



FOCUS ON BUSINESS: THE INVESTMENT PARADOX OF THE ENTREPRENEUR

The majority of Prism Financial Concepts' clients are micro- to small-business owners. While each business and owner's financial situation is unique, certain commonalities exist amongst those who operate a "system" made of financial and human capital designed to deliver goods and services for a profit. This paper identifies core tenets that, if not properly addressed, can obfuscate the highest and best use of capital decision-making and extend a business owner's time to reach financial independence.

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"I would like to acknowledge the valuable assistance I received from Brian Pry, CPA and the rest of my team, clients, and friends."

WHAT MAKES BUSINESS OWNERS DIFFERENT?

Small-business owners are courageous risk takers and incubators for ingenuity and employment growth in the United States.

They are also a substantial, yet often underserved, segment of the investment and financial-planning industry. While there are many reasons for this, compared to their non-business owner counterparts, the business owner's road to financial freedom requires balancing the financial needs of two competing forces; personal goals and business growth. From a planning and investment perspective, this adds complexity to the already difficult task of identifying and meeting personal financial objectives during one's lifetime. Success, therefore requires a healthy respect for the following statistics:

- **\$270,000 = The average sale price of a US small business in 2019**
- **NOT OFTEN ENOUGH TO RETIRE ON**
- **4% = The number of companies that reach sales of more than \$1mm annually**
- **AFFECTS AN OWNER'S ABILITY TO GENERATE SUSTAINABLE SYSTEMATIC PROFITS**
- **36% = The number of owners that contribute to an IRA**
- **18% = The number of owners who contribute to a 401k**
- **FORCES RELIANCE ON BUSINESS EQUITY AT SALE OR EXTENDS WORKING YEARS**

The result: **many US business owners end up woefully unprepared for retirement** and struggle to meet personal financial goals as they build their businesses over many years. This reality emphasizes the critical importance of the role that financial advisors play in supporting these small-business entrepreneurs. It also speaks to the need entrepreneurs have for this trusted source of financial guidance to provide affordable, comprehensive, and competent advice designed to help entrepreneurs:

- **Provide advice at the intersection of their personal and business life**
- **Assemble and oversee their professional service team**
- **Support activities that build future business enterprise (sale) value**
- **Address the cash needs of the business**
- **Help plan and meet personal financial and life goals during the business building process**

Commonly, business owners turn to a trusted financial advisor to guide them toward financial freedom. A potentially catastrophic impediment to this outcome, however, is that financial advisement largely focuses on investment opportunities outside the business. Other common sources of owner advice, such as bankers, CPAs, and business consultants, are too often siloed in their service offerings and face a number of restrictions to collaborating effectively with other professionals for the benefit of both the owner and business.

This paper explores two key issues business owners face that are misaligned with the traditional investment-advisory relationship, as well as five ways to overcome them.

PROBLEM #1

The Investment Paradox of the Entrepreneur

Richard Branson is famous for saying, “Never take your eyes off cash flow, because it is the lifeblood of business.” Branson’s nod to this critical metric emphasizes why **cash flow is widely regarded as the most important financial metric for businesses to track**. In the absence of stable and consistent cash flow, cash reserves can easily and quickly be consumed, requiring the need to borrow funds, sell equity capital, or worse yet, close the business entirely. In other words, cash-flow interruptions (planned or unplanned) require access to cash, a problem that is solved differently for companies of different sizes.

For small, non-public companies, specifically, those without access to the broader capital markets, solving cash-flow problems has a different set of complexities from their larger, public counterparts. **The biggest challenge that small businesses face is that they often share a balance sheet and income statement with the owner or owner group.** This makes the personal financial challenges of the owner more likely to become the financial concerns of the business—and vice versa. This relationship is even more pronounced in micro-companies, businesses with fewer than 10 employees and limited access to venture or even bank capital.

A full **33% of small- and micro-business owners say that cash flow and lack of access to capital are among the top challenges they face.** However, the problem with building a cash reserve is that it has a cost: growth! This inverse relationship requires businesses to address a critical and persistent question:

“How do we balance cash reserves with required long-term ROI?”

