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From entrepreneur to investor

Navigating the transition and preserving wealth

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Since the transition from entrepreneur to investor is not always as straightforward as it might seem, this report outlines the journey and delves into some lessons and considerations at the following key points:

1. Investing as an active entrepreneur
2. Navigating the transition period, and
3. Implementing a wealth preservation strategy

Each stage includes a to-do list to help entrepreneurs stay prepared and avoid common pitfalls.

Source: Getty Images

Introduction

Entrepreneurs are a special group of people. They are typically able to maintain an unwavering focus on their business, pouring time, effort, and capital into it to start it, scale it, and potentially sell it. When successful, this can accumulate immense wealth for the entrepreneur and their family. At each point in this lifecycle, from active entrepreneur to post-sale, there are specific risks and biases at play. But there are investment strategies entrepreneurs can utilize to mitigate these challenges.

This report provides an introduction to the investment opportunities and pitfalls throughout this journey. We also pay particular attention to the period between contemplation of a sale and its completion, as the transition from entrepreneur to investor is not always as straightforward as it might seem. Everyone has an investment strategy whether it be through intention or merely as a byproduct. By understanding the broader purpose and vision for one’s business, wealth, and family, an investment strategy becomes an invaluable tool for successful planning and managing of assets, even as these priorities shift over time.

Section 1: Investing as an active entrepreneur

To-do list for entrepreneurs

- [ ] Diversify investments: To mitigate risk, avoid putting all capital into one business.
- [ ] Maintain liquidity, but not too much: Hold 3–5 years' worth of lifestyle expenditures in liquid assets.
- [ ] Don't rule out stocks: Consider public equities for potential returns and diversification.
- [ ] Avoid familiarity bias: Diversify across different industries and geographies to reduce risk.

A natural consequence for entrepreneurs from pouring effort and resources into their businesses is concentration of capital. This concentration, and often illiquidity, can generate significant returns, but it also exacerbates risk and can make some natural behavioral biases more pronounced. The best ways to create wealth are not necessarily the same as those to preserve it. No matter how skillfully a company is managed, company- or industry-specific risks cannot be perfectly offset. This makes concentrated investments prone to outsized losses (as well as gains) while limiting the flexibility to compensate for this return profile.

To balance the higher uncertainty associated with a less diversified portfolio, a concentrated position may lead entrepreneurs to hold more cash than they need, for longer than needed. Over time, inflation can erode the purchasing power of this cash, reducing the likelihood of meeting long-term spending needs. Second, reducing cash to meet spending needs while maintaining a concentrated position leads to increasing portfolio risk as spending goals get closer—the share of cash in a portfolio falls while the share of the concentrated asset rises. This is the opposite approach to traditional financial planning, where investors de-risk their portfolios as they approach a spending goal.

Another tendency stemming from the deep knowledge successful entrepreneurs acquire about their business and industry is familiarity bias. However, investing further into the geographies and industries that are familiar might even further compound the risk of the business. In contrast, diversification and a deliberate proportion of agility through more liquid investments maximizes the chance of delivering a replicable, consistent return throughout the economic and market cycle. This is beneficial for meeting objectives, long-term planning, and overall wealth preservation. Most importantly, it is imperative to take into account not only planning for the business, but also personal and family spending needs as well—even as they might evolve as the entrepreneur begins to contemplate, and eventually implement, a partial or full exit from the business.

So what should a diversified portfolio look like? A first consideration might be to diversify the business. While this could create new opportunities and revenue streams, doing so has its drawbacks—the business will still be vulnerable to idiosyncratic risks, and flexibility will be reduced due to illiquidity.

There's also the need to hold enough liquidity but not too much. Entrepreneurs typically need more liquidity than the average investor, for example, to pursue opportunistic business projects. If a firm runs into trouble, it can take time to adapt. Closing a firm typically takes longer than merely finding a new job. Many entrepreneurs set up various companies before one takes off, and so may need seed money for their next venture.

