicle through which to achieve personal financial freedom and prosperity. However, I've only witnessed a minority of them reach their desired level of financial independence.

Why is that so? I've found that it is because entrepreneurs tend to possess beliefs and behaviors that that prevent them from making the best decisions about the distribution and use of their capital, which ends up prolonging the time it takes for them to reach financial independence. I believe that business leaders can confront these destructive beliefs by altering their 'entrepreneurial mindset,' thereby allowing them to make more informed choices, as well as more effective use of financial planners, consultants, and advisors. In doing so, I've found that the road to financial freedom involves finding the right balance between two competing forces:

Invest more into the enterprise to achieve business success

Prioritize the demands of reaching one's personal financial goals

CONSIDER THE FOLLOWING SOBERING FACTS:

$300,000 ***May be insufficient to retire on***

median sale price of a small business in the US 2023[2]

6% ***Can have a limited effect on growth***

percentage of companies exceeding $1 million in annual revenue[3]

34% ***Could lead to reliance on business sale proceeds to fund their retirement and extend working years***

percentage of business owners who don't have a personal retirement savings plan.[4]

The result is that most US small business may struggle to reach their personal financial goals as they prioritize the building of their businesses over the course of many years. This in turn could leave them woefully unprepared for retirement.

This hard truth underscores the critical role that financial advisors should play in guiding small business owners towards financial freedom. Entrepreneurs need a trusted source of financial guidance to deliver affordable, comprehensive, and competent advice that will help them:

- Make informed financial decisions at each point where their personal and business life intersects.
- Assemble and coordinate the services of their collective professional team.
- Grow a best-in-class company while narrowing their personal income and wealth gap.
- Understand when and how to reinvest in their company rather than extracting capital from it.

However, a significant impediment stands in the way of generating successful outcomes from a business owner/financial advisor relationship. Traditionally, financial advisement focuses on investment opportunities *outside* of the business, which ends up leaving behind a vital potential source of growth.

Other frequently used forms of advice, such as bankers, CPAs, and business consultants, are too often siloed within their own service offerings. These professionals may also face a range of restrictions over how they are able to engage with clients as well as potential conflicts of interest, preventing them from working with small business owners in the most constructive, independent, and collaborative manner. Thus, business owners are in desperate need of a new strategic framework to help them navigate **their own investment paradox.**

WHAT MAKES SMALL BUSINESS OWNERS SO UNIQUE?

Small business owners are a special breed when it comes to providing effectual financial guidance. Compared to their non-business owner counterparts, the need to balance personal goals *and* business growth adds a significant layer of complexity to the already difficult task of charting a person's financial roadmap over the course of a lifetime.

There are three principal reasons for this:

1. A tendency by small business owners to underestimate the scale of their cash management problems, and then oversimplify the solution.
2. A blurring of the boundaries between the business accounts and the personal financial statements of the business owner.
3. A problem of misalignment in the traditional investment-advisory relationship.

PROBLEM 1: TAKING AN OVER-SIMPLIFIED APPROACH TO CASH FLOW PROBLEM-SOLVING

Cash flow is widely regarded as the most important financial metric for businesses to track.[5] Without stable and consistent cash flow, a business' cash reserves can be easily and quickly consumed, creating a need to borrow more funds, sell capital, or (in a worst-case scenario), to close down the business.

Cash flow interruptions (whether planned or unplanned) demand the business owner's urgent attention to identify ways to replenish stocks. Larger companies may be able to access the broader capital markets to improve liquidity, but this source of funding is not normally available to smaller, private companies.

Solving cash flow problems is, somewhat paradoxically, a more challenging task for small businesses than their larger, public counterparts.

One way to address this problem is to identify and establish a core capital target,[6] somewhere between two and six months of operating expenses depending on the business' cash conversion cycle. To the extent that owners can resist taking distributing profits until they hit this target, the eventual reserves can soften the impact of the cash flow speed bumps that inevitably pop along the business' growth path.

Source: Three Strategies to Improve Cash Flow For Your Business, Forbes.com

Still, committing to a cash reserve policy is only half the story. Cash also needs to be executed and managed well. An effective cash balance management program must consider multiple factors in addition to the target amount, such as:

- What is an acceptable return on investment from a cash reserve?
- What type of investment is needed to produce the desired returns, while at the same time allowing the necessary access to the funds (on call, if necessary)?
- To ensure liquidity, what is the smallest amount of cash reserve that must be kept on hand?
- Should any cash be kept inside the business (rather than outside)?
- If so, what is the maximum amount of cash reserve that the business should hold?