We call this dilemma “the investment paradox of the entrepreneur,” and it’s something that all business owners face, yet few ever develop a consistent long-term solution for addressing.

Gregg Crabtree, CPA and author of *Simple Numbers, Big Profits*, offers a framework to address part of this problem.

He suggests that you identify a core capital target, typically equal to two months of operating expenses, that you always have access to and that you further resist taking profits out of the business until you hit this target. Other seasoned business consultants and experts suggest a three-month cash reserve with varying profit distribution policies. **Given that each business has unique capital requirements, and most require profit to pay the owners, we typically recommend customizing cash-reserve models and distribution policies that serve your specific needs.**

While appropriate cash balance management increases the likelihood that you will have enough capital to weather the inevitable cash-flow speed bumps that come with growing a business, it does not solve the problem that low-yielding cash has on long-term financial outcomes. Throughout the **1980s and 1990s, money market interest rates paid between 5.5% and 12.5%**, making cash an attractive alternative to risk assets such as stocks. However, due to the persistently low interest rate environment of the last decade, and the possibility that interest rates will remain exceptionally low for the next decade or longer, business owners seeking to shorten their journey to financial independence may need to radically adjust their cash location strategy.

To determine WHERE to keep your cash, you must first answer these four essential questions:

- What is the minimum amount of cash reserve to keep on hand?
- What is the maximum amount of cash reserve the business should hold?
- What is the optimal location for cash (in the business or out)?
- How can we maximize both return and liquidity (investment type)?

PROBLEM #1 CONT.

Solving the investment paradox of the entrepreneur means overcoming the challenge of consistently identifying and executing on the opportunities both in and out of the business that maximize long-term asset growth and minimize opportunity cost.

Opportunity cost is like a stealth tax and is often a byproduct of a lack of clarity. Entrepreneurs and advisors know this tax exists but identifying it with consistency can be a real challenge. What's more, in the absence of properly clarifying capital's best and highest use, **owners commonly either starve their companies of needed cash by over-allocating to low-velocity personal investments, or they unnecessarily delay their path to financial independence by holding excess cash at a suboptimal growth rate over many years. The result: persistently unproductive cash can strip hundreds of thousands—or even millions—of dollars off an owner's lifetime balance sheet.**



Minimizing the opportunity-cost trap requires a clear understanding of the levers that will most affect financial outcomes for the owner(s). Things such as willingness to take risks, the need to take risks, time horizon of funds to meet goals, desired length of time to operate the business, and post-business plans, as well as many other factors, come into play. **A clear understanding of all these elements can often mean the difference between reaching financial independence early, late, or possibly never.**

PROBLEM #2

Finding the Right “Expert” Guidance

Since every entrepreneur has grappled with cash issues, this problem is easy to relate to. Solving the problem is a bit more complex, though, as **solutions are often clouded by the behavioral biases of business owners and further cluttered by the conflicts inherent in service providers’ business models. Further complicating the matter is human nature, which lends itself to overconfidence, and often causes people to anchor their decisions to simplified solutions to problems of an uncertain outcome.** For business owners, the problem with this approach is compounded due to:

- The exponential number of issues they often deal with at any given time
- Varying degrees of uncertainty tied to each decision
- The collective difficulty of prioritizing and applying proper decision filtering to each choice
- The high correlation business choices have to their personal financial outcomes and the difficulty of determining when to favor the business vs. personal need

This can lead to an over-simplified financial problem-solving approach, which creates unintended suboptimal outcomes. It also causes owners to seek overly simple, pre-packaged solutions that are often designed to be delivered at volume by providers. The simplicity of a cookie-cutter solution can lead to an “advice see-saw” effect where one issue is solved while another one is created. Financial advisors are often uniquely positioned to identify and solve this problem.

