SECTION I

Every Family Needs a Chief Financial Officer

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CHAPTER 1

Why Do I Need a CFO? I Don't Even Own a Business

Growing up, my brother, Dave, and I developed different attitudes and behavior about money. Dave's nickname was Spendsworth, given to him by our grandfather because, as Grandpa said, "He spends what he is worth." Dave supported his carefree spending because he always seemed to have some sort of job. Making money wasn't the hard part for him; holding on to it seemed to be. Like any good younger brother, I took the opposite tack. I, too, had many jobs—newspaper deliverer, farmhand, babysitter, Christmas tree trimmer, and stationery salesman, to name a few. But I saved almost everything I earned, made some investments with my father's help and even loaned some of it out to poor Spendsworth at usurious interest rates.

While most of these youthful habits have stood me in good stead, they haven't exempted me from the sometimes scary financial decisions and challenges that come with becoming an adult. In my twenties, I resigned an Army commission to go to Harvard Business School just as my wife, Michele,

became pregnant with our first child. While the opportunity to attend Harvard was exciting, it came at a high cost. Boston was much more expensive than we anticipated, and the job Michele got at Harvard barely covered child care and housing. Because I had some modest savings, I wasn't eligible for financial aid. For the next two years, we depleted my savings and borrowed heavily to pay for school, fund living expenses, and carry a monthly mortgage on our previous house, which we ultimately sold for a $50,000 loss. As my savings dwindled, so did much of my confidence, replaced by the humility and sense of helplessness that many families experience in the face of financial hardship.

Even when I was a newly minted MBA, the financial losses continued. We had to borrow money from a family friend to move to New York, where we spent our first night sleeping on the floor, sweating with no air conditioning in the city's summer heat. Lying there, feeling more than a little defeated, I realized that in spite of a lot of effort and hard work, bad financial decision making had put us in this precarious situation. I was still managing our finances as I had as a young single man. It would take another decade of more learning and more mistakes to make sense of how my everyday life decisions fit together financially into the precepts for success on which this book is based.

Many of us go to great pains to separate our work life from our family life, and to leave "business" out of the family equation. But doing so diminishes our ability to make sound decisions about our financial future—and the financial future of each of our family members. What I'll introduce in this chapter, and elaborate on in the chapters that follow, is how to apply the business principles of corporate finance to your own personal wealth management decisions.

Asset and liability management, practical financial statements, control of risks, asset allocation, tax planning—all are tools in the world of corporate finance that help companies achieve their goals. And there's no reason these techniques can't be adopted for your personal use. Every business has a CFO—a chief financial officer—and every family needs one.

Though few people think about it this way, everybody owns not just one but two distinct businesses: a temporary labor business and an asset management business, which together comprise Family Inc.

1. Your temporary labor business. Each of us is born with a finite amount of labor potential to be harvested over a lifetime. Regardless of whether you are an employee in a large company, a soldier in the Army, or a small business owner, in all cases you are in the same

basic business—converting your labor into money. Like natural resources such as coal, natural gas, or gold, your labor potential is finite and is depleted over time. As part of a family, it's not just your own labor you need to consider, but that of your family members as well. The financial objective of your temporary labor business is to convert your labor into financial assets as efficiently as possible. In any job, your temporary labor business sells your skills and energy.

2. Your asset management business. The second business is an asset management business that manages the assets you have acquired through your temporary labor business or by other means, such as inheritance. These assets might include your home, your savings, your 401(k), and more. Your objective in your asset management business is twofold: (1) manage and enlarge your portfolio of assets; and (2) produce adequate cash flow to support both your consumption needs—everything from groceries, clothes, and car expenses to recreation—and investments to further your labor business, such as my return to graduate school for further education that enhanced my earning power.

These businesses are complementary and interdependent, and they must be managed in a coordinated manner. Your objectives as CFO in managing these two businesses can be simplified into three basic goals:

1. Provide adequate cash flow to support your spending, now and in the future, while allowing necessary investments to enhance those two businesses of yours: labor and asset management.

