Sound Financial Bites 031 - You’re in danger and it’s your fault

Episode Transcription

> *“You retire on your personal balance sheet, not your business balance sheet.”*

Hello! Paul Adams here. Welcome to Sound Financial Bites, where we help you with bite-size pieces of financial and life knowledge, to help you design and build a good life.

Hello, and welcome to Sound Financial Bites. This is Paul Adams, president and CEO of Sound Financial Group. I'm so glad you could join us, listening to podcast today. Today, we've got a unique topic, and the topic is "Entrepreneurs: You're in danger and it's your fault." You're in danger and it's your fault. I'm going to lay out a set of principles, that many entrepreneurs and business owners aren't readily aware of, and we're not readily aware of them because the amount of time we take to focus in very tightly on growing a business, on getting successful, on hiring the next employee, on scaling up on handling the cash book crunches that occur, and all too often, the whole reason why we'd be doing anything, gets ignored. We're going to come back to that in a moment.

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And you can connect with us on LinkedIn, on Facebook, send us an email to info@sfgwa.com. Anybody who's investing themselves, I'm happy to invest right back in you. So, if you want to spend some time together with me on the phone, just give us a call. We'll set up a 30-minute meeting. We may or may not be a fit to be able to work together, but you know -- it'll be great to chat with you and look forward to the conversation.

Now let's get back to this somewhat big claim that I made about Entrepreneurs, you're in danger, and it's your fault. We're going to hit some major topics as we work through this. One is that the default position an entrepreneur is putting themselves in is a situation that if they're not successful, they're in danger. Everybody knows that. The one most entrepreneurs are not familiar with, is that if you're really successful, you're in danger again. That's the one that kind of sits in the blind spot of everybody, so we're going to come back to that.

There's another very specific and important financial philosophy everybody needs to be aware of, and that is you retire on your personal balance sheet, not your business balance sheet. I would say that in another way: if you're high income earning executive, working for another company, you do not retire on that company's balance sheet. Now, years ago that was the case. Back in the '70s, it seemed like everybody had a defined benefit plan, a pension that was going to come in. If you are a high-income earning executive, somebody making north of $300,000 a year, the odds of you having an actual guarantee pension are not high, so you do not retire on that company's balance sheet.

So, if you don't retire on the company's balance sheet which one do you retire on? You've got to retire on your personal balance sheet and then last, but certainly not least, is the idea that the human capital, in the marketplace at work, earns significantly more money than just your capital at work. So, you at work in the marketplace make more money than your money sitting on the sideline and you don't know how long that money has to last, which we're going to hit on, which is just this idea that you're going to live longer than you think.

So, let's go back to our first one. When I say that entrepreneurs are putting themselves in danger, we know that. Any business owner that's ever opened up the doors to a business, whether you're a physician that opened up a surgical center, you're a dentist that bought an existing office or built a new one, you're a manufacturer who bought and has grown plants and dealt with debt, we all are familiar with the danger we're putting ourselves in to do that. But, let me explain what's really cause this conversation to pick up and this conversation has been picked up by Entrepreneur, Forbes, Inc., and a series of interviews that I've done with those organizations.

But, why it's caught on is that nobody's thinking about the fact that it doesn't matter how successful our business is. Two things have to occur: one is someday the value of that business has to actually land on our personal balance sheet, as something other than stock in that company. It has to become cash, it has to become real estate, it has to become some kind of investment, or we have no ability to be able to retire. So, it has to make that transition, number 1. Number 2, it will likely, never make a big enough transition to be able to retire on.

Let me explain that. What I mean by that is that you look at your finances of your company. Let's say you have a very successful company right now, things are going well for you. You're able to take home, after everything, half a million dollars a year. Well, whoever buys that company is going to buy that revenue, that income stream and that profitability. So, how much, if you were buying a company right now, that was perhaps going to be a strategic acquisition for you, how much are you willing to pay for an asset, whether strategic or a financial acquisition, how much are you really willing to pay for an asset, this other business that's going to make you half a million dollars a year? I want you to think about that. It's going to make you half a million dollars a year, how many years do you want that to be able to give you enough money?

"If there's nobody there to write a check, then that business that we think is worth x amount is not worth that money."

