Chapter One

# Our Finances Are Bigger than a Brokerage Account

## *Pondering the Paycheck in the Mirror*



THINK BIG. Really big.

Ask folks about their financial lives and they might mention their 401(k) retirement savings plan, their bank accounts, and their mortgage. But in truth, our financial lives are far, far larger. How large? Wrap your brain around these four contentions:

1. The retired teachers around the corner shouldn't have nearly so much in bonds, and certainly far less than the retired lawyers who live next door.
2. Your penniless 22-year-old niece is a millionaire and she should diversify by investing heavily in stocks.
3. Your real estate agent may be super-savvy when it comes to the property market, but that doesn't mean she should buy rental real estate.
4. Your brother-in-law is betting on stocks with borrowed money and he doesn't even know it.

Puzzled? To understand what's at issue here, consider everything you own—and everything you owe.

## Taking Stock

As you tote up your assets, your thoughts probably turn first to things like your savings account, individual stocks and bonds, mutual funds, and real estate. But don't stop there. You would also want to include your Social Security retirement benefit and any pension you're entitled to. When you and your spouse die, your Social Security and pension may cease to have any value. But while you're alive, these two assets are like enormous bonds, kicking off heaps of regular income. A fixed monthly pension is similar to a conventional fixed-interest bond, generating the same income every year. Meanwhile, Social Security, in its current form, is like owning a big inflation-indexed bond, delivering a stream of income that rises along with inflation.

That brings us to our retired teachers, who receive pensions for all of their years of service in the local school district. If those pensions cover much or all of their living expenses, they won't need much income from their conventional investment portfolio, thus freeing them up to invest more heavily in stocks. Stocks don't kick off as much income as bonds and they involve considerably more risk, but they also potentially deliver higher long-run returns.

In fact, investing heavily in stocks will diversify our retired teachers' bond-like pensions and it could salvage their standard of living later in retirement. The reason: If their pensions are fixed, the spending power of that monthly income will decline over time as inflation takes its toll. Later in retirement, they may find their pensions no longer cover all of their living expenses. But if they took the precaution of investing part of their portfolio in stocks and leaving it to grow, they may amass a handsome nest egg that'll help sustain their lifestyle in their later years.

By contrast, the retired lawyers next door aren't entitled to a pension. Instead, to cover their living expenses, they will need to rely on their savings and Social Security. To ensure they have a reasonably reliable stream of income, they might hold a fairly standard retirement portfolio, with maybe half their money in bonds and half in stocks. During their working years, the lawyers may have invested their savings more aggressively, with a hefty percentage stashed in stocks and only a modest sum in bonds. But back then, of course, they didn't need income from their portfolio, because they had regular paychecks coming in.

Think of these regular paychecks as the return on human capital, possibly the most overlooked asset. This is the reason your penniless 22-year-old niece can consider herself a millionaire. She is like an enormous bond that will likely generate income for the next four decades—a bond that might easily be worth $1 million. As your niece considers how to invest her savings, she doesn't need yet more income. Instead, what she needs is long-term growth, so that one day she can afford to retire. With that in mind, and also to diversify her big "bond" holding, your niece might invest heavily in stocks. But as she approaches retirement and the waning of her human capital, she'll probably want to follow the lead of the retired lawyers, cutting back on stocks and adding to her bonds. See Exhibit 1.1.

**EXHIBIT 1.1 You, Inc.**

*As you think about how much you're worth, here are some assets and liabilities to consider.*

| Assets | Liabilities |
| --- | --- |
| Human capital | Paying for retirement |
| Home | Children's college |
| Stocks | Other goals |
| Bonds | Mortgage |
| Bank accounts | Student loans |
| Pension | Credit-card debt |
| Social Security | Auto loans |

Not everybody's paycheck is like a bond. If you're a salesperson paid on commission, an employee of a financially troubled company, an actress who works sporadically, or an executive whose annual income varies widely because of an unpredictable bonus, your income is less bond-like and you may want to stash more of your savings in bonds, certificates of deposit, money-market funds, and other conservative investments. That will give you assets that can be easily sold if your income proves lower than expected.

