Managing your surplus cash —

Savings and investments

BUSINESS COACH SERIES

- Establishing a plan
- Putting your plan to work
- Thinking long term

BMO Bank of Montreal

Your money should work as hard as you do

The situation

Thanks to seasonal factors, increased sales or your continued hard work, your business has begun to generate surplus cash. Although you recognize that it's inefficient to keep this extra money sitting idle, you are unsure about how to effectively manage your surplus cash assets or make funding decisions that will both benefit your business in the short term and increase your personal advantage over time.

The solution

At BMO Bank of Montreal®, we are committed to helping Canadian business owners succeed. The purpose of this Business Coach booklet is to help you ensure that your cash assets work as hard as you do. By reviewing your various options, including the potential for investing your surplus cash, you may be better positioned to achieve both your business and personal financial goals.

There are many reasons why your business may be accumulating surplus funds. You may receive large cash inflows at certain times of the year. Perhaps you've been setting aside funds for a large purchase you plan to make in the future. Or maybe your business just simply generates a lot of cash that accumulates in your account.

Regularly reviewing your cash flow allows you to assess the extent to which your cash inflows exceed your disbursements. This will give you an idea of how much surplus cash you've been generating over time. Whatever the reason, if you are cash flow positive, you owe it to your business and yourself to review the options available to you for maximizing the value of your surplus cash. This Business Coach booklet can help by prompting you to think about whether or not it makes sense for you to invest your surplus cash, and by outlining various investment strategies you may want to consider based on your business goals.

1. Consider the source of the surplus

Companies need cash to remain operational and meet ongoing expenses. However, cash can also have an "opportunity cost". If your business has too much cash in its deposit account, your money may not be working as hard as it could.

To determine whether your cash is truly a surplus or not, it helps to consider its source.

- If your cash is from **increased sales**, it is likely a surplus. Before investing all of that money, consider whether the surplus is due to increased seasonal sales or a result of longer-term business growth.
- If your cash is from the **sale of an asset or equipment**, it may be surplus. Consider if you need the money to purchase a replacement asset or whether it truly represents "extra" cash.
- If you have recently injected **your own money** into your business as capital, you may want to explore ways to earn a maximum return on that cash, depending on your business priorities.

2. Select a strategy

If you determine that your business does have a surplus, here are three strategies for maximizing the value of your cash assets:

- Weigh the relative merits of paying down debt:
  - If you decide to pay down long-term debt, keep in mind that you may have to repeat the loan application process and potentially incur additional costs if you ever need to re-borrow that money.
  - Paying down a revolving line of credit may make sense if your borrowing costs exceed your potential investment returns.
- Purchasing fixed assets with cash only makes sense if you are certain you will not need access to your surplus cash in the future.
- Consider your various investment options:
  - Short-term investments provide you with ongoing liquidity.
  - Medium-term investments can help enhance your returns while retaining access to your funds.
  - Long-term investments let you maximize the yield on your surplus cash over time.

Tips !

Investment vehicles with longer terms-to-maturity tend to yield higher returns

3. If you decide to invest

The principal goal of a successful owner/manager is to manage assets effectively, not to own them. That's why it makes sense to consider selling unused or under-utilized assets.

Surplus cash is a lot like an under-utilized asset. To maximize its efficiency, you may want to consider investing it. The question is: How much should you invest?

- Consider how much cash you need in reserve for daily operations and as an emergency fund.
- Ensure you retain sufficient cash to service your debt obligations.
- Look at your bank statements to figure out how much your balances fluctuate. Don't look only at your end-of-month balances; review your minimum balances as well.
- Determine if you're required to keep a certain amount of money in the bank to meet government regulations or other legislative guidelines.
- Review your working capital and equity ratios to assess the extent of your surplus (see the companion Business Coach booklet *Managing Your Cash* on this topic).
- Review your business' operating cycle to determine how much cash you're going to need in the coming months and quarters.
- Spend some time forecasting your future expenses. Keep in mind that certain market conditions beyond your control, such as exchange rate fluctuations or changing customer demands, may increase your need for ready access to your cash.