Well, odds are, most people are going to buy that if it's a fairly large company in terms of sales and scale, you might be able to get 4-6 times EBITDA. But, if you're a smaller company, you may only get two and a half times seller's discretionary earnings. So, if that's going to be the case, let's just take the mid road and call it 5, 5 times what you're making. So, your $500,000 now translates as a sale, not an after tax amount, but a sale of 2 and a half million. So, that sale of 2 and a half million falls on your balance sheet, and then you're lucky enough to end up with $2,000,000 after tax, depending on long term capital gains, depreciation recap or etcetera, we now have an amount of money, which is going to take me right into the next component, which is you've retired on that personal balance sheet. That's the transition that you went through. You retired on your personal -- your business balance sheet is what you've been living off of, during your career, while you're building your business. That business made you, in my example, half a million dollars a year and all of that translated to a $2,000,000 sale.

Now, let me step out of this for just a moment. It's no guarantee that the company will sell for that amount of money. There is zero guarantee. There's a lot of people that I knew who, either because the market overall had constriction, lending has tightened up, or because their specific market was just not in vogue with people wanting to buy that type of business, and when they had to get out, there was nobody there to help them get out. There was nobody there to write them a check. If there's no one there to write you a check, then that business that we think is worth whatever amount is not worth that amount of money, and you would be surprised how often businesses simply get wound down, or given away because there wasn't an actual strategic plan to be able to get the best amount for that sale.

Now, in a later podcast, we'll talk about the best way to get that sale. We're going to have experts in, talking about that. We recently had Paul Menneg on one of our past podcasts talking about how to optimize business cash flows and the kinds of things you should be thinking about when wanting to sell your business. This is not that conversation. So, for now, we're just going to assume it all went splendidly and $2,000,000 went from the business balance sheet to the personal balance sheet. Now, there you sit.

Well, when you take distributions, your human capital, while at work, running that business, who's worth half a million dollars a year, and now we need capital at work. That's investments, that's assets, that could be anything that you invest in, but that money, now, has to be drawn off of every year. How much can you take? Well, you can take 4%. That's what the academics, that's what the economist are saying. Some of them are saying less, but let's just, for now, stick with 4%. If we're going to take 4% a year off of the $2,000,000 that were left with after tax, we have $80,000 a year of income.

So, picture yourself, if you can, going from half a million dollars' worth of income down to $80,000. That's pretty tough. What almost any business broker will tell you is that what most often caused them in being able to successfully transition or sell a company to a new buyer is that sometime near the sale, that former business owner, the one that is the seller of the business finally sits down with somebody and does the Math of how they're going to retire on the amount of money they're going to have after the sale, and they pull and say "I just can sell the company or I have to sell it for a lot more."

But, what we know about free markets is that it doesn't matter what we think a stock is worth. Right? More to come on that and what it means to build a portfolio, and what it means to have pastured structured investing in a future podcast. But, we know that we can't simply say, no more than can we say, "We think Microsoft should sell for double what it's selling for right now." We can't say for our business that it just should get twice what it's going to gain in the market. It's only going to sell what the market value is at, which is what somebody's willing to write a check for.

That is key. It's only going to sell for what somebody's going to buy it for, which means that leaves people's financial future in an entrepreneur's future, up to a tremendous amount of uncertainty, that is 100% centered on one single stock. That's the shares of their company. It will be no different than someone who say works for a very, very large publicly traded company, and they have little to no other assets or savings anywhere else in their life, and what they have is a truck-load in that company stock.

"Many publicly traded companies were making huge promises that everything would work out, but it didn't work out."

Now, I will never forget because I know this is a sensitive subject. That's why I like talking about it on the podcast instead of kind of interfacing with somebody directly because I think this is less confronting, so let me share with you a story of a family. A family that was meeting with a friend of mine - this is well over a decade ago - working for a successful, one of the top telecom companies in the world, and what they did is, he sat down with them. They were in their 30s, they were making good money and they had kind of ridden this large telecom company up in value, they had been working there for a while, the husband at least.

As they sat down, he had a conversation with them, in their 30s and - and I think this goes back about 14 years altogether - they had a really, really nice chunk of money. So, 14 years ago, a million four in that company stock. And while they had a million four in that company's stock, he suggested that what they do is they ought to take and build a structured portfolio. Now, what they need to do is no longer be all in on this one stock but rather have, instead of diverse 5 holdings, globally diverse 5 and academically allocated, giving them the highest likelihood of success over long periods of time and no longer be betting on the single company. And, it was so confronting, that literally, one of the spouses said, "I think you're trying to rip us off. This company's been good to us. They're never going to fail. We're riding this all the way to retirement. We're going to be worth tens of millions of dollars and you just want to make money," and literally sort of shamed this friend of mine that was trying to help them.

