Entrepreneurs and concentrated wealth part 2: setting financial goals

Executives & Entrepreneurs

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- Business owners typically hold much of their wealth in their business. This can be described as holding a concentrated stock position.
- We believe concentrated equity holders should regularly question why they are holding a concentrated position. We suggest identifying three initial questions:

1. What is the role of a concentrated position in achieving financial goals?
2. Which types of goals does the founder aim to meet by using a concentrated stock position?
3. What constraints do founders face with regard to their concentrated equity positions?

Source: Getty Images

In some ways, the principles of a successful entrepreneur are poles apart from those of a successful investor.

Business owners customarily concentrate their resources in the business. Entrepreneurs commonly pour everything—time, talent, and treasure (capital)—into their business to start it, scale it, and potentially sell it.

The idea of spreading risk by investing in companies they don't control is anathema to many entrepreneurs.

Those who invest in other ventures often do so only when the original operating company is well established and generates sufficiently high profits to provide surplus capital beyond the business's needs.

The general maxim in investing, by contrast, is that diversification—spreading capital across asset classes, sectors, and regions—is the only "free lunch."

In the first of this three-article series, we explored why entrepreneurs who keep wealth concentrated in their company may put their personal financial circumstances at risk.

In this second article, we'll consider how concentrated wealth affects financial goals.

And in part three, we'll examine ways that entrepreneurs can manage a concentrated position that benefit their business and wealth.

Why do entrepreneurs hold concentrated equity positions?

Entrepreneurs may have had great success in holding a concentrated stock position. But past performance is no guarantee of future success. Financial needs are not static, so the plan crafted to meet them shouldn't be either.

We believe concentrated equity holders should regularly question why they are holding a concentrated position. We suggest identifying three initial questions:

1. What is the role of a concentrated position in achieving financial goals?

Is a business owner or investor holding a concentrated position for non-financial reasons? Examples of this include retaining control of a company, working as an activist shareholder, preserving family ownership, or holding stock because it is a function of having a job with a particular employer.

In these instances, business owners may do well to ask whether these non-financial motivations require trade-offs to financial goals—and whether they're still happy to accept these opportunity costs.

Does a business owner or investor hold a concentrated position for financial reasons? If yes, is the stockholder targeting a set return or seeking the greatest possible returns?

What has worked in the past may not always work in the future. Do past financial motivations (e.g., expected outperformance of the concentrated position versus the rest of the market) still hold? And is the concentrated position the most efficient way to maximize the chances of achieving short-term spending and long-run saving and giving goals?

2. Which types of goals does the founder aim to meet by using a concentrated stock position?

Does the concentrated equity position need to serve day-to-day spending needs (i.e., to refill a Liquidity strategy)?

If so, a founder's main aim may be to raise liquid funds from their position, even if the stake is held in a seldom-traded or untraded company. And if the business owner holds cash to meet spending needs, does a high cash balance put wealth at risk due to high inflation that erodes future purchasing power?

Will the business stake ultimately fund lifetime spending such as retirement or paying for college fees (i.e., a Longevity strategy)?

If so, the entrepreneur may seek to balance return generation against volatility management by matching assets with liabilities and aiming to reduce the risks either of not having enough money (shortfall risk) or of being exposed to a market fall just before selling assets to meet expenses (sequence of return risk).

Or is a concentrated stock position aiming to meet goals that extend beyond the entrepreneur's lifetime, like bequests to family or charity (i.e., a Legacy strategy)?

In this instance, what is the founder's ambition—to maximize financial returns so beneficiaries have the largest possible capital pool, or to give heirs particular assets so that they can retain company control or familial ties to a business?

3. What constraints do founders face with regard to their concentrated equity positions?

Did a business owner or executive choose a concentrated stock position, or did it choose them?

Many executives are not free to determine how much of their company stock they hold, but rather face minimum holding size requirements or lockup periods. Business owners may need to hold a certain proportion of their business's equity to retain the level of control they desire. And some stockholders may face family pressures to hold a position for sentimental reasons.

Others may face restrictions on how much they can change their concentrated position. Market liquidity may limit the amount that can be bought or sold without having a material impact on the share price. Stock purchases or sales may trigger regulatory disclosures that lead to a loss of privacy, inflict reputational damage, or even have an adverse effect on the overall business value.

These various constraints should shape a financial plan, helping business owners and executives to manage their personal wealth (and meet spending goals) by efficiently using their capital so they can avoid selling assets simply because they are most liquid or least constrained.

How can holding a concentrated stock position influence financial goals?

As we mention above, past performance is no guarantee of future success. Prior success may have been warranted by market-beating earnings performance or stock rerating in a period of scarce growth and low interest rates.

But when valuation levels are elevated, the bar for earnings beats and even higher stock prices rises. And if macroeconomic, regulatory, or political conditions change, a concentrated stock position can look more vulnerable to correction. One example would be shifts in market sentiment and positioning, for example, from "growth at any price" to "growth at a reasonable price" or from growth stocks into value equities. Another would be a narrowing in market breadth where a declining number of stocks drive the performance of the overall market.

For concentrated stockholders in a private company, it may also be prudent to consider how performance may differ in the event of going public. Initial public offerings (IPOs) tend to underperform a broad market index following their listing.

This finding has been repeatedly studied in academia and held true in 2021, as well, with the median IPO underperforming the Russell 2000 by 15% according to Bank of America Global Research.

Conclusion

It's important to ask whether a concentrated position is the best means of achieving financial objectives—whether those be saving for retirement, building a legacy for others, meeting day-to-day spending needs, or raising capital for investment in a business.

Entrepreneurs may have had great success in holding a concentrated stock position. But past performance is no guarantee of future success. Shifting financial needs warrant evolving plans crafted to meet them.

Concentrated stockholders should therefore review their positions and their financial plans frequently. Three questions can help business owners and executives to assess and manage their concentrated stock position:

1. What is the role of a concentrated position in achieving financial goals?
2. Which types of goals does the founder aim to meet by using a concentrated stock position?
3. What constraints do founders face with regard to their concentrated equity positions?

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