2. Maximize your "Family Inc. Net Worth"—the sum of your labor and financial assets after taxes.

3. Manage your legacy by maximizing what you can leave to family members (and their ability to manage these assets) or to worthy causes. While this goal is worthwhile, it is a distant third in priority. You can't do number 3 without first accomplishing both 1 and 2.

To illustrate the interaction between these businesses over time, let's take a simplified snapshot of one young man's current financial situation, encompassing all the assets he has to work with, which include estimates of future compensation for his work, future returns on his investments, and future

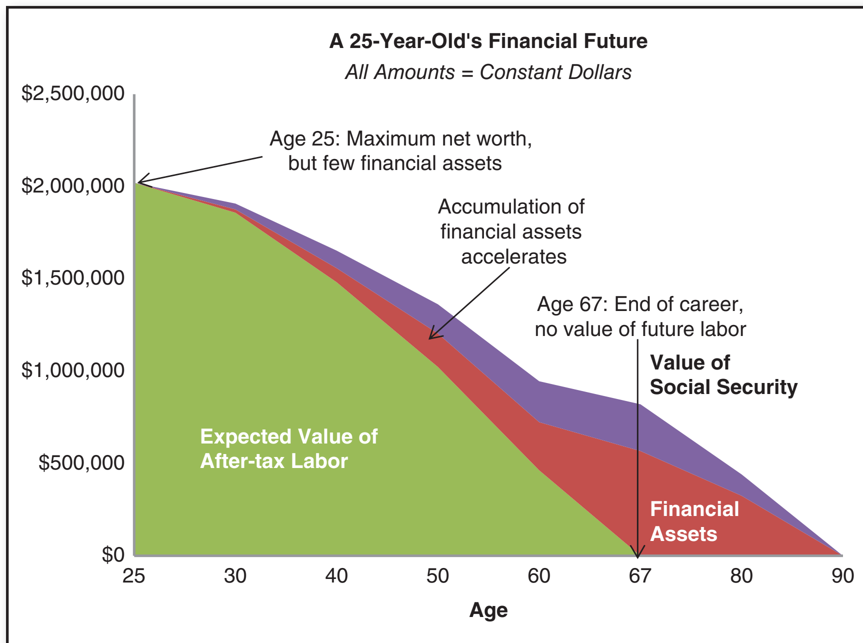

FIGURE 1.1 The Three Parts of Family Inc. Net Worth and How They Evolve Over Time

Social Security payments, based on assumptions that are reasonable today.* Throughout this book we present examples like this one that illustrate key concepts by representing common circumstances. Tools to personalize the examples to fit you and your family can be found at familyinc.com.

These assumptions allow us to generate the holistic view in Figure 1.1 of the young man's projected Family Inc. Net Worth over his lifetime, including the value in today's money (that is, 2016 dollars) of the expected future assets generated by both of his businesses after all of his spending. For example, Figure 1.1 shows that at age 25 he estimates his *expected lifetime labor value* (compensation for his work,

*The assumptions: He is 25, has no financial assets—or liabilities—and a starting job that pays $44,500 per year, the average salary for college graduates in 2013. We assume he will work for 42 years. As his skills develop, he expects his salary will grow at 2.0 percent annually in *real* terms (adjusted for inflation) through his retirement at 67. His annual contributions to taxes, Social Security, and other required deductions approximate 30 percent of his gross salary. He saves and invests 10 percent of his after-tax salary throughout his career and estimates his investments will provide an annual return of 5.0 percent after inflation, fees, and taxes. Today's Social Security eligibility rules apply with an assumed benefit equal to the average 2014 benefit for a single-income earner. He plans to consume all his savings during retirement through level, inflation-adjusted annual consumption through age 90—the financial equivalent of a 23-year annuity.

