by Joan Adams

Finance 101 — Joan's Guide To Risk & Return

Money — what a great invention! It makes business so easy.

Just imagine for a moment that barter was still the principal means for selling and acquiring goods and services. How would a seller or buyer find the perfect barter partner, someone who wants exactly what is being offered?

That would be pretty near to impossible. The beauty of money is that it is accepted everywhere by everyone. Its value is known. Money makes business simple and neat. Money comes in all sorts of denominations; it is completely fungible and very easy to add up. It is the perfect medium for measuring and comparing the relative values of things.

Yet for all the simplicity money affords us, many business folks aren't terribly comfortable with money. In fact, they can be downright illogical about it. Business decisions are guided more by "gut" feelings, rather than by systematic financial analysis.

Much of how to think about money can be boiled down to a few simple axioms, perhaps the most important being: "A dollar today is worth more than a dollar tomorrow." We know intuitively that inflation will (almost) always be with us. Prices go up over time. This is not news.

Dollar Economics

But there's something much more important here. Dollars are not equal. They do not have the same long-term intrinsic value.

Example: The dollar in my pocket right now will in fact be worth a tiny bit less tomorrow, and a year from now it will probably be worth about 95 cents in 2006 dollars. But a dollar in an interest-bearing account will be worth something like $1.05 in a year's time.

This is what the finance folks call the time value of money. Look at those two dollars right now and they are equal. Looking at them to see which one will keep up with inflation and which one will lose ground shows they are not equal. Some dollars have better returns than others.

Of course, keeping even with inflation is better than losing value – but the object of most companies is to make money, to put current dollars to work such that at the end of the year, the company makes a tidy profit and beats the rate of inflation.

This is how you should think of every dollar you spend: when you are hiring staff, upgrading computers, buying inventory. These transactions can be summed up in dollar values and viewed as investments. Your company is no different from the Wall Street firms. You should expect your investments to bring a return superior to inflation. This is just like buying property or investing in the stock market.

Evaluate Investments

Example: Proposed computer system upgrade for $5,000.

In order for this investment to make sense, the $5,000 invested must bring in more dollars than a money market fund. The proposal needs to demonstrate (with projected savings or increased sales) how this upgrade will beat the going interest rate. The project can't ensure increased cash flow in a year's time? Then don't do it. Better to put the cash in a money market account and reap your guaranteed returns in a year.

Investments in money markets are sure things. The bank offers a guaranteed rate and your risk is pretty close to zero. Most business investments don't have certain outcomes. Some investments will not bring in the anticipated results. In the land of finance, the higher the risk (that a project may not succeed), the higher the percent return must be in order for you to jump in.

Think about it — why invest in something risky only to get the same rate you would get from a sure thing?

Convertibility is extremely important, too. An easily converted dollar has a very different value than a dollar that is tied up. In other words, a dollar in your pocket is worth more than a dollar's worth of truck. The pocket dollar can be invested, and can start earning interest right now. The dollar tied up in the truck can't be put in the bank so quickly. It takes time and money to turn a truck into cash. You have to find a buyer, transfer the title and collect the cash. No wonder you fully expect a truck to bring in much more cash than just your bank's interest rate.

The same goes for inventory. When you sell it, it brings in that high rate of return you counted on (those 10%, 20%, 30%, etc. margins). Sitting in your warehouse, that valve is an "inconvertible" item — one with risk (that it may never be sold). Risk, inconvertibility and the cost of money invested up front all must be covered by high margins.

Think about the slower moving items in inventory. These are typically the more expensive and the more obscure items. They have more risk. They cost more up front, take longer to sell and may not sell at all. Therefore, they have to carry the highest margins to make financial sense.

Let's look at the computer upgrade again. You know this investment needs to give you a higher return than a money market account. You know that the upgrade may take some time before it brings in any return. And you know there's risk that the upgrade might not actually be all that you thought it would be. Plus, the upgrade has zero convertibility (you can't possibly sell it).

So before going forward, you should ask: What return makes this investment acceptable?

`Hint`: It had better be high!

The next question to ponder is: Could you invest the same money somewhere else and get an even better rate?

This is why money is so great! Using simple finance techniques, you can compare wildly dissimilar investments (a new truck, a new hire, a new computer system), assess the risk and figure out the desired return. You can also use these to track the progress of your investments, to ensure they are bringing in those returns.

You should look at all company projects in the same way a Wall Street trader does, in terms of up-front cash, convertibility, level of risk and expected return.

All dollars are not created equal. Make sure each and every one of your dollars is the high-rate-of-return kind! <<

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