4. Develop a plan

When developing an investment plan, consider:

- your overall investment goals for both the short and long terms
- the time horizon before you'll need your funds
- whether you need quick access to your funds or can afford to lock them in
- whether you're prepared to accept some investment risk for potentially higher returns

With a little foresight and knowledge, you can also develop a plan that can guide your investment decisions through the various lifecycles of your business.

- Consider allocating short-term surpluses to more liquid investments.
- When saving for a large capital purchase, the intended date of purchase can dictate your investment strategy.
- Determine which portion of your capital purchases can be paid for in cash and which portion should be financed.
- When developing an investment plan, consider not only your business goals but your personal goals as well. With advance planning, your business surplus can help you prepare for the day you may wish to sell your business or retire.

Tips !

Investing your surplus cash can make sense if safety and liquidity are assured.

5. Determine your time horizon

Many business owners believe that surplus cash investments should automatically be allocated to short-term investment vehicles. However, as with any other investment decisions, your time horizon is a key consideration when determining your investment approach.

- Consider **short-term** investments if:
  - you are interested in maximizing your returns on your business's surplus cash, while maintaining ready access to funds
  - your business is required to hold deposits and/or reserves for a specific, shorter period of time
- Consider **medium-term** investments if:
  - you are working to set aside money for an upcoming event, such as a down payment for a large capital purchase or a business expansion
  - your business is required to hold and invest deposits and/or reserves for a longer period of time
- Consider **long-term** investments if:
  - you are interested in building up long-term cash reserves to enhance the value of your business
  - you would like to prepare for the future by taking steps now to set aside money for your retirement or the eventual sale of your business

Tips !

It's inefficient to continually reinvest your surplus cash in short-term investments.

- If you need to draw upon your surplus funds on a regular basis, long-term investing may not be right for you.
- Consider using a different investment strategy for different percentages of your surplus cash. For instance, keep money you require to fund operating expenses in shorter-term investments while setting aside a certain amount of money for longer-term investments where you can earn a potentially higher return.

6. Maintain liquidity

When making investment decisions, businesses must consider how much cash they need in reserve for daily expenses, working capital, debt service and capital expenditures. However, with the right investment products and strategies, you can maximize your investment returns without sacrificing liquidity.

- Don't sacrifice investment efficiency for liquidity. Research your investment options first. There are many investments that deliver solid performance without locking in your money.
- Business savings accounts with premium rates of interest allow you the flexibility of a deposit account.
- Look for investments with flexible options such as cashable features, automatic renewal features, and fixed or variable rate features. These can give you the benefit and convenience of longer-term investing without losing access to your cash when you need it.
- Money Market and T-Bill mutual funds provide a high degree of liquidity, allowing you to withdraw your funds without penalty.
- There are many Guaranteed Investment Certificates (GICs) that offer competitive rates while featuring attractive levels of flexibility and cashability.
- Many mutual funds are liquid investments, although short-term fluctuations in their value may make you hesitant to withdraw your funds on a regular basis.

7. Manage risk

When investing surplus cash, you need to decide what types of returns you'd like to earn for your business, bearing in mind your investment time horizon and your risk tolerance. Here are some strategies for managing risk:

- Before choosing an investment, assess your comfort with market fluctuations and determine how well your business can handle those fluctuations.
- Review your previous investment experience to gain a better understanding of your comfort level when dealing with volatility.
- Consider what percentage of your portfolio is held personally and by the business to determine if you need to better balance risk between the two.
- Identify the external risks that may affect your business. External risks can include economic downturns, new or emerging competitors, changing or new technologies, changes in consumer demand, or tightening government regulations.

Tips

By forecasting your operating expenses, you can make more informed investment decisions.

- Some businesses are more susceptible to external risk than others. Assess how well your business can withstand unexpected external changes and how they would affect your investment strategies.
- Save your money for unexpected expenses by putting aside enough surplus cash in a low risk investment vehicle to last several months — anywhere from three to 12 months, depending on your industry — in case the economy contracts.
- Before tying up excess funds in long-term investments, make sure you've put aside enough operating income for the next three to six months.