shown in green) at about $2 million. (For details on how to calculate expected lifetime labor value, see the Appendix.) By age 40, as the chart indicates, he will have received almost $500,000 of that value, so his remaining labor value has shrunk to $1.5 million. However, that $500,000 of used-up labor has funded his living expenses for the past 15 years while also allowing him to accumulate over $75,000 in savings and other financial assets (shown in red). By age 40 he has also paid enough into Social Security to earn some $95,000 in expected future Social Security payments (shown in purple). By age 67, he will have retired, so he'll have no remaining earnings—he depleted the $1.5 million of potential earnings over the 27 years since he was 40—but his financial assets have increased to about $570,000 and his expected Social Security payments to more than $250,000. At 67, he will have to use these assets to support his spending for the rest of his life.

As Figure 1.1 demonstrates, Family Inc. Net Worth embodies three key components: (1) the value in today's money of expected after-tax labor income; (2) the value in today's money of after-tax future Social Security benefits; and (3) net financial assets (financial assets minus financial liabilities). In summary, the family converts labor into money and future Social Security payments during working years so it can use these assets to fund consumption during retirement.

This graphic is oversimplified, and the assumptions, based on today's realities, are certain to be off base because circumstances will change. Yet the concepts, insights, and planning tools that it facilitates remain powerful. First and foremost, this 25-year-old has an estimate of what his future financial life might look like if he doesn't go back to school. If, however, he were thinking of leaving his job to go to law school, he could modify these assumptions to reflect the impact of becoming a lawyer and compare the two scenarios. Figure 1.1 highlights several concepts that we will explore in greater depth throughout the book.

Family Inc. Net Worth is an expanded definition of net worth (all your financial assets minus all your liabilities) that includes as assets the value today of anticipated lifetime after-tax income and Social Security benefits. Including these as assets highlights several critical principles:

- For most people, future earnings from work are the largest asset, so the greatest net worth is achieved at a time when financial assets are minimal. This dramatizes the *opportunity cost* (the value you give up to get something else) of wasted labor, unemployment, or "excess" schooling, as well as the negative implications of failing to save or invest some of your wages. It shows that if our 25-year-old does pursue a law degree, to make this a good *financial* decision he'd better earn enough more in his new job to compensate him for his school costs and his lost earnings while studying.

- In the later years of your Family Inc., success is driven by the power of increased earnings and compounding financial assets. Figure 1.1 shows it takes this man about 25 years to accumulate $180,000 of financial assets, but in the next 17 years, those assets more than triple to about $570,000. For your financial assets to benefit from this exponential growth, you must start the saving and compounding process early. Delaying savings until later in adulthood puts you at a substantial disadvantage in the quest for financial security.
- Money management skills are a critical and often overlooked precondition for financial security. As Figure 1.1 suggests, savings and capital appreciation represent approximately 20 percent of the total assets available for consumption over a lifetime (including labor and Social Security benefits), yet most people spend significantly less time on managing this part of their business. Do you know anyone who spends 20 percent of his or her professional efforts on personal asset management activities?

In the context of the Family Inc. Net Worth framework, Social Security should be viewed as nothing more than the mandatory purchase of an inflation-indexed annuity that is guaranteed by the government—just another part of your financial asset portfolio.* By itself, this asset will not provide financial security, and future changes in policy are likely to decrease these benefits. Regardless, for most people, Social Security benefits are an attractive asset and an important part of a financial planning program.

While our labor assets are by definition finite—we all die sometime—*capital assets* (investments) can grow without limit and, if managed correctly, can provide a perpetual annuity whose annual gains and income exceed consumption. This is the ultimate accomplishment in achieving financial security because it means you've practically eliminated the risk of outliving your assets.

Assumptions and Reality

Employing this Family Inc. Net Worth framework allows an individual or family to identify the 10 key variables that ultimately influence their financial security. These variables include:

1. Labor wage rates: Salary and bonuses.
2. Labor duration: How long can you work?

* An annuity provides a stream of fixed payments over a specified period; an inflation-indexed annuity adjusts payments over time to reflect inflation and preserve purchasing power.