Obtaining a sufficient rate of return on cash investment presents a much greater challenge today than it did twenty or thirty years ago when money market interest rates as high as 12.5% were not uncommon. Unfortunately, the persistently low interest rate environment of the last decade means that real returns can easily turn negative once inflation is considered. And since money markets are in a constant state of flux, cash management policies must be designed to be flexible and dynamic. Business owners looking to shorten their journey to financial independence must therefore find creative ways to protect and grow their cash reserves.

PROBLEM 2: BLURRED BOUNDARIES BETWEEN BUSINESS AND PERSONAL FINANCIALS

Notwithstanding its positive benefits, establishing a strong cash reserve does come with a significant downside: business growth. Additionally, small businesses have a propensity for sharing their balance sheet and income statement with the business owner. When this occurs, the personal financial challenges of the business owner then become the financial concerns of the business - and vice versa. This inverse relationship requires business owners to address a critical and persistent question: How to balance the owners need to meet personal financial goals against the business' need to efficiently put cash to work to meet long-term growth objectives? We call this dilemma "The Entrepreneur's Investment Paradox."

While my experience has led me to the conclusion that this is a common challenge facing small business owners, it also suggests that too few develop an effective, reliable, long-term approach for dealing with it. Thus, solving the Investment Paradox means finding and executing on growth opportunities both inside and outside of the business, while maximizing long-term asset growth and minimizing opportunity cost. Opportunity cost is like a stealth tax, and is often a byproduct of a lack of awareness and clarity about how best to deal with a fluctuating cash surplus. Owners have a tendency to either to starve their companies of needed cash by carving it out and allocating it to low-velocity personal investments or holding *too* much cash inside the business at suboptimal interest rates. The result is persistently unproductive cash.[8]

The investment's advisor's answer to the Investment Paradox is quite simple: "Give me the cash." This inevitably causes a tug-of-war between the business owner and the financial advisor over where that cash should go. On the one hand, an investment professional is right to ask for the funds to be diversified away from the company (based on the low sale prices for small businesses coupled with owners' abysmal savings records). On the other hand, it's been my experience that capital that's reinvested in a well-managed and well-advised business can generate between 15-25% return on equity, whereas Vanguard's Balanced Composite Index only averaged 7.55% through the ten years ending in 9/30/23.*

* Vanguard Benchmark Returns: https://personal.vanguard.com/us/funds/tools/benchmarkreturns

PROBLEM 3: CONFLICTING AIMS OF BUSINESS OWNERS AND THEIR ADVISORS

Twenty-two years working with financial advisors has led me to the conclusion that most financial advisors see their job exclusively as being the delivery of returns on investments they manage. Entrepreneurs on the other hand typically seek two outcomes: a return on managed investments as well as "relationship ROI," defined as the collective value of the services delivered by the advisor and the impact those services have on the owner's business outcomes, personal financial outcomes, and general life use of money. What is more, business owners do not just want to pay a dollar to get a dollar - or even to get a dollar and ten cents. They want leverage of 3x, 5x, 10x... the more the better! Unsurprisingly, the investment management industry has had a hard time meeting investors' expectations through investment management along.[9]

The difficulty of finding the right investment advice for a small business means that many owners often end up choosing what appears at the time to be the safest path: simple, pre-packaged solutions that are designed to be delivered at volume, but which are in fact not at all suited to the peculiar needs of this segment. The use of such "cookie-cutter" solutions inevitably leads to a see-saw effect in which one issue is solved but another one is immediately created.

There is also a range of conflicts of interest inherent in many service providers' business models, especially in the case of siloed professional such as tax advisors, bankers, Certified Public Accountants (CPAs), business consultants, and investment advisors. While each professional brings necessary and valuable expertise within their area of specialty, it is important to understand each group's Key Performance Indicators (KPIs) to determine whether their advice might be at odds with your mandate to identify the best use of capital. Uncoordinated delivery of these services can also become a serious detriment toward making optimal capital allocation and business decisions.

