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Focus

Mirror, Mirror on the Wall: Helping Small-Business Owners See the Big Investment Picture

by Nancy Opiela

Invest in what you know. Small-business owners often push this nugget of investment advice from Fidelity Investment's Peter Lynch to the extreme, plowing money into their business to the exclusion of all else. In fact, Deborah Lucas, an expert in the investing habits of small-business owners, and a professor of finance at Kellogg School of Management at Northwestern University in Evanston, Illinois, estimates that most entrepreneurs have more than half of their wealth tied up in their own companies. This creates a lack of diversification that they often fail to recognize as a problem.

As entrepreneurs themselves, planners understand the small-business owner's motivation to over-invest in themselves. Elisabeth C. Plax, CFP, of Plax & Associates Financial Services in Pepper Pike, Ohio, often counsels small-business owners on the merits of greater diversification. Says Plax, "There's nothing you know better than your own business. What's more, the business is essentially your money printing press. The better your business, the more income you make. However, having your business represent a huge portion of your total assets is a bad risk. Not only do you have everything you own in one asset class, it's invested in one company within that asset class."

Adds Percy Ermon Bolton, CFP, of Percy E. Bolton Associates Inc. in Pasadena, California: "My clients want to invest in their own business because they understand how their own business operates and don't necessarily understand how other businesses operate. However, when you pour money into your business, you are subject to the whims of your profession. If your industry hits a downturn and you have all your eggs in that one basket, then you suffer."

Gene Baynes, CFP, of Gilbert, Arizona, presents a differing opinion, arguing that, for some clients, investing in their own business might be the best option. Says Baynes, "If you invest in your own business, you're not sending your money off to someone with a $6 million compensation package who doesn't care about your money. There's a conflict of interest there if I'm telling clients to take money they'd like to plow back into their business and buy a few mutual funds. My business isn't to tell clients how to run their life. My job is to tell them how to do the job they want to do in the best way possible."

Because they are dealing with entrepreneurs in pursuit of their dreams, planners say that how much business owners ultimately decide to invest in their business is not entirely a financial decision. And that's often just what makes the job of presenting investment risks and alternatives so challenging.

Explaining the Risks

Planners say the decision of how much to invest in one's company must be based on an evaluation of the investment risk, as well as liability and liquidity issues.

Richard Stumpf, CFP, of Financial Benefits Inc. in Wichita, Kansas, works with business owners ranging from doctors to manufacturers. He notes that most of these clients initially make the mistake of over-investing in their own business, although the "professional services folks make the mistake to a lesser degree because they don't have a capital-intensive practice."

The first issue Stumpf addresses with small-business owners with all their eggs in the company basket is the question of liability. He explains, "If something goes wrong, if your secretary goes out to drop off mail and ends up in a car wreck or if one of your products malfunctions and hurts someone, if you have everything invested in your company, a single liability issue can wipe you out."

Accordingly, Stumpf advocates that business owners incorporate and put their assets in different pots to protect themselves. He explains, "I have a construction company as a client and we are in the process of setting up a family limited partnership to start building some assets outside of the construction company itself. This works for them but wouldn't be appropriate for other companies that don't have as large a capital position. For all business owners, however, it's important to protect themselves by building net worth in different pots."

Bolton notes that his clients' desire to protect their assets is what motivates many of them to diversify and direct assets away from their business. "A driving force in getting my clients to move on the issue of diversification is that they are trying to protect what they have because it was so difficult to obtain. Talking about liability gets clients to do a lot of things they might not ordinarily do," he says.

Plax points out that a lack of liquidity is another risk faced by business owners who are heavily invested in their own business. "If everything you own is tied up in the business, where do you go for money when you need it?" she asks. "You can take more money out of the business as income, but business owners with savings and brokerage accounts have the option of liquidating some of those investments and paying capital gains, which is limited in terms of taxes. If your only option is to take more and more income out of your business, you could push your income tax rate up to 39 percent and that becomes expensive financing for your business."

On the subject of liquidity, Suzzette B. Rutherford CFP, of Clarfeld Financial Advisors Inc. in Naples, Florida, notes that the degree to which she's comfortable with small-business owners investing in their business depends on the stage of the business's life cycle. Says Rutherford, "There is a stage where business owners may need all the money they have available to get the business off the ground and running. Later, as the business matures and becomes profitable, it's important to save in accounts outside the business."

An alternative Rutherford suggests in the start-up or growth stage is loans. "Why risk everything when you can get help someplace else?" she asks. "Rather than putting all their money back into the business, it can make sense for business owners to take a loan and subsidize the investment over a 30-year term."

