STRAIGHTENING OUT WEALTH MANAGEMENT™

Insight 36: If I were a rich man…

We tend to assume that wealth is accumulated over time, often growing fastest in the later working years. Yet, in a broader sense, we are all born with wealth in the form of human capital, which represents the value of the earning potential that we have over our working lifetime. As younger people have a long time to go before they will need the money, the advice they receive is often that excess earnings should be invested predominantly in equities. A subtler approach takes into account the attributes of each person's human capital which ranges from bond-like to equity-like in nature. How assets are invested should, ideally, take this into account. Cash-flow modelling can help those in the accumulation phase of investing to understand the financial impact of changes to their human capital. Owning sufficient life cover to protect the outstanding human capital should be an important part of the discussion.

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We are all born rich

Most of us have held a newly born child – our own perhaps, or that of a relative or a close friend – and in its fragile, dependent state wondered what life has in store for him or her. We perhaps frame these thoughts in terms of the current state of the world and the tough climate for young people struggling to get onto the housing and jobs ladder. According to the Resolution Foundation[1], the younger generation is the first in living memory to be worse off than their parents. Yet perhaps we should frame our thoughts in a more positive manner, starting with how rich every child is at birth.

We tend to see wealth as accumulated financial assets, large houses, nice cars and the freedom and time to do the things that are important to us. Yet on the very day we are born we are wealthy in terms of our *human capital*, or in other words, the present value of all the future earnings that we can accumulate over our working lives. Part of those future earnings is turned into financial assets, which ultimately deliver income in our retirement.

From a financial perspective our lives can be divided into three distinct phases:

- Phase 1 – growing up and getting educated: this phase is of enormous importance to our financial lives; there is plenty of evidence to show that investment in education at a tertiary level can have a big impact on future earnings. Investing in education may well have a far larger impact on wealth than the rate of return achieved if the money spent was invested instead.
- Phase 2 – working: this phase presents investors with a range of choices, not least how to invest excess earnings and protect their human capital from sickness or even premature death.
- Phase 3 – retirement: this phase possesses its own challenges, particularly how to invest assets to deliver stable retirement income, without running out of money.

Today, investors have to take far more responsibility for their financial assets than ever before and maybe need to think a little more deeply and subtly about how to structure their investment assets.

Today is not like yesterday

Up until the mid-1980s the conversion of human capital into retirement income was far more straight forward and considerably less risky than it is now, as companies offered their employees generous defined benefit pensions, i.e. a percentage of final salary that would be paid monthly on retirement, usually with some form of inflation protection. This income, coupled with the state pension, provided a stable, inflation-proofed, risk-free income for life. Excess earnings could be squirreled away into extra savings, paying down debt quicker or the purchase of a second home. Today, £50,000 of inflation-proofed income, purchased at age 65, would cost over £1.5 million via an annuity. Rejoice if you have a defined benefit pension!

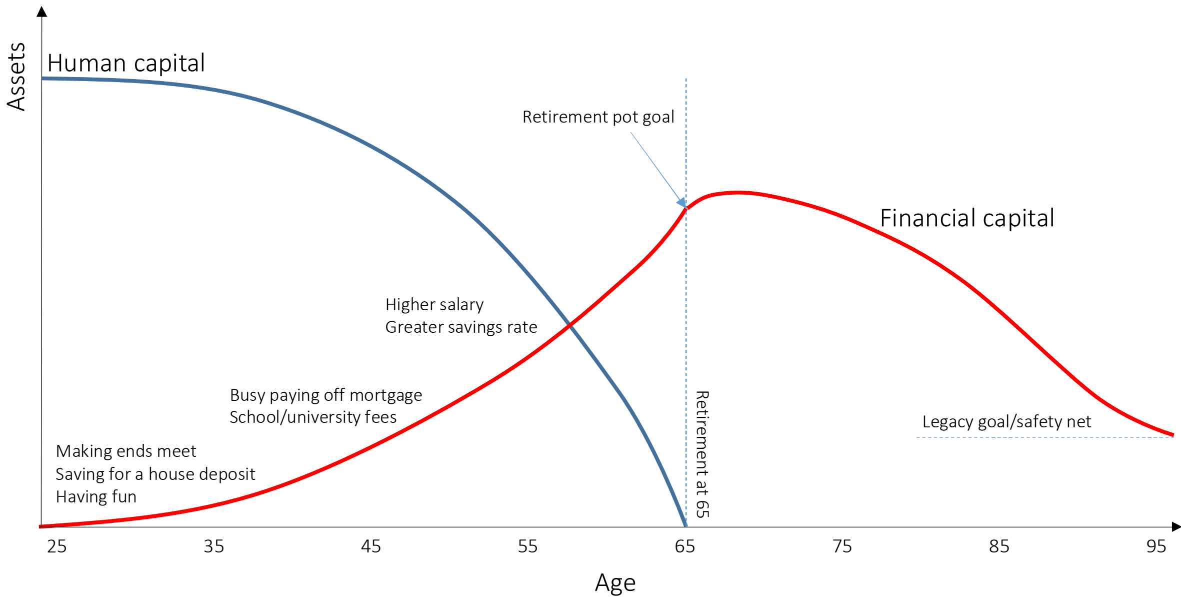
However, for those still working today – and some more recently retired - such income security does not exist. The demise of defined benefit pensions – a sad story of government and corporate mismanagement – is too long a subject to be explored in this short note. However, the impact of these changes, including the transfer of income risk from corporations to the individual, combined with a more flexible, fluid and entrepreneurial work environment are worth noting. These changes have a material impact on the process of turning human capital into financial capital. How one invests these assets, protects the value of human capital and secures a stable retirement income matter. These are not easy decisions to make without the help of a good financial planner.