But entrepreneurs often hold more cash than they need, even for an emergency as mentioned above. We recommend that business owners hold three to five years' worth of lifestyle expenditures in liquid assets. Beyond this amount, entrepreneurs run the risk that their portfolio won't contribute to achieving their financial goals. Splitting your portfolio into a Liquidity. Longevity. Legacy. framework can guard against it.

Another consideration is to not rule out stocks. Entrepreneurs may find it hard to shift money from their own business (one they control and whose "paper value," if unlisted, stays constant day to day) to public stocks in businesses they don't control and whose value fluctuates on the market. The illusion of stability may lead one to overestimate the volatility of stocks and underestimate their potential returns.

Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

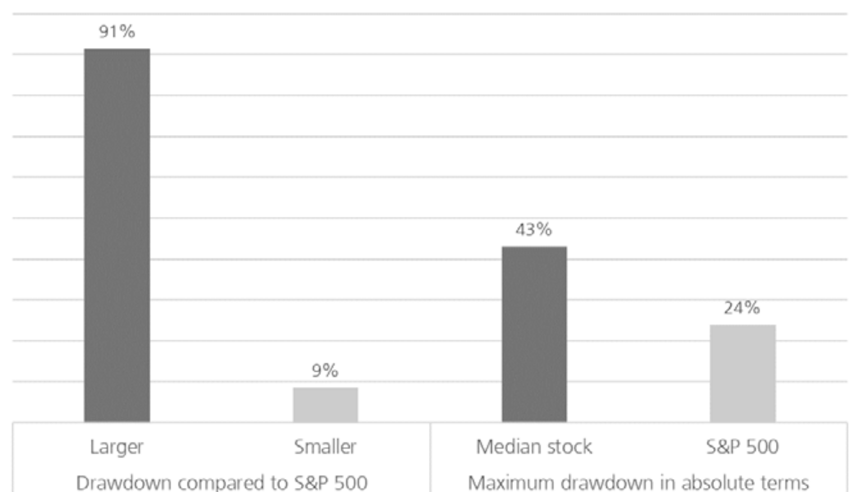
While private businesses are subject to considerable idiosyncratic risk, there's little evidence their returns are connected to major asset classes. In fact, the correlation between individual micro-cap stocks and the S&P 500 index is very low. Entrepreneurs often benefit from building a well-diversified portfolio without making sweeping changes. Entrepreneurs with more mature businesses typically prefer a traditional diversified portfolio split between global equities and bonds, while younger entrepreneurs with fast-growing businesses and long investment horizons usually look for higher-risk options. As for all investors, building a financial portfolio depends on a number of factors, including goals, time horizon, and risk tolerance.

Case Study
The illiquidity trap: A Southeast Asian family's journey

A family in Southeast Asia owns a successful business. For them, their company is more than just a business or source of wealth; it embodies the core values by which they define themselves as a family unit. The younger generation is expected to contribute to this shared venture as well. While they may study or gain experience abroad for some time, they are expected to eventually return and use what they have learned for the benefit of the family business. When discussing potential benefits and means to diversification, the founders prefer to reinvest in the business and ultimately decide to buy a few properties in the region. Despite excellent management and business acumen, the company's value has plummeted nearly 30% in the last year due to headwinds across the entire industry and region brought on by geopolitical tensions and unexpected regulation. While the valuations on the real estate properties have not suffered, they are illiquid and cannot be exited to shore up the family's balance sheet. And since everyone in the family is dedicated to the business, there are no alternate income sources to call upon. In this case, the family would have benefitted from additional diversification of capital, both human and investment, with an eye on maintaining the flexibility by considering liquidity risks as well.

Figure 1: Single stocks experience higher drawdowns

Comparison of the maximum drawdowns of the S&P 500 and its current constituents since 2010. The maximum drawdown is measured over the past ten years using monthly total net return data.



Source: Bloomberg L.P., UBS, as of 31.10.2023.