Quite often however, owners instinctively see a disconnect between the value proposition of the traditional investment advisor and their business goals. **Where most financial advisors see their job as the exclusive delivery of ROI, entrepreneurs instinctively seek out both return on investment and “relationship ROI,” defined as the collective value of the services delivered by the advisor and their impact on the owner’s business outcomes, personal financial outcomes, and general life use of money.** What’s more, business owners don’t just want to pay a dollar to get a dollar—or even a dollar and ten cents. They want leverage of 3x, 5x, 10x...the more the better! **Unfortunately, the investment management industry has had a difficult time meeting investors’ expectations through portfolio construction alone.**

Better meeting these expectations in the future means doing two things: Opening up the architecture of investment options available to investors and harnessing **a planning-focused, business-inclusive, no-conflict advisory solution designed to deliver Clarity For Owners while helping to check the biases that may detract from the expected outcomes of the advice.** We call this a “best-fit advisory solution.”

In a best-fit advisory solution, business owners and planners would spend time:

- Prioritizing the personal financial needs and goals of the owner that compete for business resources
- Identifying expected returns of competing personal investment opportunities (where fees to the advisor are not tied to the investment recommendations)
- Visualizing the long-term impact of compound returns on personally invested capital
- Calculating return on capital employed, return on equity and return on assets of the business
- Understanding other meaningful business efficiency metrics essential to successful owner outcomes

PROBLEM #2 CONT.

So what is a best-fit advisory solution?

A combination of owner bias and service conflicts can lead to a rushed approach to understanding the biggest problem owners think they face. A best-fit advisory solution creates the time and space necessary to properly visualize the long-term impact of highly interconnected choices that affect both the owner and the business. Albert Einstein is famous for saying, "If I had an hour to solve a problem, I would spend 55 minutes thinking about the problem and 5 minutes thinking about solutions."

Too often, siloed providers encourage a rush to the solution step. Again, if problems are truly simple, this may be advisable. For complex financial, business, and tax questions, however, we advocate for something different.

While this paper focuses on the importance and impact that financial advisor(s) and financial planning companies can have on the best and highest-use decision-making process of business owners, it's prudent to highlight common conflicts that can exist in the owner's relationship with bankers, CPAs, and business consultants. While each professional brings necessary expertise to the owner/business, siloed services come with their own drawbacks when trying to make clear investment and capital allocation decisions.

In our experience, two forces most affect the ultimate capital investment and allocation choice of the owner: the amount of time taken to understand the owner's unique challenges and the availability of competent, trusted providers who are well aligned with helping overcome them.

If you are in the market for time-saving clarity and unconflicted advice, understanding the key performance indicators (KPIs) of the professionals you are interviewing can help you understand if their advice may be at odds with your best and highest use of capital mandate. Common examples of this are:

Tax Preparer KPIs

- KPI: Minimize tax cost – encourages tax advice that may drive funds toward low ROI, ROA, and ROE investments
- *Examples*
Tax preparer may suggest purchasing excess inventory to take a section 179 tax deduction instead of hiring an employee with a greater ROI.
- *Costs and Considerations*
Excess inventory lowers return on assets and takes funds away from steps that have a greater ROI, such as hiring a key employee or marketing to generate more sales.

Banking KPIs

- KPI: Maximize interest on cash
- *Examples*
Bank may offer higher interest accounts in exchange for progressively large minimum deposit amounts.
- *Costs and Considerations*
Leads businesses to hold too much cash for too little long-term return.

Business Consultant KPIs

- KPI: Improve business outcomes
- *Examples*
Consultant may advise taking any number of steps in the process of building the company, such as investing in technology, people, accounting systems, operational process, etc. Funding may require debt or a cash infusion from outside the business or simply an allocation of cash from cash flow.
- *Costs and Considerations*
If an owner is not comfortable divulging too much of their personal finances to a consultant, they can find themselves unable to act on worthwhile advice or in receipt of advice that does not fit their personal risk threshold.

Investment Professionals KPIs

- KPI: Fees billed on assets under management (AUM)
- *Examples*
Advisors are incentivized to build their portfolio of assets they manage for clients and identify active managers whose story and past performance help raise assets.
- *Costs and Considerations*
Causes advisors and clients to focus on the expected return of the investments managed with little mutual analysis of the benefits of reinvesting back in the business.

PROBLEM #2 CONT.