[1] Resolution Foundation (2016), Millennials facing 'generational pay penalty' as their earnings fall £8,000 behind during their 20s, www.resolutionfoundation.org

Human capital slowly converts into financial capital across a working life

At the start of a person's life, human capital represents the major part of his or her total wealth, when wealth is viewed in this broader context. As they progress through their working lives, some of their earnings will be converted into financial assets in the form of payments into defined contribution pensions (by employer and employee), other investments and a family home. At retirement, human capital is exhausted, unless the retiree does some part time work. Financial assets then take over the financial burden of delivering income, supplemented by other sources such as a state pension and rental income, if they exist. The schematic below illustrates this relationship in a generic form.

Figure 1: Human capital, financial capital and total wealth



Source: Albion Strategic Consulting

It is interesting to note that in many instances, toward the end of a person's life, residential property may well be the principle asset, as other financial assets have been depleted.

Careers can be bond or equity-like

When it comes to saving and investing for retirement, i.e. the accumulation phase as it is sometimes known, advice has often been quite generic suggesting that as the investor has a long time horizon, they should invest more in equities to obtain a higher rate of return than holding bonds or cash. In general that makes sense for many. However, the risks associated with each person's human capital will vary widely. This is plain to see looking at three different career paths:

- Low risk: A tenured professor at a university has great job security and a regular, inflation-linked income that will rise in a predictable manner. Her or his human capital acts like an index linked bond.
- Higher risk: A salesperson, whose high remuneration is based on commission, and who faces the threat of being fired if targets are not met, has higher earnings risk. His or her human capital acts more like a high yield (lower quality) bond, delivering strong returns when times are good but doing poorly when times get tough.

- High risk and correlated: An entrepreneur launching an online retail equity trading platform has even more earnings risk. His or her income and rewards are both variable and uncertain and, more importantly, income is likely to be correlated with equity markets. Human capital, in this instance, acts like equity.

So, if they are all 40 years old and have the same level of financial capital, should they all invest in the same way? Intuitively, the answer is no. As Burton Malkiel stated in his seminal book *A Random Walk Down Wall Street*:

"The risks you can afford to take depend on your total financial situation, including the types and sources of your income exclusive of investment income"

Those with more bond-like human capital could well take on more risk and those with more equity-like human capital should, perhaps, take on less risk with their financial capital. Ironically, it is also possible that those who choose steady, stable jobs may have lower tolerance to losses than the entrepreneur, and vice versa. One can see the risk of this scenario. Additionally, two partners may also have different levels of risk in their human capital. Imagine a professor married to an entrepreneur; together they form a balanced portfolio between bonds and equities and their investable portfolio of financial capital should reflect this.

Figure 2: How human capital attributes influence asset allocation

Lower equity content in portfolio	Higher equity content in portfolio
Low job and earnings stability	High job and earnings stability
Low earning flexibility	High earning flexibility
High correlation of earnings to equities	Low correlation of earnings to equities
Low earning capability	High earning capability (replenish losses quickly)

Source: Albion Strategic Consulting

In effect, investors should invest their financial assets in a way that provides balance to, and diversification of, their human capital during the accumulation phase. In some extreme circumstances, it might be necessary to adjust an investment portfolio to avoid the specific industry risks that relate to a client's human capital.

"Human capital should be treated like any other asset class; it has its own risk and return properties and its own correlation with other financial asset classes."

Ibbotson, Milevsky, Chen and Zhu (2007)[2]

As an example, one of the saddest outcomes of the Enron collapse in the US in 2001 was the fact that many Enron employees held Enron stock in their pension plans making their human and financial capital highly correlated with devastating consequences.

[2] Ibbotson, Milevsky, Chen and Zhu (2007), Lifetime Financial Advice: Human Capital, Asset Allocation and Insurance, Research Foundation of CFA Institute publication.

Protecting human capital risk

As part of a comprehensive financial planning process, two key forms of protection exist that will need to be discussed. The first is protecting human capital using income protection and life insurance. The second is protecting retirement income through the purchase of annuity. The astute reader will spot the fact that these are exact opposites; one is a bet on dying early and the other is a bet on living a very long time.

Purchasing life insurance, which is a perfect hedge for human capital risk, needs to be modelled based on the outstanding level of human capital, which reduces with time as human capital is converted into financial capital. Fortunately, when most life insurance is needed (young and with a family), it is relatively cheap to obtain. In a simple sense, the life insurance cover needs to fill the gap between accumulated financial assets today and the target level of assets at retirement.

Conclusion

The true value of cash-flow modelling by a financial planner is the ability to take both human and financial capital into account and to run a number of scenarios for each. It is difficult to see how a stockbroker or investment manager can structure a portfolio sensibly, particularly where the investor still has substantial human capital, without the insight into, and modelling of, the client's total asset picture. No financial portfolio is an island.

The next time you hold a baby, remember just how valuable and unique he or she is in so many ways, not least in terms of human capital.

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