


THE TIME VALUE OF MONEY



Life is about decisions, whether they relate to your work, business or personal life. Often ignored is the interplay between all these areas, and the fact that a little interdisciplinary thinking can go a long way. This might sound obtuse, but many important decisions can be made easier by thinking simply, and a bit differently.

Before we do, a note about value, and 'utility'. Business is about creating value. Our personal lives (according to economists) are about maximizing our utility, where utility is simply a measure of the happiness or satisfaction gained from a good or service.


Think of it this way, and business is considered first. If shareholders (either Owners or investors) could create more value themselves using other means, why bother running or investing in a business?

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Assuming we don't all have a perpetual income stream it comes back to this – if you don't create value in today's economy, you'll be forced to do one of two things. **Change how you do things, or cease to exist. For business the value question is rather important.**


People have it a little easier in some respects. Creating maximum utility is an incentive in and of itself. In the end, we all want more, whether it is revenue and growth for business, or old-fashioned utility in our personal lives.

To get more, we return to the decisions mentioned earlier, as all the decisions we make have a direct impact on both value creation and utility maximization, in particular those related to finance. Successful strategic management (the direction you want to take the business) is supported by your investment policy (choosing which projects to undertake) and your

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Personally, financial decisions influence your quality of life, and your ability to enjoy the things you want. Once again we are back looking at the study of incentives – how people get what they want, or need, especially when other people want or need the same thing. In this case, it's maximum utility.

One of the cornerstones of modern finance assists us in understanding which decisions to make, and it is equally applicable to business and personal finance. It's known as the time value of money. Simply put, **\$1** today is worth more to you than **\$1** received in the future. Why? Money has a time value because of interest rates, no matter how measly, making **\$1** today more valuable than **\$1** received at some time in the future because it can be invested today to provide a return. The income from the investment will in turn, make the dollar you get today worth more than the one promised you in the future. Perhaps an example best illustrates the point.

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Peter is offered the choice between **\$100** now, and **\$100** in a year's time. He takes the cash now, and invests it in a security (or bank) yielding **8%**, and in a year has **\$108**, which is clearly more than if he deferred taking the money at the start.

Again, this comes back to the incentives mentioned earlier. Interest rates are paid because someone else can use your money now, and they are prepared to pay you a return for the privilege of doing so, which is in truth a premium for taking the risk of giving your money to someone else. With business, this concept is part of what is known as the Sharpe-Lintner Capital Asset Pricing Model (CAPM for short), allowing people to work out, in today's terms, the value of future cash flows on any project or decision requiring investment. Widely used, this concept varies in appearance and complexity, from sophisticated models developed by General Electric to the small business owner using the 'NPV' formula in an Excel spreadsheet.

There is another side to this discussion, and it's slightly more personal. The time value of money can apply to you, and specifically, your utility. To understand how, we need to look at things the other way around and get a handle on the incentives of everyone involved.

Think of large personal assets you might have, like a structured settlement. The agreements reached in setting up the settlement left you with a sense of security for the future and continuing, dependable payments over time. Comfortable. Hmm. Let's look at the incentives.


Think like they do. The illusion is that you will be better off down the track with the settlement. The problem is, they don't want you to have all your money now because they understand the time value of money. It's worth more to them, and they bank on the fact that you haven't given it a second thought.

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Remember that structured settlements are designed so that the paying company get the maximum benefit from the time value of money. This doesn't happen by accident or through some amazing act of benevolence driven by concern about your long term well-being. It's pure market and negotiating power. Considering the time value of your settlement, the incentive is for them to keep your money as long as possible to maximize their value growth.

The intent of this discussion is to make you think. Consider the time value of money in your personal life. How much value is there for you in holding first-mortgage on a property for **20** years, compared with maximizing your utility? How much utility is your monthly settlement check going to provide you in 10 years? Just think about increases in the cost of living over the next fifteen years, and how the monthly check stands up.

Avenues exist in today's marketplace for you to better utilize these high-value assets like structured settlements and real estate notes. . Naturally, decisions to do so should not be

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taken lightly, treating your largest assets as whimsically as an ATM card. Whether in business or in your personal life, always consult a diverse range of industry professionals to increase the amount of information and knowledge brought to bear on any decision. As mentioned at the start, risk management is an important part of any decision making process.

Remember the time value of money. It can be used both for and against you. And find out which way it is being used, just look to which party has the larger incentives.

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Our commitment is to making the global local, we are **GLOCAL!**

At **Dawgen Global** we help you make Smarter and More Effective Decisions

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