TAX PREPARER KPI
Minimize the Tax Expense

Examples of Advice:

- Buy excess inventory and take a Section 179 a deduction.
- Pay quarterly taxes based on last year's income.
- Make a retirement plan contribution.

POTENTIAL ISSUES:

- Excess inventory lowers the return on assets and takes funds away from other initiatives that may produce a higher Return on Investment (ROI), e.g., hiring a new employee or increasing marketing to generate more sales.
- If income is down and cash is tight, paying quarterly taxes at last year's rate may not be worth the penalties in interest.
- Retirement account investments may significantly underperform the Return on Equity (ROE) of your business.

Banker KPI
Attract Cash Deposits

Examples of Advice:

- Offer higher interest accounts in exchange for progressively larger minimum deposits.
- Offer loans.

POTENTIAL ISSUES:

- The business hold too much cash for too little long-term return.
- The business raises its risk exposure level due to loan repayment commitments.

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CPA KPI
Comply with Tax Regulations

Examples of Advice:

- Contribute to a retirement plan

POTENTIAL ISSUES:

- Retirement contributions are difficult to claw back if the business needs cash later.

BUSINESS CONSULTANT KPI
Improve Overall Business Outcomes

Examples of Advice:

- The consultant may recommend taking any number of steps to build the company such as investing in technology, people, accounting systems, or making process improvements. Funding may require debt or a cash infusion from either inside or outside the business.

POTENTIAL ISSUES:

- Business consultants are unlikely to have a clear understanding of the owner's personal financial situation.
- There may be a higher risk of over-capitalization of the business, increased debt levels, or constrained cash flow.

INVESTMENT ADVISOR KPI
Build Client Portfolio of Assets Under Management (AUM)

Examples of Advice:

- Invest in a diversified range of financial products.

POTENTIAL ISSUES:

- Asset management fees may cut into capital that could be better used inside the business.

Incentives drive outcomes, so look closely at the motives of the service provider to determine whether they will be a good fit for both your business and personal needs. In particular, pay attention to how the provider structures their operation to support the owners and businesses that they serve, and what their process of multi-professional planning looks like, as cohesive teams often see better results then disjointed ones.

Many advisors structure their fees based on assets under management. This model suits a variety of financial planning scenarios. However, for more intricate financial, business, and tax situations, a broader approach might be beneficial

5 Strategies for Small Business Owners to Secure Their Financial Future

1.) Hire an Integrative Planner

For most business owners, their business is their most valuable asset. Thus, when searching for financial advice, find an integrative planning firm with specific experience working with businesses and a clear dedication to the unique financial planning needs of entrepreneurs. Integrative Planning can create more time and space for entrepreneurs, while helping them visualize the long-term impact of highly interconnected choices affecting their personal and business life. Integrative Planners may also offer more innovative approaches to pricing and services that business owners need. Entrepreneurs who work with Integrative Planners would work together to:

- Prioritize the owner's personal financial needs and goals, which compete for business resources.
- Identify optimal solutions to narrow the income and wealth gaps of the owners.
- Understand expected returns of competing personal investment opportunities and weigh them against the returns and risk of current and upcoming business investments.
- Manage protective services such as tax, legal and estate planning into advisor-owner meeting rhythms.
- Contextualize the long-term impact of any investment made in or out of the business.
- Make business value acceleration a regular part of the financial planning process.
- Create space for ongoing vision work to help entrepreneurs see the financial, lifestyle and family outcomes of their hard work.

Integrative Planning firms are usually made up of a variety of different professionals. One of the most important roles to have on the team is a fiduciary: a financial advisor who is legally obliged to act in the best interest of their clients, even if this means going against the interests of their own firm. Secondly, seek out a company that has a business-centric advisor who is skilled in the art of business value acceleration. These professionals can oversee and coordinate the efforts of all the other tax, legal, and business advisors, helping to maximize overall relationship ROI.

Additionally, Integrative Planning companies tend to offer more flexible approaches to the pricing and delivery of their financial services, which may be better suited to small business owners. Along with providing services under a traditional AUM fee structure, many will work under a fixed fee, retainer fee, or equity-sharing arrangement - depending on the structure that aligns best with the collective interests of the parties - which balances the expected delivery of the value with the client's budget and overall need.