Section 2: Transition

To-do list for entrepreneurs

- ☐ (Re)assess values and goals: As you plan for a business exit, reassess your values with the help of the five purpose questions.
- ☐ Prioritize: Clearly articulate your post-sale priorities, including lifestyle, expenses, and potential investments.
- ☐ Don't underestimate the mindset shift required to transition from successful entrepreneur to successful asset manager: Consider available resources to attain the necessary understanding of the concepts and terminology employed by advisors and in the investment industry.
- ☐ Control vs. delegation: Balance the desire for control with the benefits of delegation post-sale.

The phase of the entrepreneur journey from owner to investor that can be categorized as "transition" is in some ways mostly a state of mind. At some point, entrepreneurs usually begin to contemplate either a full or partial exit from the business. Ideally, this is entwined from the beginning with an assessment of values and goals by articulating answers to questions such as:

- What do you want to accomplish in your life?
- Who are the people who matter most to you?
- What do you want your legacy to be?
- What are your main concerns?
- How do you plan to achieve your life's vision?

Have those values and goals changed over time? Perhaps this is the first time undertaking such an exercise. While it is never too late to do so, the fruits of thinking things through are maximized if the decisions that follow around the type of sale, timing, acceptable compensation, wealth planning, asset structuring, and investment process can all be aligned.

Some more specific questions to help structure and articulate priorities as well as help advisors understand objectives related to investment strategy might be:

- How much do I want to change my standard of living after the sale?
- What are my short-term expenses that I need to finance in the next 3–5 years?
- Is a significant purchase in my plans? For example, for real estate? Collectibles?
- Do I want to allow for the possibility to invest in a business idea like buying another business?
- If I were to live on my wealth, what would that look like?

It is common that after a sale, some or all of these elements might take on a different light. When prioritizing reinvestment in the company—post-sale and once wealth is more liquid—both the planned expenditures and resulting investment strategy might change.

At UBS, we use the UBS Wealth Way framework to help clients formulate a wealth plan so they can meet their different objectives. UBS Wealth Way structures one's wealth in three strategies.

- Liquidity strategy for short-term expenses.
- Longevity strategy for lifetime goals.
- Legacy strategy for goals that go beyond one's lifetime.

Furthermore, entrepreneurs should also consider how their behavioral preferences and risk tolerance may change. Notably, the attitude to risk may change significantly after a sale. Some founders tend to become very risk averse with the proceeds of their sale, while others are more comfortable taking risks as they feel that, if need be, they can recreate this wealth. Mental accounting, which is the tendency to treat money differently based on its origination, manifests itself in different ways for different individuals. It is therefore

UBS Wealth Way is an approach incorporating Liquidity. Longevity. Legacy. strategies that UBS Financial Services Inc. and our Financial Advisors can use to assist clients in exploring and pursuing their wealth management needs and goals over different timeframes. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved. All investments involve the risk of loss, including the risk of loss of the entire investment. Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability.

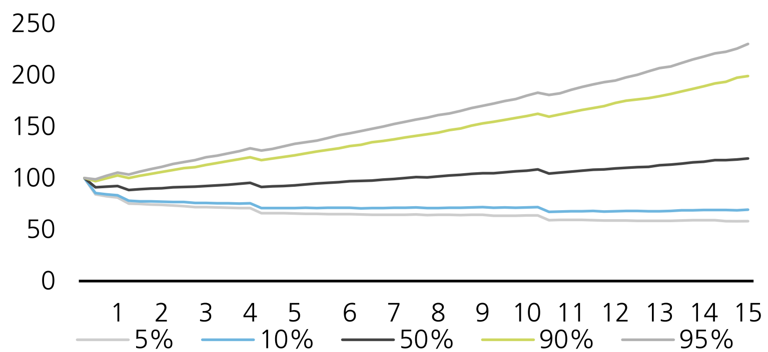
important for an entrepreneur considering a sale to be aware of how they feel toward putting the wealth from an exit at risk and how much risk they are comfortable taking.