Our point is not that all providers are out to get their clients. Rather, if you believe that incentives drive outcomes, then paying close attention to the motives of the provider can help you filter advice you receive and stimulate great questions to ask of the provider. For instance, understanding how service providers are compensated, how they set up their firm to support the owners and businesses they serve, and what their process of multi-professional planning looks like are just a few of the questions we encourage owners to ask.

The Unintended Conflict of the AUM Pricing Model

As we bring the focus back to the role of the financial advisor, the potentially negative impact of poorly understood opportunity costs often falls squarely on their shoulders. Since most advisors are paid on the assets they manage, their focus tends to be on investment opportunities they are compensated on—often at the expense of understanding the true potential and impact of business growth. **Whether the advisor charges an asset management fee of 1 - 2% or a commission of 3 - 8% on investment purchases, too often, the investment advisor's answer to the investment paradox of the entrepreneur is: "Give me the cash."** This can create a natural tug of war between the owner and his financial advisor over where cash should go. On one hand, the investment professional is right to ask for funds to diversify away from the company given the abysmal savings statistics and low enterprise values at the sale of the typical micro and small business. **On the other hand, capital that is reinvested in a well-managed and well-advised business, can generate significantly higher returns than stocks, bonds, and real estate.** Case in point, a **reasonable return on equity is 15 - 25% for a small business**, whereas a diversified portfolio of stocks, bonds, and real estate may only yield 6 - 9% per year with less control than dollars invested back in the company! In this context it makes sense for business owners to better understand this tradeoff before making capital allocation decisions.

Benjamin Franklin once said,

"An investment in knowledge pays the best interest."

What does that mean to the business owner? Thinking about it similarly to the equity curve of a stock, over time, **owners who invest in themselves may see an exponential increase in the value they bring to their business.**

This return can be far greater than even the compounded returns investment professionals seek out for the invested capital of the owner. To the extent that owners improve their business acumen, they often see a corresponding increase in their income, cash position, investments, and business/personal net worth. For this reason, we caution hyper-focusing on external business investments at the expense of creating time and space for well-rounded conversations about the benefits of investing in yourself and your business.

We think that **the old way of pricing and delivering financial services to business owners deserves a creative new approach.**

We further see technology lowering the cost of investment services while enabling more effective and beneficial integrated planning solutions for the owners who need them.

5 CRITICAL STEPS TO SOLVE THE PROBLEM

If your advisor's pricing solution was adopted with a "because we've always done it this way" attitude, we advocate for reconsidering solutions to the above-mentioned problems as follows:

1. Eliminate the Conflict

Begin your search for a trusted advisor by looking for an advocate fiduciary. There is a movement happening in the financial services industry toward fixed fees. This solution removes commissions, transactional business, and the traditional ways of charging based on AUM. This simple but pivotal difference promotes a different kind of conversation about capital's best and highest use. While seasoned professionals in varying fields often fill the trusted advisor role, financial advisors working under a compensation arrangement that minimizes conflicts of interest, while aligning the outcomes of the clients they serve, offer an attractive solution to business owners of small companies. To that end, firms operating under a fiduciary umbrella who offer team-based tax advisory and business services in concert with investment and planning implementation are well-positioned to maximize relationship ROI and fulfill the role of a best-fit advisor.

2. Hire a Best Fit Advisory Team:

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. Since it can take years to build a team of trusted professionals who understand how best to support your needs and have the expertise to guide you as your financial complexity increases, consider using your advisory team to facilitate this process for you. In short, use their bench. Too often, clients find their attorney, CPA, insurance professionals, and bankers operating in a silo rather than collaboratively. Your outcomes are driven and optimized 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 appropriate 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.

3. Find Clarity by Focusing on Planning:

Dwight D. Eisenhower was known for saying, "In preparing for battle, I have always found that plans are useless, but planning is indispensable." **Thus, we recommend that business owners never underestimate the value of making time to think about the challenges they face and the strategies necessary to overcome them. Your team needs to play a significant role here.**

Your focus and the focus of your advisor should be on outcomes in the context of a foundational plan. This involves organizing and analyzing your entire financial life into one big picture. Planning activities should incorporate a comprehensive level of service to include financial planning, behavioral conversations, low-cost portfolio construction, and tax planning, as well as business and personal investment ROI analysis and other comparisons designed to help business owners make confident decisions between the two.