Well, about 9 months later, after this company absolutely imploded in the public market place, and if I said the name of the company, you'd absolutely know it and it just totally imploded. When it did, he had another meeting with them because he managed some of their money, they're willing to -- they were not willing to diversify away from the million four. Now, I want you to think about this for a moment. That million four -- I know this is tough while you're driving. Let's do some easy Math, rule of 72, that if they had a diversified portfolio and it just doubled, if it did 7% instead of 7.2%, if it did that over time, it would double every 10 years. So, by 45, their million four would've been 2.8. By 55, their 2.8 would've been, aside from taxes, things like that, anything will be a drag like fees, but let's say 7.2 net of fees. By 55, the 2.8, would be 5.6 and by 65, the 5.6 would've been a total of $11.2 million. $11.2 million if they didn't save any other money.

So, be with me -- I'm trying to do Math. I think this and all imploded in 2002. So, that's 15 years ago. So, this 35 real couple would be about 50 now and would've well north of $3 million, but they didn't do that because when my friend came back, all of that million four, was worth less than $35,000, less than $35,000.

Now, we can all see that. We can see it from the outside. I think anybody working for a large publicly traded company, would look at their friend and say "Gosh, with all the stories that are out there, these major companies, whether it's a WorldCom or Enron, or Colortile, we have these major publicly traded companies in the past that kind of made these huge promises and everything was going to work out." People would ride that into a successful retirement, and it didn't work out. We can all offer advice, "Well you shouldn't do that if you work for one of these large publicly traded companies." But, it's hard to do that when it's your baby. It's hard to think that way when it's the company you're building, that the stock may not be worth anything or might not be worth what you think it's worth.

So, how much does it have to be worth to give us the same amount of income? Well, when we talk about how much in assets you have to have and capital at work, to take 4% a year off of, well that family, if they were simply diversified, their holdings in the one company they work for, which by the way, if you're a business owner or you're a high-income earning executive with large amounts of stock options, I want you to think about this for a moment, not only is your portfolio undiversified, but your income source is tied to your largest asset. Your income source is tied to your largest asset, so if you lose your job, you're likely also going to lose all the value, same thing for a business owner.

Now, by no means, am I saying you should not own company stock in your own company, or in the large companies you work for, it's just that that money needs to be transitioned back to your personal balance sheet and we need a methodical strategy for doing that. Here's why. When you need 4% a year is what you can take off of a portfolio, if you take more than 4% a year, you run the risk of running out over long periods of time. Because, when you retire, or when you're going to be using your portfolio, your assets for income, it's not like the way you experienced assets and investing while you were saving money, while you were accumulating assets.

You see, variability of the market going up and down is our money is going in and it doesn't hurt us. That's just investing. But when we retire, we're not taking withdrawals. We are disinvesting from those assets. And as we disinvest, when the market goes down, our withdrawals, the money we disinvest, accelerates the erosion of the capital. So, you can look up things like the Trinity study, you can look up things like Monte Carlo scenarios. If you reach out to us, we'd be happy to run one of those for you on your portfolio. What I want you to think about is, you can't take out more than 4% a year.

So, let's talk about how much capital at work, then, is required. The capital at work required to replace that $500,000 of income is $12.5 million. $12.5 million, which means the company probably had to sell for like $15-16 million, which means your company had to sell for over 30 times. 30 times your current earnings to be successful. Which means whoever buys the company is okay with waiting around 30 years to have that happen.

Now, I'm not saying that never happens, but you need to be present to the fact that even though the business owners you know or the stories you hear about in Forbes -- all that stuff has somebody beating on their chest because they did do that. The only problem is, that one voice is a lot louder than all of the voices we never hear of the people that had to quietly wind down their companies or the person that sold their company just that somebody else would take them off the debt, or somebody that sold their company, hoping to get $5 million and they got $500,000.

Those are the stories that people don't tell and we suffer from this survivorship bias because we're only hearing about the really successful ones, because they're the only ones screaming their stories from the rooftops, and if you can only take 4% a year, and by the way, the reason it's 4%, is I don't think any of our clients, really think of themselves getting old and unhealthy. And if you look at how long you're likely to live, if you're married and you're 65 and you're still healthy, then the odds are, 50% likely, 50% mortality does not mean it's an end point. People treat it that way. 50% mortality means at age 92, one of you two is still going to be alive. One of the two of you will still be alive beyond the age 92.