A particular theme for entrepreneurs during this transition centers around control. Intense focus, a desire to have control over operations and outcomes, and willingness to take concentrated bets are some of the attributes shared by successful entrepreneurs. For investors, however, some degree of delegation can be both lucrative and liberating, since a sale allows for a reallocation of time and energy into new projects and interests. That isn't to say there isn't a place for direct investments in a portfolio or for active views. It is just important to have the right strategy, risk management and monitoring in place. If not already a point of knowledge, entrepreneurs keen to become more hands on in investing could look to learn about the various financial concepts utilized by advisors in allocating assets, such as understanding broader financial markets, types of risk and ways to measure and evaluate risk, investment processes, models and philosophies, etc. After all, the mindset and tools of long-term asset managers can be surprisingly different from what makes entrepreneurs successful.

Case Study
The art of transition: A UK entrepreneur's path to financial freedom

An entrepreneur in the UK was considering exiting his business in order to pursue other interests and spend more time with his family. He also wanted to relocate his family to Switzerland. After speaking with peers who had similar goals, he realized the necessity of engaging advisors on topics like taxes, asset structuring, and investments. After working so intensely for many years, he was looking forward to living a comfortable lifestyle. In discussions with his advisors, he was able to articulate further goals, such as collecting art and preserving the principal amount for his children. Using his risk tolerance and planned spending, an analysis (See Figure 2) revealed that there was an uncomfortable level of shortfall risk. Without adjustments leading to a financial plan aligned with his goals, the impressive wealth he had accumulated might have been depleted.

Figure 2: Forward-looking simulated final portfolio Value percentiles



Source: UBS, QIS. Data as of 31/10/23 Time horizon: 15 years Initial amount: CHF 100

Case Study
Friends, family & faith: a Columbian experience on the risks of applying an entrepreneurial skillset to wealth management

After a liquidity event, an investor in Colombia wished to continue to be hands on and active in how he deployed his wealth. He didn't shy away from direct and concentrated investments as he had personally experienced how this can have an attractive return during the growth of his business. Many friends and family brought him ideas, which formed a pipeline of investment opportunities. Unfortunately, like many in this situation, after accounting for the high proportion of these investments that not only didn't perform as expected, but ultimately failed, the portfolio as a whole had suffered. Notably, two thirds to three quarters of venture-backed firms in the US don't return investors' capital, according to Harvard Business School research by

Shikhar Ghosh and Prof Tom Eisenmann. Furthermore, founders may have the control and skills to implement improvements in their own firm, but this is not the case generally in a minority stake. And the typically illiquid nature of the investments doesn't allow for a timely exit if a deal begins to sour. Ultimately, an entrepreneur may have an edge in industry, knowledge, or network, which should not be discounted, however, like any other investment direct or co-investments should be considered in the context of the broader investment strategy.

Section 3: Preserving wealth as an investor

To-do list for entrepreneurs

- ☐ Define a Liquidity strategy: Plan for short-term expenses to avoid selling assets at discount prices.
- ☐ Define a Longevity strategy: Focus on long-term growth, with an asset allocation tailored to your risk appetite and aspirations.
- ☐ Define a Legacy strategy: Plan for cash flows lasting beyond your lifetime, including philanthropic goals and assets for future generations
- ☐ Create your investment plan: Together with financial experts, write down a detailed plan based on your profile and including currencies, asset classes, and investment preferences.
- ☐ Implement wisely: Consider various options for investing a lump sum, all at once, a hybrid approach, or preferably, dynamically phasing in over time.

Once a sale or exit has occurred, it is time to put the investment strategy to work. In the previous section, the UBS Wealth Way strategy was outlined: Liquidity. Longevity. Legacy. What might such a strategy post-sale look like?

Liquidity—to provide cash flow for short-term expenses
Failure to plan adequately for liquidity needs can force clients to sell assets at discounted prices. By assessing the family's cash flow needs over the next two to five years, and setting aside funds to meet them, it creates a buffer between cash needs and market returns, thus reducing the risk of being forced to sell assets with high return potential at the wrong time. This strategy generally involves low volatility assets such as short-term fixed income and cash, as well as borrowing facilities.