2.) Find Clarity by Focusing on Planning

Business owners should never underestimate the value of setting aside time to analyze the challenges they face and the possible strategies to overcome them. The financial advisory team needs to play a significant role here. The owner's long-term vision, goals, and desired outcomes provide the foundation for building a comprehensive, consolidated plan that maps out the entire financial journey for the business and the business owner.

Some of the benefits of adopting a detailed and rigorous approach to financial planning can include:

1. **Risk Reduction:** Consider the wise adage: "If you fail to plan, you plain to fail." Financial planning provides a structured process for figuring out how and when an individual can meet their life goals through the proper management of financial resources. Think of the planning process as being like a SWOT analysis, delivering greater clarity about what needs to happen to reach those goals along with the risks of missing or avoiding them.

2. **Behavioral Awareness:** Use the collaborative planning process to develop a better understanding of the illogical and irrational decisions that human beings are prone to make concerning financial matters, and how to avoid those same mistakes using behavior self-assessment.[10]

3. **Portfolio Optimization:** Financial advisors may place their core value proposition on their stock-picking abilities to beat the market. However, statistics shows this to be one of the lowest value-add items in terms of ROI.[11] Smart investment planners understand that the most important decisions are not about which stock to buy, or whether to go active or passive. Rather, what's critical is the construction of an investment portfolio using a blend of strategies to reach an overall objective.

4. **Reduced Tax Exposure:** Integrative Planners take account of the added complexities involved in owning and operating a small business, and plan around all of the moving components (not just the investment accounts) to minimize the overall tax obligations.

5. **Asset Optimization:** Rather than getting caught up in the perpetual search for the best personal investment, look no further than the business itself. In terms of ROI, this could present the single biggest opportunity for growth. As such, a thorough ROI analysis will go far beyond just the investment accounts, encompassing all business as well as personal assets.

"In preparing for battle, I have always found that plans are useless, but planning is indispensable."

-Dwight D. Eisenhower

3.) Delegate Execution

The #1 reason people start a business is to be their own boss. Put another way, having flexibility of time and decision-making authority can be an attractive alternative to employment. Of course, ask any entrepreneur about the reality of the expectation and they will tell you that getting to that point requires an appetite for less flexibility of time and a greater reliance of help from others. Thus, successful entrepreneurs must become excellent delegators within their business. While most entrepreneurs are familiar with the concept of business delegation as a means of accelerating their business outcomes, they do not always apply this to their personal lives. In the context of this paper, **solving the problem of time is really a question of how well you use and integrate the intelligence that is all around you (i.e., how well you delegate your integrated business and personal service needs).** Hiring a best-fit advisory team is an excellent start. This step should be adding time to your life, not taking it away. In a no-conflict advisory relationship, your advisors focus on filing your knowledge gaps, alllowing you to solve issues more quickly. Your financial plan provides your team with the vision of achievement you are looking for, and that shared vision offers added leverage that speeds up the time it takes to level up your business and personal financial outcomes. Collectively, these steps create more time.

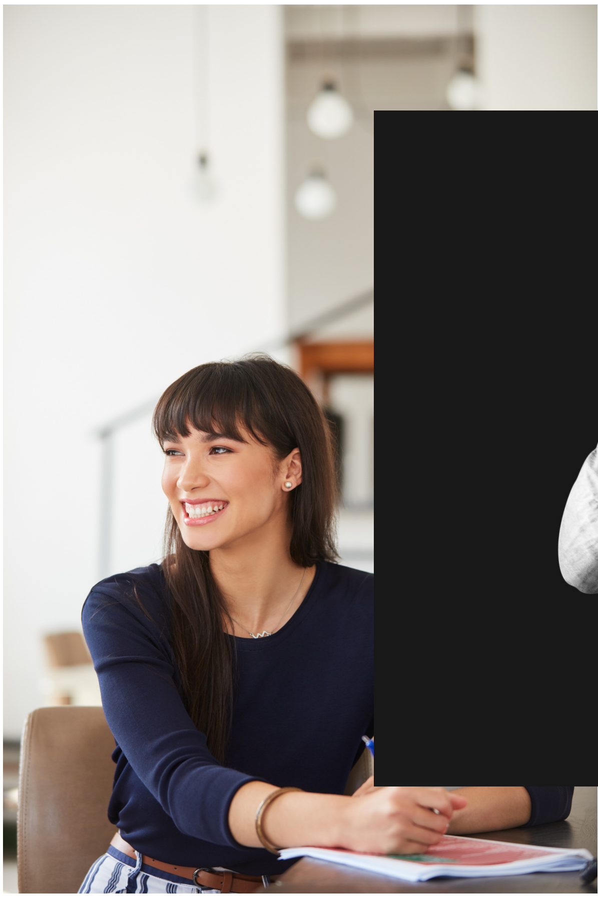
Your knowledge and skillsets are unique, but no one is equipped to do it all. This understanding leads savvy entrepreneurs to hire coaches, consultants, and advisors in the first place. It can take years to build a team of trusted professionals who understand how best to support your needs and who can guide you as your financial complexity increases. Consider using your advisory team to ease this process for you. In short, use their bench.