Even if you're confident your job is secure and your income will cover your living costs, and you are therefore comfortable taking a fair amount of risk with your savings, you should think carefully about the type of risk you take. For instance, your real estate agent may be inclined to buy rental real estate, because she's well versed on the property market and she figures that that will give her an edge. Similarly, Silicon Valley workers might be tempted to invest in the hot new technology company they heard about, oil company employees might purchase energy shares, and almost everybody considers buying their employer's stock. Yes, some employees receive shares as part of their compensation. But many others choose to invest heavily in their company's stock. Buying what we know can be enormously comforting.

But in these examples, it might not be smart. What if the real estate market implodes, the technology sector craters, oil prices plunge, or our employer gets into financial trouble? In each situation, we're looking at a potential double whammy—both losing our jobs and losing our savings.

## Living with Leverage

To complement your new, expansive view of your assets, aim to adopt a similar approach to your liabilities. Your liabilities aren't just your mortgage, student loans, credit card balances, and auto loans. They also include the cost of your goals, such as buying that next car and paying for your children's college education.

Maybe more important, there is the cost of your retirement, which is the key reason you need to save and invest during your four decades in the workforce. I hate to reduce the broad sweep of our lives to a grim calculus involving dollars and cents. Still, from a purely economic perspective, our working years can be viewed as a period when we amass financial capital so that one day we can live without the income from our human capital. Your niece's income-earning ability may be worth more than $1 million. But that's just as well, because that seven-figure human capital will come in handy as she seeks to amass a seven-figure retirement portfolio.

Taking a broader view of your finances can bring some startling insights—and some ways to improve your finances. Remember your brother-in-law, who is investing in stocks with borrowed money and doesn't know it? We all engage in mental accounting, associating the mortgage with the house and the auto loan with the car. But once we have these debts, they leverage our entire finances. Let's say your brother-in-law has a $300,000 home, $150,000 in stock funds, and $50,000 in bonds and other conservative investments. Meanwhile, his debts include a $225,000 mortgage, a $20,000 car loan, and $5,000 in credit card debt. What he effectively has is $500,000 in real estate and investments, but half of it is bought with borrowed money, so his net worth is only $250,000.

This sort of leverage lets us own more stuff than we can currently afford. It works best when our investments earn returns that are higher than the interest rate we're paying on our borrowed money. But leverage can also bite when things go wrong, sharply worsening our losses. If your brother-in-law's bonds held steady at $50,000, but his home slipped in value to $240,000 and his stocks slumped to $110,000, his total assets would drop 20 percent from $500,000 to $400,000. That might seem grim. But what's really grim is the hit to his net worth, which would plunge 40 percent from $250,000 to $150,000.

Even without a market decline, leverage can sting. Your brother-in-law's bonds might be yielding 5 percent, while his credit cards could be costing 14 percent. The implication: Your brother-in-law should probably cash in $5,000 of his bonds and use it to pay off his credit card debt. That would reduce risk by trimming the amount he's borrowing and simultaneously save him money.

Indeed, bonds and borrowed money can be viewed as mirror opposites. One pays you interest. The other costs you interest. You might even think of borrowed money as a *negative bond.* Your brother-in-law may assume he is being pretty conservative, because he has $50,000 in bonds. But thanks to his $250,000 in debts, his net bond position is a negative $200,000 and he is forking over a lot more interest each month than he's earning.

That doesn't mean your brother-in-law is taking too much risk. After all, if he has a paycheck coming in, he may have no problem servicing his debts. But as your brother-in-law approaches retirement and considers buying more bonds in his portfolio, he should probably also look to pay off his debts. That way, when he retires and no longer has a salary coming in, he will be earning a lot more interest than he's paying.

## Street Smarts

- If you have a long time to retirement and a secure, steady salary, consider diversifying this bond-like income by buying stocks.
- Don't double risk by investing heavily in the economic sector that provides your paycheck.
- Borrowing allows you to own more stuff than you can currently afford—but it will exacerbate your losses during market downturns.