Longevity—for longer-term needs
These assets are designed to satisfy lifetime needs. With short-term cash needs met by the Liquidity strategy, these assets can be focused on long-term growth, with an asset allocation tailored to the investor's risk appetite and the family's aspirations

Legacy—for needs that go beyond the investor's own
This strategy is assigned to improve the lives of others, both within the family and in society. In many cases, this will include cash flows lasting beyond the investor's lifetime, including philanthropic goals and assets earmarked for future generations. Given the opportunity focus over a very long investment time horizon, this strategy has the capacity to invest in asset classes that offer an illiquidity premium, such as private equity, or investment themes that seek to profit from long-term secular trends in society or technology.

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Putting lump sums to work
In many scenarios, investors naturally enter the market and invest over time as they receive dividends or set aside a portion of their income. In the case of a partial or full exit from a business, it is likely that this would be in a lump sum. In this case, the considerations around possible implementation strategies come to the fore. What are the various options for investing a lump sum?

Theory concludes that investing all at once has an edge as the best option. Markets usually trend higher and bear markets don't occur often. Meanwhile, excess cash is a drag on a portfolio in real terms for the most part. Thus, time in the market becomes key. However, when dealing with a large lump sum, the psychological damage that an immediate drawdown could incur might easily offset any modest statistical advantage.

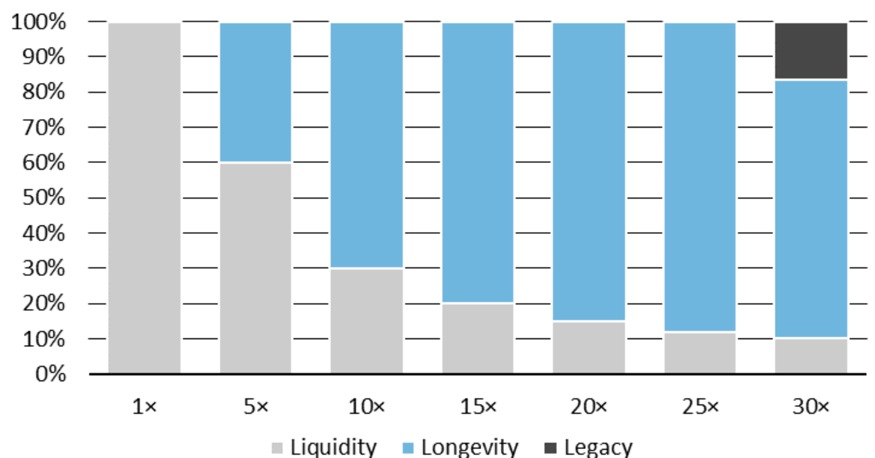
Another approach is to invest into bonds all at once and to phase in stocks. Since bonds have lower drawdown risk and might even rally to provide additional capital to buy into equity markets on dips, to some extent, this mitigates the psychological risk of the all-at-once approach.

All things considered, we think the best strategy for most is to dynamically phase in over time. This entails setting up a defined schedule that accelerates if there is a market dip of a certain level. This can be paired with return-enhancing strategies like selling put options.

Case study
A tailored plan: A US clean beauty entrepreneur's practical investment strategy

A US founder started a company in the clean beauty space eight years ago and is now in the earn-out phase of her exit. About two years before the sale, she sat down with her advisors to do a full review of her financial situation in light of the upcoming lump sum and interim earn-out structure. This allowed the proper structuring and wealth and tax planning for the assets. Additionally, she was able to use the UBS Wealth Way framework to structure her investment strategy. Since life can be unpredictable and circumstances change, she continues to have regular contact with advisors to review her plan. For example, her strategy will look different during the earn-out as she still receives an income to fund her expenses versus later when she has received her final payout from this venture and Liquidity needs to be refilled by Longevity returns. An example of how the ratio of financial assets to annual spending might affect how wealth is distributed can be found below in figure 3.

Figure 3: Illustrative exposures based on the ratio of financial assets to annual spending



Source: UBS. Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.

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