# Your Business Value Vs. Market Correlation

It is a fact that a privately-held business will, in most cases, represent the largest financial asset in a business owner's personal portfolio. This newsletter is written to have business owners consider a simple question – 'how correlated is your business value to the overall economy?' The reason that this question is so important to ask is because most business owners put the majority of their financial wealth at risk when they fail to view their business as an asset; in particular, as an asset that fluctuates in value. Therefore, this newsletter is designed to get you, the owner, thinking about protecting your overall wealth by thinking through a potential future date when you will transition your business – perhaps before the next economic downturn.

## Investing 101: Diversify Your Assets

It has been said that there is such a thing as a 'free lunch' when it comes to investing – that 'free lunch' is the diversification of your assets. The reason that diversification is called a 'free lunch' is because in a liquid portfolio of investments (i.e. stocks and bonds), diversification costs almost nothing beyond some transaction costs. However, the low / no cost of diversification provides a substantial amount of benefit to the investor because the investor is not solely invested, or 'concentrated' in a single investment or perhaps in only a few investments.

In fact, in a well-diversified portfolio, different types of assets / investments rise in value in certain markets while others will fall. Overall, the investor is provided protection of their wealth by spreading it out.

However, when a business owner's largest asset is their illiquid privately-held business, how can they apply the same diversification mentality?

The first way that an owner can begin to address this 'concentration of risk' in their privately-held business is to understand how their company's value is correlated to the overall marketplace.

## Your Business Risk Relative to the Market

Let's begin with a simple question:

- When the overall economy is on an upturn, does your business become more profitable?

For the majority of business owners, the answer to this seemingly simplistic question is an obvious 'yes'. Most owners rely upon favorable economic conditions to increase the value of their businesses.

If this is true for your business, i.e. the profitability and value rises with overall economic conditions, then, of course, the same is true when the economy falters and the value of your business will fall when the economy slows down.

**"Correlation" vs. Market Returns**

If the statements above apply to your privately-held business, then it can safely be said that your business value has a 'high correlation' to economic conditions. As such, you are likely hopeful that the economy will improve so that your business value can increase. However, having been through a number of recessions, you also know that you cannot control the overall economy. What you can control, however, is how well prepared you are to protect and/or harvest the value of your business despite the timing of the next economic downturn.

**Shifting the Riskiness of Your Business**

Can the value of your business somehow be immune to the next economic downturn? Probably not – at least not 100% of the value. However, one of the concepts that you might embrace in your thinking is that of 'shifting the risk' to another investor. This could include taking on a partner in your business.

The average business owner enjoys the freedom and financial advantages of running and owning their own business, so they don't want to sell it. However, they also realize that having the value of their largest financial asset tied to the overall economy is also something that makes them very uncomfortable.

**Taking Chips Off the Table**

If you were to think of your business the way that you think of your liquid investments, you might sell off some of them (or technically 'raise cash' in order to reduce the fluctuations that can occur when a downturn in the economy sets in). Private equity groups invest in privately-held businesses but also partner with the existing owner and work on growing the business together with you. This is a way that you can stay actively involved in the business without needing to keep 100% of your business value at risk.

**An Abundance of Capital vs. Continued Control**

Today's capital markets are flooded with 'dry powder' or investment capital that is waiting to be deployed into profitable businesses. If you have a profitable business today (i.e. more than $1 million in annual profits) then you might be attractive to an investment partner such as a private equity group.

While capital alone is not a reason to transact, you may also take into consideration that with so much capital looking to be put to work, you are actually in a relatively good position to choose the form of the partner or capital that you attract to your business and, perhaps, work with these capital providers to continue controlling parts of the operations of the business while working to increase its overall value. In short, the diversification of your personal wealth might also serve as the catalyst for growth at your company.

## Concluding Thoughts

We hope that this newsletter has accomplished the objective of having you understand that while the economy is a large indicator of the value of your business, there are planning techniques available to reduce the overall risk to your total wealth. Paying attention to not only the economy but also to the sources of capital for your business, may lead you in the direction of reducing the overall riskiness of your business while protecting your wealth.

Regards,

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