STIFEL

BORING MAY BE BEAUTIFUL

White Paper Volume 1, No. 5

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Business Return on Equity Was Never Less Than 20% – I'll See Something Similar, Right?

Despite the challenges that never seemed to end, investing in your business was a good proposition. Oh sure, not every new idea worked out, but generally, money invested in your company produced substantial profits and growth for many years. In fact, if you ever had an accounting or financial analyst review your history, you'd very likely determine that your return on invested equity (excluding your "sweat equity") was in excess of 20% per year. This is typical for most successful small businesses.

You likely were quite aware of this over the years and reinvested your profits back into the business as soon as they were earned. What better opportunity did you have? And those reinvested profits meant your income and lifestyle continued to improve steadily. This success is also why you likely haven't yet created a significant financial portfolio. You surely didn't hear often of others earning these kinds of returns from stocks or bonds (at least any that were believable).

But once the company is someone else's, that opportunity will be gone. Your sale proceeds will need to earn a decent return to make them last while meeting all your plans and needs for the future. But with bank rates so low, bonds paying low single digits, and who knows what you might make in stocks, the future may not look that promising for making money. You were used to making strong double-digit returns and, so, may now press your financial advisor candidates about their investment approach and track record with the expectation, *"I'll see something similar, right?"*

Financial Markets Investing

Investing via the financial markets (listed and over-the-counter stocks; government, municipal, and corporate bonds; bank certificates, money markets, etc.) is quite different from investing in a closely held business. Two key differences are largely the reason returns are usually much lower in the markets: liquidity and stability. Liquidity affords investors the opportunity to buy or sell an investment quickly without significantly affecting the price of the investment, an obvious and major advantage that privately owned businesses do not have. Therefore, small, private firms must generate a greater return on equity in order to compensate. Stability refers to the investment entity's size, history, continuity, and more predictable prospects. Companies and governmental entities usually cannot access capital in the financial markets until they demonstrate these qualities. As one would expect, usually the more stable the investment appears, the less risk it presents.

In the financial markets, investors usually have more liquidity and stability than private company investors do. They are generally willing to accept lower returns on their invested dollars. Of course, there are the more uncommon examples of the wise investor who invested in a company just prior to a major advance in its share price, thus earning returns on par with the best private company, but this is the exception, not the rule.

Financial markets' liquidity, along with reasonably small and standardized investment units of ownership (a share of stock or a bond), also allows investors to spread their investment dollars around to various potential opportunities. While it does not ensure a profit or protect against loss, this spreading, or diversification, can play a key role in reducing the risk of investing a given sum of money. The ability to diversify is another advantage financial market investors may have that investors in closely held businesses generally do not, and again may imply that return expectations could be lower.

Why You Should Be Happy With X%

Investment returns on all instruments change over time, so trying to accurately predict what one will earn in a single investment, many investments, or in the broad financial markets is impossible. So the "X" as it stands for expected return on investment is unknown.

Investing in bonds may be a more convenient way to lend money to a company or governmental entity. Generally, the investment return on a bond, if held to maturity, assuming all interest and principal payments are made in a timely manner) is its stated yield in terms of an annual percentage rate. According to Yahoo Finance as of November 20, 2013, a 30-year government bond should yield 3.88% (and a 20-year "AAA" rated corporate bond should yield 4.99%) for that term – the investor will earn just that over those years (assuming he or she holds the bond until it matures). So, if your investment strategy calls for investing some capital in these bonds, what you'll earn on this part of your portfolio should be fairly obvious.

Stock market returns are usually less predictable. And you might be tempted to seek out the next company with prospects for high returns as part of your investment portfolio for the years ahead. But uncovering such opportunities when most others overlook them is more difficult than one might imagine. Determining a fair value for a business is one thing (as demonstrated when investment bankers negotiate bids for private companies in line with their expectations), but investing in public companies also involves the collective perspectives of millions of other investors who may decide for themselves what is a fair value and will purchase or sell a stock based on their own assessments of many unrelated variables at any given moment. This tends to make successful stock investing much more difficult, even for the seasoned financial manager or analyst.

More often, experienced financial advisors will recommend that investors wishing to invest in stocks do so in broadly diversified portfolios. Such diversification could reduce the risk that any one company may have the potential to significantly lose one's investment capital. But this diversification will also reduce the opportunity for outsized gains (a low probability event). Still, this approach may offer the opportunity to earn reasonable long-term returns in line with historical experience. While the past is not necessarily indicative of the future, according to Wikipedia, from 1970 to 2012, the S&P 500 stock index produced a compounded annual growth rate of 9.94%, with the best single year (1995) producing a gain of 37.58% and the worst single year (2008) producing a loss of 37.0%.

While these are not all the opportunities available in the financial markets, they describe the most common choices and possible expectations. For the relative safety and liquidity of your capital, *you may learn to be happy with X%*.

How to Incorporate More Aggressive Opportunities

Once comfortable with the returns likely to be earned in the financial markets, looking for reasonable opportunities for higher returns is not reckless. Some investment assets and strategies can – and have – produced greater long-term returns, but usually come with the risk of greater potential losses. These alternatives include hedge funds, private equity investments, venture capital, futures trading, and many unique securities trading strategies. These investment vehicles may produce higher returns, but none are assured or predictable, and often are less liquid.

If these alternative investment vehicles are of interest to you, work with your financial advisor to create an investment strategy that includes them. You should make sure that your exposure to these investments is properly allocated to a small part of your overall portfolio strategy and be wary of chasing seemingly exciting opportunities that come your way. Any new commitments should come from these dedicated assets or the returns of capital you may have from similar investments previously made.

Mitigating Risks

Significant wealth in our society is most often created by starting, running, and growing a successful business, usually not by investing in the financial markets. For the business owner who has achieved this success and resultant wealth, selling the company provides the unique opportunity to realize this success. The financial markets provide a way to invest that wealth to seek to generate reasonable returns for the future. With this understanding, those fortunate enough to have created real wealth are wise to remember that, when investing the proceeds of their firm's sale, *boring may be beautiful*.