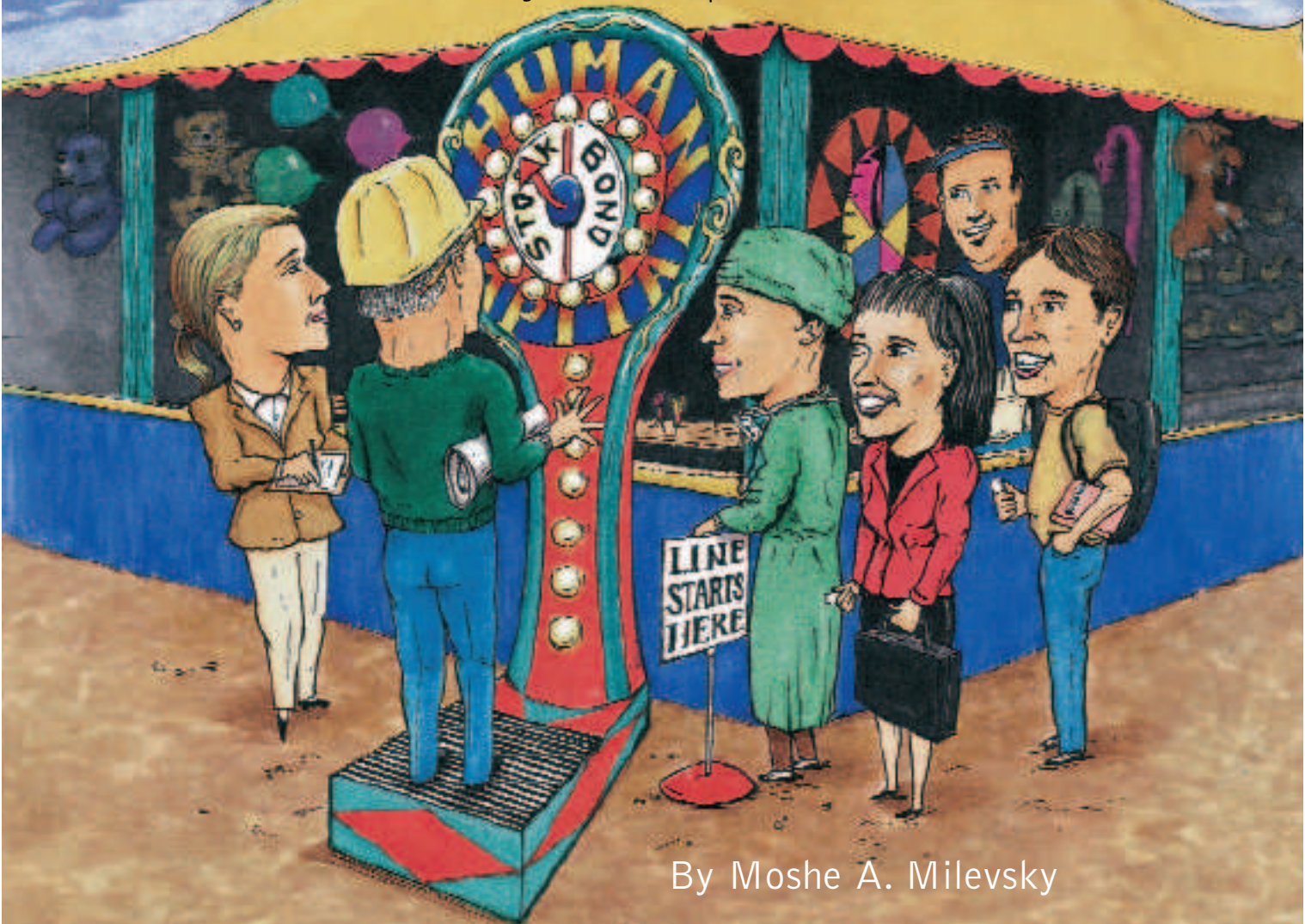


Is YOUR Client A BOND OR A STOCK?

Consider the current value of your clients' human capital when constructing their financial portfolios.



