

Assets must be balanced

COLIN READ, Everybody's Business

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— Are you a stock or a bond?

I heard this analogy recently that compared our human capital to our investment capital. The analogy helps us think about an investment strategy that complements our human assets.

Each of us invests in our human capital, through our education, our lifelong learning and the skills we master over our career. We start off with little human capital and a commensurately low earning capacity. Our earning capacity may peak in our middle ages, and declines if we do not keep up with best practices. We are individually in the best position to realize the fruits of our investments in human capital, and hence are often responsible for our own lifelong education.

Some of us invest in human capital that is fleeting or volatile. For instance, an athlete can have spectacular earning capacity, but can lose this capacity with one severe injury. Others may find employment in a profession that does not pay as well but offers great job security. Still others earn in direct proportion to what they produce. Each of us makes a choice along the tradeoff between reward and job risk.

I have always found it odd that some would begrudge the earnings of others. We each have an opportunity to educate or train ourselves for just about any occupation, and each of us makes informed decisions regarding our career path. We all do the best we can. And the market determines our rate of compensation based on its valuation of the human capital we amass. To compare my human asset and its compensation to another person is to compare apples with oranges. Certainly to believe I am entitled to the income another receives is much like arguing the return on the financial assets of my choosing must be the equal to the return other investors garner.

Our investment in our own human capital reflects our individual desire for return and tolerance for job risk. If we each make a choice about how we want to employ our human capital based on our preferences for both reward and for the volatility or riskiness of the reward, we can compare our investment in our own human capital to our other investment decisions.

We invest in housing capital, which offers a relatively steady (until lately), but unspectacular, return. This investment has the attractive byproduct that it also provides us with housing services. Even so, we balance our home improvement decisions based on our own tastes but also on the tastes of the more generic housing market in case we must someday sell our home. As a consequence, our housing investment is relatively conservative and offers steady, if unspectacular, profits.

Our third investment vehicle is the traditional financial market. There again we balance our individual tolerance for return and risk.

We can use these three investment vehicles, our human capital, our housing capital and financial capital in

complementary ways.

For instance, we can balance our asset portfolio by making riskier, higher-reward financial investment decisions if there is little risk to the flow of our employment income. Alternately, if our human capital is well paid but this pay is risky or not secure, we may want to complement this with financial investments that offer a steady stream of low-risk returns.

And if we have a lot of equity in a home that rises consistently in value over time, we can augment this steady return with greater risks in our employment or financial investment decisions.

There are a few other factors that come into play in the way we construct our human, housing, and financial capital portfolio. Economists have demonstrated that greater wealth provides greater economic security and hence a greater willingness to take risks.

They also suggest that women avoid risk more than men of the same age.

And age itself affects our investment decision. A young person can more easily handle a risky investment decision gone badly. They have an entire financial lifetime to recover.

Contrast that financial resilience to the genuine hardship that occurred to some as financial portfolios fell 40 percent to 60 percent over the past couple of years. Those that were on the cusp of retirement do not have the time for markets to come back. Instead, they are increasingly deciding to postpone retirement. They need a steady and reliable flow of income from their human capital to balance the volatility and losses from their financial capital.

Worse yet, many of those who are well into retirement have seen their nest egg reduced substantially. While a middle-aged person may only modify her consumption slightly as a consequence of the global financial meltdown, a retired person relying almost solely on his financial assets must make much more drastic adjustments.

To capture some of this complexity, financial advisers use the Rule of 110. This rule states that 110 minus your age should give you the amount of your financial assets that can be invested in stock. For instance, I am turning fifty, meaning that 60 percent of my financial assets should be in stock and the remaining 40 percent should be invested in bonds that provide a predictable but modest flow of income.

This rule should be modified to take into account other streams of returns. For instance, one with a very steady job or with good housing equity can afford to choose a different point on the return risk tradeoff. Alternately, those who have more precarious or volatile employment earnings may be better served to choose a less-risky investment strategy.

Even within the category of stocks, there are blue chip stocks that provide a relatively consistent, but perhaps not a spectacular, return but may also consistently pay dividends that can augment employment income. Those seeking a more even flow of income can look for stocks that are the "Old Faithful" type. Alternately, those with secure employment income may look at some of the high-flying technology stocks that can prove to be both highly profitable and highly volatile.

So, as you construct your investment strategy, you must ponder your human capital. Are you a stock or a bond?

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