Some Thoughts on Finance
by
Brent Gloy

At the end of my undergraduate course in agricultural finance I try to provide students with some final thoughts on financial management and finance. The following article is a summary of that lecture.

Financial management plays a key role in helping you build your personal wealth. If self-employed, financial management will go a long way in determining the stability and success of your business. It is a task that you will undertake throughout your lives and one that can be done more or less wisely. Here are a few observations about financial management.

1. **Do not be afraid of debt**: Debt is a useful tool that can be used to grow your business and purchase assets that generate a return in excess of the cost of borrowed capital. It allows you to seize opportunity when it presents itself. Completely avoiding debt will limit your business opportunities. Sometimes the opportunity cost of avoiding debt is very high. However, you should always respect the use of debt and the increased risk that it brings to your financial situation.

2. **Use debt in moderation**: The use of debt increases the risk associated with your business and personal finances. If you cannot service your debt, your financial situation will deteriorate rapidly. Most businesses cannot sustain high levels of debt for prolonged periods of time. Studies of long-lived businesses consistently point to judicious use of debt as a contributing factor to their stability. In simple terms, you can’t be “all-in, all the time”. Those that consistently live on the edge, eventually end up at the bottom of the cliff.

3. **Understand the economics of your business**: The greatest risk to your business usually comes from not knowing what you are doing. Your success in the industry will be determined by the extent to which you can build a business that is better than your competitors. If you have an advantage, always work to increase it. In order to do this you have to know the source of your advantage and how to build on it. Don’t be consumed by predicting macro-economic variables. It is almost impossible to consistently predict these factors. However, it is possible to understand whether your business is competitive in your industry and how to improve that competitive position.

4. **Cash flow determines value**: Ultimately cash flow will determine the value of an asset. Value can diverge widely from cash flow fundamentals at points in time but ultimately value will return to fundamentals. Do not be convinced by people who argue that asset prices always go up (or down). Asset prices are ultimately determined by the cash flow that the asset generates.
5. **Do not be paralyzed by analysis and complication:** There are millions of ways to analyze decisions. Find decisions that you can analyze and understand. Complexity is sometimes beautiful, but it is always complex. When your financial future hangs in the balance you would like to be able to understand it – see number 3. Do not blindly make big decisions based on faith. If you don’t understand your business you can’t make good decisions. When you do understand it, decisions should be easy to make.

6. **If you find good opportunities take them:** Things that appear too good to be true usually are. Finding good business opportunities is work and capturing the value of these opportunities is really hard work. Rarely will wealth be handed to you. You will have to make the investment and then do the hard work of managing the business to capture the value. When you have a chance to make money do it.

Remember that as humans we are not wired for independent economic reasoning. We tend to want to buy when others are buying and sell when others are selling. In many cases, we should be doing the opposite or should we should at least be aware that our view of the opportunities is likely biased by the views of the broader community.

7. **Avoid the outstanding business opportunities of others who have no personal investment in the business or only upside to be gained from the opportunity:** Investment works best when those managing the business have the same incentives as those owning the business. It is not the same when management benefits tremendously from positive outcomes but loses little if things don’t turn out well.

8. **If you find yourself in financial trouble address it early and honestly:** Work with your partners (these include lenders) to find a solution. Most financial distress situations are made worse by not admitting all of the issues from the beginning. Once you are in financial distress, it is likely that all of the problems will eventually surface so address them from the beginning. Communicate clearly and try to remove emotion from the situation as much as possible. Avoid betting it all on a miracle. Sometimes the best solution is to find a way out, but you can’t make this decision if you don’t understand the economics of your business.

9. **Clearly understand risk and return trade-offs:** Don’t gamble your financial security for things you don’t need.

10. **Invest in yourself:** Your knowledge and talent is the most valuable set of assets that you own. You can invest in these assets and improve them, you can allow them to depreciate, or you can do things that make it impossible to get the maximum benefit from these assets. Make good choices here and you will reap benefits for years to come.

11. **Invest in those around you:** There are many talented people in this world. You will clearly be better off if they are working toward helping you solve problems. This is obviously true for employees in your business. When you invest in someone else it usually pays dividends down the road.
12. **Don't underestimate the power of compound growth and long-term savings/investing**: Investment and wealth creation benefit from momentum. Starting early and diligently saving and investing is a good way to start momentum.

13. **Building wealth requires sacrifice**: In order to build wealth you must delay or reduce consumption below income generation. This means that you have to make some sacrifices today for the benefit of having more in the future.

14. **Seek advice and input from wise people, but take responsibility for your financial decisions**: You have your best interests at heart so you should be the person making your business and personal financial decisions. Do not rely on others to make good decisions for you. Take responsibility to understand your financial situation and make the best decision. Remember Warren Buffet’s advice that “you already know what the response will be if you ask the barber if you need a haircut”. This does not mean that you shouldn’t seek input from others. Just remember that their view of what you should do will likely be influenced by their interests as well as yours.

15. **Remember Warren Buffet’s lesson that success usually requires integrity, intelligence, and initiative**: Two of the three will usually get you in trouble or nowhere.