By Moshe A. Milevsky

No, there isn't a typo in the title. I'm not asking about whether your clients own stocks and bonds, or whether they work in the stock or bond market. Rather, I'm wondering whether your client's human capital exhibits the financial characteristics of a stock or a bond. Because, if they are stocks, you should be encouraging them to lighten up on the risk and hold more bonds, but if they are more like bonds, then you should be selling them more stock-like investments.

I'll explain shortly, but first some background. According to Statistics Canada, in 2000 the average Canadian family unit whose head of household was 30 years old had a median net worth of approximately \$47,000. If the head of household was 40 years old, the median net worth of the family unit was \$96,000 and for 50-year-olds the relevant figure was \$165,000. There should be no surprise about the impact of age on median wealth.

Illustrations by David Rolfe



It's not the magnitude of income or the stability of the job that determines human capital's asset classification. Rather, the objective is to make sure your salary and financial portfolio do not share the same zigs and zags.

While I certainly do not quibble with Statistics Canada's methodology in this and similar studies, I truly think that a traditional account's "assets minus liabilities" view of the human balance sheet greatly underestimates the true economic net worth of your client—the company I like to call Me Inc.

Here is some news: Your client is actually much wealthier than Statistics Canada is willing or able to admit. In fact, the younger your client and his family are, the more underestimated is their wealth. For the majority of Canadians, especially the educated and potentially affluent ones, the greatest single asset on their personal balance sheet is not being measured by Statistics Canada—human capital.

Human capital is a measure of the present value of your client's future wages, income and salary (net of any future income taxes and expenses). For example, if she is a doctor, lawyer, engineer or even a professor, she has probably invested an enormous amount of time, effort and money to finance her education. That investment will hopefully pay off over many future years of productive labour income in the form of job dividends over the next 10, 20 or even 30 years. Sure, clients can't really touch, feel or see human capital, but like an oil reserve deep under the sands of Alberta, it will eventually be extracted and so it's definitely worth something now. In fact, any and all companies operating in the natural resources sector spend considerable time valuing the reserves they will be extracting and processing over their operating life. You and your clients should do the same with their reserves.

During the course of your clients' working lives, they will convert human capital into financial capital. Thus, their total personal equity is the sum of these two components. When a family unit is still young, their human capital is a much larger

fraction of total personal equity, since the present value of all their future wages most likely exceeds the few dollars they might have in their savings account. As they age the situation is reversed and their human capital begins to diminish.

You might be wondering what good it is knowing the value of a human capital reserve if you can't do much of anything with it right now. In fact, you can't really borrow against it from the bank, in contrast to most corporations that can borrow against proven and established reserves.

There are quite a number of applicable strategies that come from thinking about your client's balance sheet in this economic manner.

Portfolio Diversification: You should make sure your clients' total (i.e., human and financial, capital) portfolio is properly diversified. In simple words, when one type of capital zigs, the other should zag. In the early stages of the life cycle, financial capital and investment should be used to hedge and diversify human capital. Think of clients' investable assets as a defence against adverse salaries and wages as opposed to an isolated pot of money that has to be allocated.

For example, if you took a look at my financial portfolio, you would see that my RRSP and discretionary savings are quite heavily invested in individual equities and mutual funds. And for good reason. As a tenured university professor, my human capital—and the subsequent pension I am entitled to—has the identical properties of a fixed income bond fund with monthly coupons. I am truly a walking inflation-adjusted real return bond. Therefore, I have very little need for fixed income bonds, money market funds and GICs in my financial portfolio. As a result, my total portfolio of human and financial capital is well-balanced, despite the fact that individually my financial capital and human capital are not.

Continued on page 25

Continued from page 23

In contrast, my MBA students might earn a lot more than their university professor during their lifetime, but from year-to-year their relative income and bonus will fluctuate depending on the performance of the stock market, the industry they work in and the unpredictable vagaries of their labour market. Their human capital is almost entirely invested in equity, and so their financial capital should consist primarily of bonds and GICs early in their working career.