Plax also notes the risk that a sudden illness or death of the owner could cause the value of the business to plummet. “In a lot of situations, if you remove the business founder from the business, it’s not worth as much. In a manufacturing business, you may still have the value, but in a service business, the value decreases because people work with the person, not with the business,” she explains.

When determining a business owner’s risk tolerance, planners stress that although entrepreneurs take risks by definition, that doesn’t necessarily mean that they should take risks with their investment portfolio. Business owners, they say, tend to fall into two camps. They either feel they are taking all the risk with their business and want to be conservative with their investments, or their tolerance for risk extends well beyond their business and they want to invest aggressively.

Stumpf, however, notes the following irony: “Many business owners have faith in what they are doing and think the potential return on their business will probably exceed what I am going to get them with a diversified portfolio. However, when I see their retirement funds all invested in bonds and suggest another asset class, such as small-cap growth, they’ll say that’s too risky.”

Diversifying the Portfolio

Determining the appropriate investment mix for a business owner requires thinking about the business and the rest of the portfolio in a consolidated fashion. Bolton begins by analyzing the business to identify cycles. He explains, “If you are trying to pay yourself an ongoing salary and you have unpredictable income, you have a problem. In technology and other volatile industries, you have to measure cash flow and put money away for times when your business is down.”

Another crucial step in the diversification process is to help clients control their emotions and look at their business as if they didn’t own the company. It’s the same “diversifying sources of income and net worth pitch” planners make to clients who invest all their 401(k) money in their company’s stock.

There are, however, additional factors entrepreneurs should consider when allocating their assets. For example, Lucas says it’s important to consider access to the capital markets. “Business owners can afford to take more risks with other investments if their business can easily get bank loans,” she notes.

To the extent the business owner agrees to hold other investments, planners try to find offsetting risks, investments that will tend to move up when the business owner’s company moves down. That means helping clients avoid the common mistake of investing in other companies in their industry.

Explains Gayle H. Buff, CFP, of Buff Capital Management in Newton, Massachusetts: “Some clients will say, ‘This is what I do for a living, I know the industry well, so it makes sense for me to pick out a few companies I understand and invest in them.’ I don’t disagree with that thinking, but my counterintuitive approach is, ‘This is the industry where you are earning your living, so my goal probably would be to diversify you away from that industry when it comes to investment dollars.’ Ideally, we’d invest in another industry that historically does well when the client’s industry suffers. I explain this to clients by suggesting they invest in companies that sell umbrellas and companies that sell sunscreen so that performance doesn't correlate. It's interesting, but people don't tend to process information this way. Rather, they reason, 'I'm an engineer so I have an advantage when it comes to investing in engineering companies.'"

Adds Plax, "The role of the good financial planner is to teach clients that if they invest in ten different software companies, they really have not diversified. Business owners may feel they are better off picking a few individual software stocks rather than mutual funds, but they need to understand if their company's in software, we need to move away from other software companies and think about all the different ways you can invest."

When it comes to these alternatives, Baynes suggests real estate, equipment leasing, and natural gas. He says, "There are so many things you can do with your money. The majority of the world's wealthy people did not make their money through the stock market, nor do they have their money in the stock market. So why is 'mutual funds' the first thing out of our mouths?"

Stumpf points out that many business owners like to invest in the building they work in. In fact, he bought the building he practices in, setting the office building up in a separate corporation. He explains, "If one of my employees is in a car accident or someone slips on the sidewalk, I have that liability wall built between my business and the building."

Option of Choice, Retirement Plans

Ian D. Quan-Soon, CFP, of IQ Financial Services Inc. in New York, New York, notes that retirement accounts are the most attractive option for dollars directed away from the business. He says, "I started working with a manufacturing company 15 years ago when they were a small, five-person operation. Now they've grown to 150 employees. They have expanded operations and bought new buildings, but as they plow money back into the business, they also save frantically outside the business. They wanted to retire early—so while they were building the business, retirement was always on the horizon."

Adds Bolton, "The clients with a stable business do save for retirement, but when a business is in the start-up phase, just putting away reserves for quarterly taxes is a battle. My clients look at that cash as something they would like to use. I see more retirement plans in the more old-line professions, accounting or engineering firms; but with provision of the new tax laws, it's getting easier to convince business owners to begin to save for retirement."

Notes Plax, "There are now ways to really superfund these retirement plans, and when you invest in a retirement plan, you have deductible dollars that are being moved away from the business. A retirement plan fits well because you are investing pre-tax dollars, the business gets the deduction for whatever it contributes and the employee gets a tax deduction on what he or she contributes to the plan."