Now, wait a second. That doesn't -- Paul doesn't jive with what I read in U.S.A. Today. It doesn't jive with that little graph that I saw in the lower left-hand of the Wall Street Journal Business section. Here's why. When they look at those, they're giving you an average of all baby boomers. This includes the alive and wealthy, the alive and unwealthy, the sick, and those that are already dead, are averaged into those numbers when they give those mortality rates and it's on a single life, but your income in our old age, our income has to last well beyond when the last one of us is going to live.

So, think about that for a moment. If 92 is the midpoint, that means it's up to 10% likely that one of the two in a couple is going to make it to 100. Now, that is real insurance company data that they've been kind enough to release so that we can know the real numbers about longevity. So, if that's the real longevity of us, that means, as an entrepreneur, business owner, or high-income earning executive, you may be living off of your assets for longer than you actually worked in the marketplace. That can really happen.

So, we're not going to get a 30 times multiple in all likelihood, selling the company. So, how are we going to make up the amount of money? We need, in our example here, to produce $500,000, we need about 12 and a half million, and if we sold the company for $2 million, how's the rest get made up? The rest gets made up in what you will be able to diligently save onto your personal balance sheet over time. Now, what that required is that you set for yourself a marginal propensity to save. So, many of you listening to this, might say to yourself, you're getting ready to just go and skip to the next podcast because you're saying to yourself, "There's no way that I can save that amount of money. It's going to take a ton of money for me to get that $10 million capital at work, if that's your number.

But, what I want you to think about is almost everyone listening to this should be at a 15-20% gross savings rate and some of these should be higher. So, a 15-20% gross savings rate can seem like a large hurdle, and that means that's not money investing back in your company. Remember, that needs to be money coming back somewhere else on your balance sheet. Now, that can be invested in real estate. It could be invested in a portfolio. It can be invested in retirement plan but untied to your business.

Now, if that's going to happen, you've got to get pretty diligent to get to where you can save 20% of your gross income, and many people don't get there overnight. So, I want you to think about this marginal propensity to save. Your marginal propensity to save, is the amount of additional money you'll save when your income rises. That's very simple. When your income goes up, if you make $50,000 more next year, well then, save half that. Set yourself a 50% marginal propensity to save. Set that 50% amount so that you save more money when you make more money, and eventually, that will close you win on an appropriate level of savings but every time you make more money, you also get to enjoy more money.

The reverse of your marginal propensity to save is your marginal propensity to consume and what we want you to be able to think about is how can you continue to increase your savings, the amount of money that's going onto your balance sheet? Because investments will never bail you out for retirement. Now correction. They'll bail somebody out. Somebody will be bailed out by their investment on some big stock that they had. Believe me, you're going to meet that person because they're super, super loud about their ability to have done that, which was pure luck. Total speculation, it was gambling and yet they're going to tell everybody about it.

So, other than that person, which in all probability, is not going to be you, you just got to save your tail off. So, what I want to encourage all of you to do, who are business owners or who work for a large company, you've got a lot of money wrapped up in that stock, I just want you to consider what it means and what safety looks like both for you and for your spouse. Like, imagine if you're an entrepreneur business owner, and the vagaries of the business that can sometimes happen: you have a tight quarter, somehow revenue is down, or you had to take on additional debt and you had to sign both as owner of the company and then you signed again as father and husband, or you had to sign as mom and wife on that agreement, along with signing as the owner of that business.

Here's what I want you to think about. How much more safe does life look if you can point to your spouse on your personal balance sheet, that you have $500,000? Or $5 million as you journey toward the future, and how many better business decisions are you likely to make because you don't have the pressure of it's all riding on this one stock. It's all riding on this one bet. How much better do you navigate the marketplace? And how much more power can you have when you ultimately sell because you literally don't have to?

So, I'm so glad you guys could be with us today. I really look forward to having a chance to engage with you in some other way. Pass this podcast along the other business owners and entrepreneurs that you know. I think, if what you can do is set a strategy to be in a position to have your personal balance sheet be incredibly strong, to be robust and then do what you can to work with an educator and a coach, to help you have that balance sheet be optimized, to be in any way that you can, maximize the output of what ends up on your personal balance sheet. You're the expert at growing and running that business, engage in expert in growing and running your personal balance sheet in partnership with your spouse. I'm glad you could be with us today. I hope you have a wonderful rest of the week, and should we ever be able to be of support to you, do not hesitate to reach by email, Facebook, or just give us a call.

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