Sure, it may seem odd to advise financial analysts and experts in the securities industry to not “put their money where their mouth is,” but in fact, it is prudent risk management. I would go so far as to disagree with the famed investor and stock market guru Peter Lynch and argue that you should not invest in things you are familiar with, but rather invest in industries you know nothing or very little about. Of course, I am not advocating ignorance when it comes to picking investments—and

proper due diligence is a fiduciary responsibility no matter where you put your money—but in all likelihood industries and sectors you know and care little about are outside the financial sphere of your human capital. These are wonderful diversifiers.



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M O S H E A . M I L E V S K Y

ASSOCIATE PROFESSOR, YORK UNIVERSITY

Remember, it’s not the magnitude of income or the stability of the job that determines human capital’s asset classification. Rather, the objective is to make sure your client’s salary and financial portfolio do not share the same zigs and zags. If the client works in the biotech industry, make sure she owns tech stocks, and if she works in media, make sure she own some natural resources.

Furthermore, if you think of the flexibility involved in the decision of when to retire or whether to work overtime, then you can extract more human capital if and when needed to offset losses from your financial assets. This is yet another argument why younger investors and savers who are many years away from retirement can afford to take more financial risk and invest in more volatile instruments. If things don’t work out, they can always work more.

Employment Compensation: Once your client is willing to accept his human capital as having financial risk and return characteristics, then ongoing employment compensation should attempt to balance and smooth out the ups and downs. For example, loading up on company stock and options is not the best way to manage the

Continued on page 26

THE BALANCE SHEET OF ME INC.

Examine the value of your client’s human capital in relation to their true net worth.

<p>ASSETS</p> <ul style="list-style-type: none"> • Bank Accounts • Housing • Stocks & Bonds • Car & Vehicles • Small Business Equity • Present Value of Pension <p>+ HUMAN CAPITAL</p>	<p>DEBT + LIABILITY</p> <ul style="list-style-type: none"> • Mortgages • Consumer Loans • Credit Cards • Student Loans
	<p>TOTAL PERSONAL EQUITY</p> <ul style="list-style-type: none"> • True Net Worth



Sure, they won't get a quarterly statement saying that their human capital is worth 30% more than it was last year, but you should definitely remind them!

Continued from page 25

risk of the personal financial corporation since such a large bulk of human capital is already invested in the company. It is imprudent to take on even more exposure.

Life Insurance: If you take a holistic view of your client's balance sheet, then prudent risk management becomes an exercise in protecting human as well as financial capital. Just like financial capital and human capital would counterbalance each other, life insurance should be viewed as a hedge against a loss of human capital. Basic insurance shouldn't be acquired as an investment, rather it should be purchased for its correlation properties. If something happens to human capital, the insurance will pay off, but if nothing bad happens to human capital, the insurance will perform poorly. I believe this is a better (and more honest) way to explain, promote and sell all forms of insurance to individuals who likely view the premiums as money poured down the drain. They purchased a hedge, not an investment.

The concept of human capital is a powerful one that can guide many financial decisions. Overall, it educates and forces us to

move away from micro-finance decisions—such as where should I invest my RRSP contribution?—to the more critical macro-finance questions, whose answers truly add value to clients.

Indeed, if you carefully measure the change in the typical Canadian's personal balance sheet during the last few years, you will find that the gut-wrenching bear market of the early decade did not erode total personal equity as much as you would expect. Properly diversified personal financial corporations did not lose anywhere near the 30% to 50% their isolated investment portfolio suffered. To counteract these losses, note that housing prices increased in value and long-term interest rates declined from 8% to 5%. Remember that market prices of bonds increase and perform quite well when interest rates decline. And if your client's human capital can be viewed as a bond-like investment, then it has actually increased in value as interest rates have declined. Sure, they won't get a quarterly statement saying that their human capital is worth 30% more than it was last year, but you should definitely remind them!

Human capital is definitely an asset class and should be considered in every financial plan. Next time you sit down to tinker with a new or existing client, here is a novel question to break the ice: "Are you a bond or a stock?" **AE**

Moshe A. Milevsky, Ph.D., is an associate professor of finance at the Schulich School of Business at York University and the executive director of the IFID Centre at the Fields Institute in Toronto.
