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Investing around human capital

Michael Kitces | Pinnacle Advisory | 24 September 2015

SUMMARY

Effective investment management requires proper diversification of assets to manage risk and maximise the likelihood of funding client goals. However, the traditional approach for doing so focuses on a client's investment portfolio alone, or perhaps their personal residence as well, but often ignores their greatest asset - their ability to continue earning income through the fruits of their labor, also known as their "human capital".

Just as with financial capital, the value of human capital may rise and fall over time. However, the reality is that human capital for some clients is far more volatile than others. Careers like working for the government, or being a tenured professor, produce human capital that exhibits "bond-like" risk and return characteristics, while more corporate and/or entrepreneurial positions are more stock-like (including the fact that they may be outright correlated to the economic cycle and stock market returns).

Accordingly, effective diversification of the client's entire household balance sheet may entail using financial capital to counterbalance against the risks of human capital - in other words, those with stock-like careers should own more bonds, while those with bond-like careers can afford to own more stocks. Similarly, decisions about savings should recognise that sometimes, investing in human capital can actually produce a greater Return On Investment than saving (even better than buying stocks for the long run!). So, the next time you're working through financial planning decisions with a client, remember to consider whether their career and human capital behave more like a stock, or a bond.

ECONOMIC VALUE OF HUMAN CAPITAL

The concept of human capital draws primarily from the research in lifecycle finance. The basic principle is relatively straightforward - the present value of a client's future earning potential over his/her lifetime is a significant asset and one that can be "converted" into cash flows (income). To the extent that converted human capital supports lifestyle, it is spent. Any remainder is allocated to savings and becomes financial capital.

Over time, as we go through our working years, our human capital is slowly depleted (Figure 1), until the point that we reach the end of our working career, transition into retirement, and no longer have employment earnings. At that point - for better or for worse - we rely on our financial capital to sustain our lifestyle for the rest of our lives.

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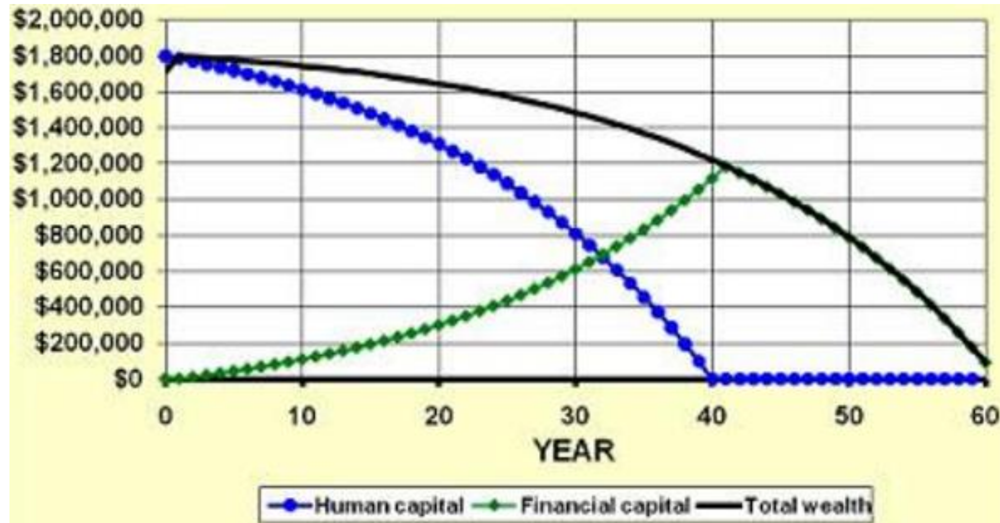
Figure 1: The economic value of human capital



However, the reality is that the conversion of our human capital into consumption and financial capital is not always a smooth process, and the economic value of our human capital itself is volatile over time. Its value ebbs and flows - sometimes quite dramatically - as our employment situation changes. While we can project regular cost-of-living (or perhaps additional real) increases in income over time, it's hard to clearly model bonuses, promotions, layoffs, new business ventures, etc. And, the reality is that some career paths - and their associated economic value - are much more volatile than others.

IS YOUR CLIENT A STOCK OR A BOND?