In this refined approach, emphasis is placed on a set of value-driven support activities that the owner and advisor establish and execute through fluid interaction.

5 CRITICAL STEPS TO SOLVE THE PROBLEM CONT.

Some of the benefits of a more comprehensive approach include:

Financial Planning: Consider the timeless saying, “An ounce of prevention is worth a pound of cure” first coined by Benjamin Franklin. Financial planning is the process of determining if and how an individual can meet life goals through the proper management of financial resources. Planning is like a SWOT analysis that delivers clarity and assigns priority to the list of action steps that will further your financial life.

Behavioral Conversations: When you and your advisors share an understanding of behavioral finance concepts, you better position yourself to identify the illogical and irrational decisions all humans are prone to make. It takes an open mind and willingness to self-assess, but if done with conviction and regularity, the process of behavioral assessment can deliver life-changing results.

Optimize Portfolio Construction: While many financial advisors hang their hat on stock picking to “beat the market”, *statistics have shown this is one of the lowest value-adds in terms of ROI.* Today, smart investors understand the most important investment decisions are not about which stock to buy or whether to go active or passive. They recognize it is critical to focus on how to construct a portfolio to meet an objective, how to identify the right blend of strategies to meet that objective, and total portfolio cost.

Tax Planning: While almost self-explanatory, tax planning needs to evolve beyond loss-harvesting and deferred gains. Your advisors should understand the complexity of your comprehensive situation to plan around all moving components, not just your investment accounts. **Opportunity exists in tax planning between your business and personal finances and should be a core focus. Ignoring any single financial component of your life could nullify a narrow strategy.**

ROI Analysis: Investors have long acted on the idea that “there is always a bull market somewhere.” The idea is that, even in times of distress, there is the opportunity to make money if you look hard enough. **Sometimes, business owners and their investment advisors get so caught up in the search for the best personal investments that they fail to see the bigger opportunity right in front of them: the owner’s business. To solve this, ROI analysis needs to evolve beyond your investment accounts and expand to encompass all your assets, including your business.**

4. Delegate to Create Time and Understand Your Money Mindset:

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 this 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 businesses. While entrepreneurs are not unfamiliar with the concept of business delegation as a means of accelerating their business outcomes, they don’t 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 leverage 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; expertise has a way of propelling you into the future. In a no-conflict advisory relationship, your advisors focus on filling your knowledge gaps, allowing you to identify and solve issues more quickly. Your financial plan provides your team with the vision of achievement you are seeking, and that shared vision provides additional leverage that speeds up the time it takes to level up your business and personal financial outcomes. Collectively, these steps create more time.

Your money mindset is influenced by many factors including the psychology of money itself. The importance of understanding your money mindset can’t 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,* confirming that **mindset matters as much, if not more, than the strategies and tactics used to achieve the success they seek.**

In the process of 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 maintain a mindset of abundance necessary to achieve your financial goals.** In the absence of a health connection to your money, a scarcity mentality can set in and if unchecked, eventually the line between more and enough never seems to cross.

5 CRITICAL STEPS TO SOLVE THE PROBLEM CONT.

5. Leverage Your Team to Solve YOUR own Investment Paradox:

Identifying 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 identify the best investments to use to hold cash. For instance, cash alternative investments capable of delivering greater yield than bank cash holdings 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 must be considered.

Not unlike 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 to theoretically maximize the efficiency of that task or project. The idea being that spreading your focus across too many activities at once is more likely to lead to discord and under-performance. If you are having trouble identifying your highest and best use of capital, perhaps 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

If you are one of the many underserved, small- or micro-business owners seeking to reach financial independence faster and with less friction than your current trajectory, consider sourcing a different kind of financial advisory team.

Once you've assembled a best-fit advisory team, leverage their bench, build your plan, and show up every day with a strong time and money mindset, thus empowering your team to return here so better empower YOU visually stays together.

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 provides a useful jumping-off point, and invite you to visit with us to learn more.

Email cfo@prismfc.com or call 480-661-1236 to schedule an introduction.