The 2002 Small Employer Retirement Survey, sponsored by the Employee Benefit Research Institute (EBRI), the American Savings Education Council (ASEC) and Matthew Greenwald & Associates, found that most small-business owners are not familiar with the provision of the Economic Growth and Tax Relief and Reconciliation Act (EGTRRA) that made employment-based retirement plans more attractive. Sixty-eight percent of those with a retirement plan and 86 percent without a plan say they are not familiar with the law. More specifically, 87 percent of small employers without a plan were unaware that the new tax law allows them to take a tax credit of up to 50 percent for the start-up costs of establishing and administering a new retirement plan.

Add Value by Improving the Business

Especially in situations where a client's business is a significant percentage of his or her net worth, it makes sense for planners to work to find ways to protect and strengthen the company. In that regard, Stumpf notes that he is starting to find more small-business owners who are willing to pay for outside help. He explains, "One client recently signed one of the larger accounting firms in town to come in and do some management consulting. They'll look at his entire operation and evaluate how he might change. Maybe there's a need for a more formalized chain of command or new policies and procedures. If someone would have approached him with this idea two years ago, he would have said, 'We're doing just fine, thank you.' Now he thinks it's worth spending the money."

In fact, Stumpf is looking to bring in a consultant to suggest more efficient, cost-effective ways for him to do business. 'We all benefit from a trained, outside eye," he says.

Stumpf also advocates forming a board of directors to improve a company. He explains, "We always see a board of directors with the larger companies. Of course, many small-business owners don't want to be accountable to anyone, but I'm seeing a growing number of small-business owners saying, 'I'm tired of wearing all the hats. I can't be the manufacturing expert and the financial expert. I can't be everything all at once.' Having a group of other business owners on an advisory board can alleviate that stress. Maybe you meet once a quarter or every other month to talk over issues. Getting a group of professionals whom you respect with different expertise together in the same room is money well spent and advice, hopefully, well received."

The board of directors can also foster more comfort with delegating tasks, which can be helpful on both the business and investment fronts. Says Bolton, "Business owners like to control everything. That's the reason they went into business to begin with. My clients have a real sense of confidence that they know best. The thought of investing elsewhere means losing control of their assets and accepting that they can't direct their investments with their willpower and abilities. Many of these clients are very hands-on. It's when they grow older and wiser that they learn about the benefits of delegating."

Today's Unique Struggle

Deborah Lucas at Northwestern notes that, in theory, the down market should make it easier for planners to convince clients to invest outside their business. Yet, although stocks are no longer overvalued, planners say the market decline is actually making diversification a tougher sell for those who are most inclined to re-invest business proceeds back into the business. For these entrepreneurs, the fourth year of negative returns has fueled their belief that they can out-earn the market.

For those clients who have diversified, Quan-Soon sees not panic, but a quiet acknowledgment that the days of double-digit stock market returns are behind them. "We've just been through a stock market crash equal to what we saw in 1929. Into year four, the market has declined further and [at this writing] we are in the middle of a war, but I don't see a panicked response. Nobody is saying the world is coming to an end. Clients are not turned off by the stock market—they just think things are going to move a little slower and they should try to enjoy some of what they have worked so hard for," he says. "People I meet when I travel outside the United States assume that the economic downturn has changed the average American's life dramatically. Yet, within U.S. borders, people are going about their business, going to work and out to restaurants. We're going through some major events in the history of the world, but nobody is panicking. My clients are finding time to enjoy life."

Although very few of Quan-Soon's clients have pulled out of the market, he notes some are more interested in alternative investments. Stumpf, too, says clients are more willing to look at alternative investments such as real estate, leasing deals and managed futures. And while it's crucial to present alternatives in this uncertain investment climate, planners say it's more important than ever to underscore the risks.

Says Buff, "We're helping and supporting people with their dreams, but I think that one can do that by taking reasonable risks. It's important to structure the business so the risks aren't untenable. Anything can fail. There could be something you just didn't think about and there is so much uncertainty in the world. There are lots of ways to have your own business without risking your financial future."

Agrees Bolton, "Our individual dreams are what make us who we are. As planners, our job is to make our clients' dreams our dreams. But we must educate our clients on the ramifications and consequences of their decisions."

In Rutherford's view, business owners take the first big step in acknowledging they need to make some changes in their investment portfolio when they contact a financial planner. "For business owners who arrive invested solely in their own company, we need to show them what could happen if they don't diversify," she says. "It's important not to ignore the consequences of doing nothing."

Rutherford concludes that highlighting this risk is an easier lesson to teach in the wake of the market of the last several years. "In the end," she says, "there are two kinds of clients: those learning to trust you and the others who already trust you. The moment you've earned a business owner's trust, the diversification argument is an easy sell."

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