The idea of viewing a client's human capital as being analogous to either a stock or a bond is a concept that Zvi Bodie, an economist and lifecycle finance researcher, has advocated (where I first heard the concept expressed). Retirement researcher, Moshe Milevsky, has published a book on the principle entitled "Are You A Stock Or A Bond? ". [Watch Moshe's top rated presentation at PortfolioConstruction Forum Conference 2015 on exactly this topic – Ed]. The concept ties to the recognition that when looking at human capital, not all careers experience the same kind of volatility, risks, and returns.

For instance, those with jobs like working for the government, or perhaps Bodie's and Milevsky's own positions as tenured professors, might be considered "bond-like" positions. Their long-term value is stable, with little income fluctuation from year to year outside of cost-of-living inflation adjustments, and an extremely low risk of being terminated. Income generally continues in a stable manner until the individual decides s/he would like to retire and no longer work, or perhaps due to a change in health.

By contrast, those climbing the corporate ladder, and many self-employed individuals and entrepreneurs launching their businesses, have a human capital value that behaves much more like a volatile stock. It can go through abrupt changes up or down as "news" occurs (a big job promotion, landing a key new client, being demoted or getting fired). In fact, because many of these changes in human capital may be tied to the overall economic environment (which impacts the business, and most other businesses as well), the reality is that a client's estimated human capital value in such stock-like careers may literally show a high correlation to the stock market itself. Or, viewed another way, some careers may have a very high market beta.

Similarly, just as it's much more difficult to accurately value a stock - where the future cash flows, and therefore their associated present value, are so uncertain - than a bond, so too is it much more difficult to accurately estimate the human capital value of a stock-like career than a bond-like career.

THE INTERSECTION OF PLANNING FOR FINANCIAL AND HUMAN CAPITAL

Given the difficulty of valuing human capital in the first place - especially for stock-like career paths - with both the volatility that it faces (for example, due to the business/economic cycle, big career promotions, potential layoffs, etc.) and also the sheer uncertainty of when/whether any of those events will happen, planning for the risks of human capital should be crucial to the financial planning process, especially for younger Gen X and Gen Y clients. Some strategies - like disability insurance - are fairly straightforward. But recognising and managing the risks to human capital are about more than just effective insurance.

For instance, from the perspective of a holistic balance sheet - which incorporates both financial and human capital - effective diversification implies that if a client's human capital is stock-like with a high beta, the actual financial portfolio should be more lower beta, more conservative and bond-like (or, perhaps, even with a large outright cash allocation) to diversify and manage the aggregate volatility of the household balance sheet. Conversely, clients whose human capital is more bond-like have more of a career and human capital buffer against financial uncertainty, and can afford to take more portfolio risk.

However, in practice, it seems that clients who have a higher level of risk tolerance tend to choose both high-beta stock-like careers and high-beta stock-like portfolios, while more conservative low-beta-oriented clients have bond-like careers and bond-like portfolios - which suggests that many/most clients are diversifying improperly because they are failing to view their personal balance sheet holistically.

Similarly, the fact that stock-like careers may have far more uncertainty about the end date - when human capital may cease and clients have to rely solely on financial capital - than bond-like careers, suggests that investing towards a goal like retirement might be

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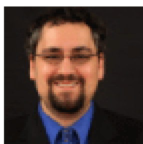
conducted differently. Given that more volatile, equity-centric portfolios have greater "retirement date" risk - and, therefore, a greater risk of being misaligned with an involuntary retirement transition - it again appears crucial to ensure that human and financial capital are properly diversified and complement or counterbalance risks rather than amplifying them.

Another important distinction of stock-like versus bond-like careers is the relative value of making investing in human capital - that is, spending money in ways that might advance a career, such as additional education, training, certifications, etc. This is especially true for those who are younger and in the earlier stages of their career, where even if money spent on training and education doesn't yield an immediate return, if it increases the overall upwards trajectory of income, the "Return On [Human Capital] Investment" can be significant. In fact, modest investments in human capital for those in their early careers can create dramatically more economic value than even long-term compounding of savings, implying that a more careful analysis of where/whether to "save early" in retirement accounts is really appropriate.

The bottom line, though, is simply this: human capital is a key asset for those still working - and, for younger workers in particular, it may represent 50%, 75%, or even 95%+ of their entire net worth. As a result, making effective decisions about whether to invest in human capital, how to best "convert" it to financial capital, and how much risk to take with financial capital given the client's risks of human capital, should be key financial planning decisions. Perhaps, as a starting point, though, we should at least begin to make an attempt to show human capital on the client's household balance sheet, to recognise the prospective economic value that is there, and be sure it is managed - and diversified - appropriately!



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