3. Savings rates: How much of your after-tax income will you save?
4. Consumption profile: How much will you spend?
5. Reinvestment rates: What return can you expect on your money after fees and taxes?
6. Life expectancy.
7. Family inheritance.
8. Tax rates on income, capital gains, and estates.
9. Social Security eligibility and policy.
10. Inflation rates.

While we'll explore the potential impact of all these variables in greater detail throughout this book, note that you can influence items 1 through 7. With the benefit of more information, they can be adjusted over time to help you achieve your financial goals. You have no influence over items 8 through 10, but they also have a significant impact on all business owners and must be considered in your financial planning.

The same assumptions used to develop the Family Inc. Net Worth forecasts in Figure 1.1 can also be translated into a Family Inc. Cash Flow Projection. A Family Inc. Cash Flow Projection represents cash that will be available throughout life to cover living expenses *after* your taxes, planned savings, and debt repayments (if you have any).

Figure 1.2 projects the dollars available, adjusted for inflation, over our 25-year-old's future years of consumption. In the early years, his consump-

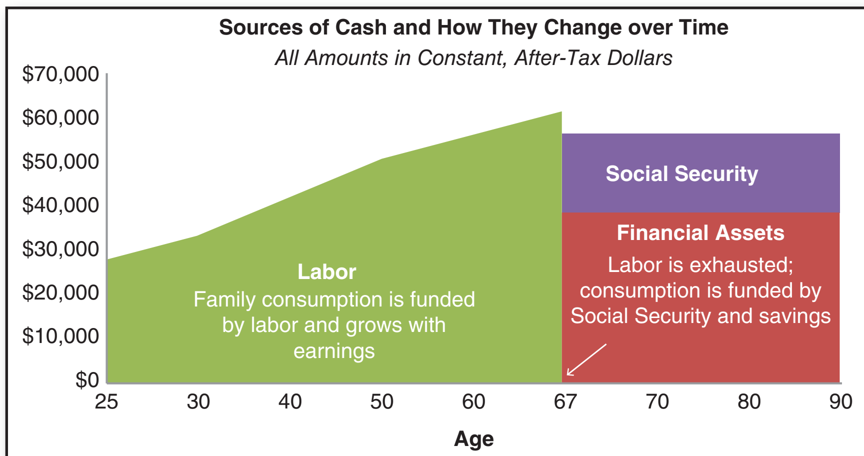

FIGURE 1.2 Annual Family Inc. Cash Flow Projection

tion is funded by his largest asset—labor. As he gets older and his labor is depleted, he has to fund consumption from his financial assets. Figure 1.2 also highlights some of the challenges of managing your businesses in a way that satisfies your family's needs. It's useful because it suggests a spending pattern a person could adopt over time while incurring no debt and saving 10 percent of after-tax earnings, but it's theoretical. In reality, no one's cash flow looks just like this. For example, this Family Spending Profile is often inconsistent with the financial needs of a young family—including mine. At 28, I stopped working and returned to school to pursue an MBA. For two years, my wife, child, and I spent approximately $50,000 annually more than we earned after tax. We maintained consumption that was much higher than our earnings by depleting our limited savings and borrowing money. Later on, to meet my savings goal, we had to consume dramatically less than we earned for several years to make up for this deficit.

Even though my financial assets decreased dramatically, the principles of this book demonstrate that the effect on our Family Inc. Net Worth was positive almost from day one. During my two years in graduate school, our financial assets plummeted to about negative $100,000: I depleted my financial assets to zero and also borrowed $100,000 in school loans to make this major investment in my labor development. However, at the same time, thanks to the value of the degree and the skills and relationships I developed, the expected value of my labor went up dramatically to more than offset the depletion of financial assets. In other words, between ages 28 and 30, my Family Inc. Net Worth increased in aggregate: Financial assets decreased but the increase in labor assets more than made up for that loss.