Too often, clients find their attorney, CPA, insurance professionals, and bankers working in a silo rather than collaboratively. Your outcomes are maximized through the latter, and there are several excellent reasons to **make your financial advisor the facilitator of team assembly and team-based planning.** For starters, the architect of the plan is often the most knowledgeable about your desired outcomes. Additionally, most long-time advisors have spent years developing relationships with attorneys, CPAs, and other specialized consultants ranging across R&D tax credits, M&A, and accounting/administrative experts to help support their clients' business interests. Finding the right professional in each category or function is critical. Finding the wrong one can be very costly. **Assemble the right team or find the go-to trusted advisor to do it for you.** It could be the most important thing you do.

4.) Understand and Improve Your Money Mindset

Your money mindset is influenced by many factors including the psychology of money itself. The importance of understanding your money mindset cannot be understated. Consider the words of Henry Ford, “Whether you believe you can do something or not, you are right.” In a study of 10,000 millionaires, one of the most interesting statistics was that 97% of millionaires believed that they could become millionaires,[11] confirming that **mindset matters as much, if not more, than the strategies and tactics used to achieve the success they seek.**

In financial planning, developing and maintaining a positive money mindset begins with clarifying your personal and professional goals. Often, the more specific your goals are, and the more consistently you connect with them, the greater the likelihood of reaching them. **Staying in touch with your spending and continuously narrowing your knowledge gap around money, investing, and finance are also excellent ways to create a mindset of abundance that is necessary to achieve your financial goals.** In the absence of a healthy connection to your money, a scarcity of mentality can set in and if unchecked, eventually the line between more and enough never seems to cross.



5.) Solve the Investment Paradox

Determining the highest and best use of capital is a question that should exist at the core of every decision and permeate the coveted time you spend with your advisors. As it relates to cash holdings, this may require an adjustment to risk taking with your cash. Often, your financial plans will dictate your need for risk taking. Make sure that your assets are fully supporting that need and work with your advisor to find the most appropriate investments to use to hold cash. For instance, cash alternative investments are potentially capable of delivering greater yield than bank cash holdings and may include laddered CD's and laddered indexed CD's, Ginnie Mae Bonds, floating rate securities, intermediate corporate and US treasury bonds, tactically managed bonds, and other types of short duration low-to-moderate volatility securities. Alternatives to cash, in many cases, should be considered in low yield environments.

Like your company vision statement, the highest and best use of capital mantra acts as your financial guiding light, your true north. In Gary Keller's book *The One Thing,* he discusses the merits of choosing a single task to work on, believing that focus improves outcomes, while spreading your focus across too many activities at once is more likely to lead to discord and potential under-performance. If you are having trouble finding your highest and best use of capital, your attention is in too many places, or your financial situation has simply become too complex to manage on your own. If this is true, evaluate whether it is time to delegate this activity to your advisory team and let them carry this sacred and important torch.

Conclusion

Once you've assembled your integrative advisory team, use their bench, build your plan, and show up every day with a strong time and money mindset, thus empowering your team to better empower YOU.

If you make the highest and best use of capital your mantra and create the time and space for a different kind of conversation about money with the professionals who serve you, exceptional results are achievable. We hope that this paper offers a useful jumping-off point, and we invite you to visit us to learn more.

If you are one of the many underserved, middle-market or lower-middle-market business owners looking to explore ways to reach financial independence, consider assembling a different kind of financial advisory team.

Visit PrismFC.com or call us at (480) 661-1236

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