8. Diversify

Regardless of the economic climate, it's always wise to ensure that your investments are properly diversified. When considering your business investments, here are a few things to keep in mind:

- Know your business. Evaluate your investments based on your business goals, tolerance towards risk and time horizons. This will help you decide how to diversify your investments according to your specific needs.
- Diversify your investments by term, by dividing up your money into short-term, medium-term and long-term holdings.
- You can diversify by term even if you're only investing for the short term. Consider dividing up your money into investments with maturities that range from 30 days to 150 days.
- If your business conducts transactions in U.S. dollars, consider making U.S. dollar investments. In addition to protecting your funds from currency fluctuations, this can help you maintain currency diversification while saving money on conversion costs.
- If you have cash available for long term investing, and your risk tolerance is higher, mix it up. You could hold a variety of cash, fixed income and equities because a mix of holdings offers inherent diversification.
- Have a solid base. Having exposure to different markets — Canadian and international — is a prudent investment strategy that can help you mitigate your risk if one market declines.

9. Address your long-term personal needs as a business owner

As a business owner, chances are you're focused on ensuring the success of your business. However, it is equally important that you take some time to consider your personal financial picture to ensure you continue to make business decisions capable of supporting your long-term goals.

Consider a range of strategies

- You may plan to sell your business when you retire. If so, you need to assess how much money you can earn in a sale and if it will be sufficient to support your lifestyle.
- Keep in mind that the value of your business can fluctuate due to market circumstances or other events beyond your control, potentially leaving you with less money than expected.
- If you plan to work into retirement, prepare in advance for unforeseen circumstances such as an illness that may make it difficult to continue working.
- Consider a range of retirement strategies to ensure you meet your goals. For instance, you can build up additional financial assets by taking full advantage of your RRSP contribution room.
- Outside your RRSP, amass additional funds through tax-preferred investment income, such as capital gains and dividends from Canadian corporations.

Plan in advance

Planning now for retirement lets you start considering long-term strategies for your business and yourself, such as:

- protecting the full value of the investment you've made in your business
- building towards creating an income stream for your retirement
- making sure the direction you take with your business is in line with your own long-term personal goals
- ensuring your business remains on track to provide you with the money you need to fund your retirement

Remember that retirement planning has less to do with your age than it has to do with making sure you're making good decisions throughout the life of your business.

Diversify outside your business

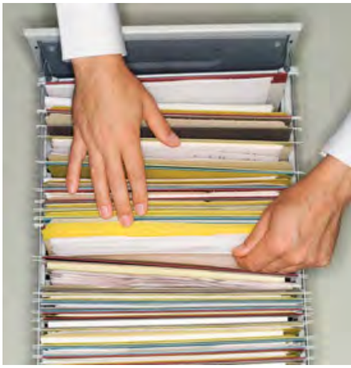
- A significant percentage of business owners have over half their net worth tied up in their business. However, it is important to consider the benefits of saving some money outside the business for retirement.
- Offset some of the business risks associated with economic downturns, competition or even the possibility of potential business losses.
- Take advantage of personal income tax deferral by saving and investing in an RRSP.
- Consider the range of income strategies available to business owners, such as income splitting.
- Establish a source of retirement income that is independent of your business operations.

Tips

In addition to affecting your business investment decisions, business risks can also affect your personal investment decisions.

10. Tax considerations

When deciding which investments are right for you, it's important to consider the tax implications of various types of investments:



- Investments that accrue interest income tend to be subject to the highest rates of tax.
- Consider holding investments with interest income inside a registered investment plan.
- To reduce taxes payable, consider investing in longer-term holdings such as equities. Capital gains earned on the sale of equities are taxed at the most favourable rates.
- Dividends earned from Canadian corporations tend to be subject to a reduced rate of tax.
- To ensure your investment decisions are tax efficient, consult with your accountant or tax advisor.

Tips

Minimize investment tax by understanding how income is taxed.

At BMO Bank of Montreal, we are committed to helping Canadian businesses develop and succeed. To this end, we've created a Business Coach Series that provides information and knowledge that can optimize the value of your company's financial resources. The booklets that make up the Series focus on essential areas of financial management allowing you to focus on operating your business more effectively.

For more information on how BMO Bank of Montreal can help your business:

- talk to your Commercial Account Manager
- call us directly at **1-877-262-5907** or
- log on to **bmo.com/business-resources**

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