Families often have greater consumption needs early in their life cycle when they have children and make significant purchases like housing, education, furniture, and automobiles. A Family CFO might choose to use debt to finance major investments such as a house purchase, or change savings rates over time. While these actions make more capital available in the short term, they do so at the expense of future consumption and introduce additional risk into the long-term financial security of the family, so they must be done prudently.

The real world offers other challenges to the theoretical Family Inc. Cash Flow Projection. The amount of spending that can be supported by interest, dividends, and capital gains from investments is sensitive to assumptions about how long family members will live and how investments will perform, both of which are unpredictable and subject to sudden changes. Finally, this profile assumes that retirement and Social Security both start at

67 and that full Social Security benefits are received. Both of these assumptions are uncertain.

Given the uncertainty, a financial plan must include a reasonable cushion against the risk of financial distress or shortfall. The adage that you can't take it with you is absolutely correct, but so is the unfortunate reality that it is all too easy to outlive your assets and become a financial burden on your family.

Many people believe that if they can't accurately predict their financial future, a plan is of little use. In my business, we often joke that there are two types of financial plans: lucky and lousy. I expect *every* financial plan to be wrong. The value in the plan is the discipline of explicitly defining your assumptions and alerting you to changes in these assumptions. A sound financial plan must be dynamic, evolving, and subject to frequent scrutiny with the benefit of additional information. Fortunately, several of the key drivers of Family Inc. Net Worth, such as retirement age, savings rates, and consumption levels, can be modified as needed to address failures in your estimates or your changing circumstances. You have some control over when you decide to retire and how much you spend and save.

But What Does a Family Chief Financial Officer Specifically Do?

We have established the key concept that every family actually owns two distinct businesses, both of which must be actively managed. But we still haven't addressed the specific responsibilities of the Family CFO. While the following list is not all-inclusive, it provides a sense of the responsibilities of the position and some of the topics we cover in the following pages.

Cash management—making sure the family has adequate funds to satisfy short-term cash needs such as monthly expenses, bills, loan payments, and unexpected contingencies.

Balance sheet management—managing the composition of the family's assets and liabilities to balance competing needs for liquidity, tolerable risk, and appreciation.

Income statement management—managing the family's incoming cash, such as salaries, and outgoing cash, such as monthly expenses. This includes developing the family budget and monitoring how actual results compare to the budget.

Family labor decisions and development—managing and investing in labor skills to ensure access to the best employment opportunities.

Risk management—managing risk through effective self or third-party insurance programs.

Asset allocation and investment decisions—developing an asset allocation and investment program customized for your Family Business's needs and your willingness to accept risks.

Managing investments in entrepreneurship—funding family owned businesses to complement your human and financial resources.

Adviser management—managing a variety of specialists such as financial advisers, lawyers, and estate planners to support your financial planning needs.

Tax and estate planning—developing and managing a tax and estate program to minimize liabilities.

Education—teaching your family the lessons and skills of a Family CFO.

Succession planning—creating an environment that allows your heirs to develop as CFOs to perpetuate your family legacy.

These extensive responsibilities of the Family CFO are critical to the financial well-being of the family.

The Big Picture

Long-term trends within the United States and around the world have dramatically increased the need for every family to have a member with the skills and knowledge to adequately manage the family's business interests and financial affairs—a Family CFO. Some influential trends include:

People are living longer. In 1960, the average time between retirement and death for men in America was approximately four years (retired at age 66, deceased by 70). Today, that interval has widened to approximately 16 years. Because of this 300 percent increase, many workers will be required to support themselves with their accumulated financial assets long after they retire.

People change jobs more often. An increasingly global economy and the resulting competition have resulted in a more dynamic business environment with more rapid change and uncertainty for both employees

and companies. Today's young professional is likely to hold more than 10 different jobs over the course of a career. This vigorous job mobility—both voluntary and involuntary—significantly reduces the likelihood of a long-term relationship between an individual and a single employer. The days of a paternalistic employer and lifetime employment are gone.

Fewer people belong to unions, participate in collective bargaining agreements, or have defined-benefit retirement plans. Over the past 35 years, the percentage of Americans who belong to a union or participate in a collective bargaining agreement has decreased by approximately half. Over a similar period, the number of private and governmental defined-benefit pension plans (the traditional plans that promise to pay retirees a set annual amount) has also shrunk by half—and by two-thirds in the private sector. In their place, 401(k)s and other defined-contribution plans, in which the individual is responsible for investment decisions, have about quadrupled. These trends, part of corporate America's attempt to remain globally competitive, have shifted risk from employers to individuals.

The costs of health care and education have ballooned. Access to education and health care is critical to successfully managing Family Inc. However, individuals have little control over these costs, which continue to increase at alarming rates. Long-term inflation in the United States has averaged about 3.4 percent per year. Health care and education costs have increased two to three times as fast.

Funding for traditional government entitlement programs is uncertain. Rising costs for safety net programs such as Medicare, Medicaid, and Social Security, accelerated by changes in demographics that are increasing the number of recipients, are contributing to the overall federal and state deficits. Clearly, these trends are unsustainable, so changes to these programs are likely. Families must prepare for negative shocks.

The financial landscape is getting more and more complex. Half a century of deregulation combined with product innovation and proliferation has multiplied the complexity of financial choices in the areas of credit, investment, and insurance, increasing the need for financial literacy and independence. Examples include:

- Consumer credit. The first plastic charge card with broad retail acceptance was issued in 1958 by American Express. U.S.

consumers today possess some 610 million credit cards, representing almost 3.5 credit cards per cardholder.

- Investment choices. The Securities and Exchange Act of 1936 and the Investment Company Act of 1940 helped democratize the financial markets, allowing the retail investment market to flourish. In 1970, there were approximately 360 mutual funds with $48 billion in assets. According to the Investment Company Institute, approximately 7,600 U.S. mutual funds hold $12 trillion in assets today.
- Insurance products. While the concept of risk sharing or pooling through insurance has been around for centuries, these products have also undergone substantial innovation and growth, with global insurance premiums reaching approximately $4.6 trillion in 2012. The United States accounts for more than 25 percent of global premiums, while representing less than 5 percent of global population. Today's consumer has more than 150 distinct types of insurance to choose from.

These trends have changed the nature of the game. Your grandfather likely worked for one or two companies during his career, and the family's wealth was primarily a product of his cumulative compensation and retirement benefits. The future for today's generation looks very different. The social contract between the employee and the employer will continue to evolve in ways that ensure that companies maintain flexibility to remain globally competitive: mergers, downsizing, eliminating poorly performing employees, and replacing labor with technology. At the same time, employees will benefit from increasing freedom to move among opportunities that offer the best personal development, career progress, and compensation. Employment has become a game of free agency.

While this evolution is scary to some, it's the reality of a global marketplace. For those who embrace this change and systematically develop valuable, enduring professional skills—those who are capable of performing the role of Family CFO and effectively managing Family Inc.—these trends create increased opportunity for financial success and security. Employing the concepts conveyed in this book will provide you with the skills and foundation of knowledge to effectively develop and manage your family's financial well-being amid real world challenges and choices.

Key Conclusions

You are a business owner. Each of us owns two businesses—a temporary labor business and an asset management business. This insight allows the Family CFO to use many of the everyday tools of the world of business to navigate important family decisions such as career choice, retirement, and education.

Most financial plans (and planners) ignore your biggest assets, especially labor. Including these assets in your Family Inc. Net Worth will dramatically change your conclusions.

Your role as the Family CFO is much broader than balancing the checkbook. Your important responsibilities include assisting in career and education decisions, budgeting, investing, managing risk, and retirement planning.

The changes in the world around you are making these skills increasingly necessary.