If You’re Human, You Have Capital

By Editor Test *Tue, Mar 9, 2010*

Ibbotson president Peng Chen asks, “Are you a stock or a bond?”

Paul Krugman, the Nobel laureate, Princeton economist and controversial *New York Times* columnist, revealed in a recent magazine profile that he and his wife liquidated their stocks ten years ago and now invest only in bonds or cash.

“It just takes a lot of work to think about it,” Krugman told an interviewer, “and at no point—except maybe early 2009, if I’d been really feeling daring, stocks really did look cheap.”

“We bought a couple of things,” [his wife, Robin] Wells said. “We bought muni bonds and some Ford Motor bonds. The thing is, if you look at it on a historical basis, even back in the two-thousands, stocks are not cheap.”

They may be selling themselves short. Someone like Krugman, a tenured professor in his mid-50s with a secure, “bond-like” income, might be wiser to balance out his personal “balance sheet” by diversifying into stocks.

Indeed, investors and their financial advisors risk missing half the picture if they limit their planning decisions to the familiar but narrow mixture of stocks, bonds and other financial assets that are in conventional investment portfolios.

Holistic approach

Instead, they should approach their finances more holistically, says Peng Chen, president of Ibbotson Associates. They should be thinking in terms of individual or household “balance sheets.”

How is a balance sheet different from a portfolio? As Chen explained in a presentation at the Morningstar/Ibbotson conference in Orlando last week, an individual balance sheet includes one’s human capital.

Human capital, as opposed to financial capital, consists of the present value of future earnings, the present value of future savings, and even the present value of Social Security and anticipated pensions.

“It’s the largest and most illiquid asset that people have,” Chen said. “It’s based on age and occupation. And, as you go through different life stages, it influences your investment decisions.”

Only when these assets are listed on an individual balance sheet, alongside liabilities like the present value of pre- and post-retirement expenses, is it possible to answer questions like: How much should I allocate to stocks and bonds? How much life insurance do I need? Should I buy a guaranteed retirement income?

One of the principal rewards of this approach is the realization that some human capital (like Prof. Krugman's) is more predictable than others (like a real estate agent's or a stockbroker's).

That leads to the somewhat counter-intuitive insight that a person who chooses a low-volatility career in academics should go farther out on the limb of the efficient frontier than a real estate agent, who might have a natural appetite for risk.

Depending on his or her occupation, a person's answers on a risk assessment questionnaire, if based solely on emotion or temperament, might lead an advisor to assign that individual an overly risky or overly conservative asset allocation.

Putting the present value of human capital and personal expenses at the center of the financial planning process, rather than at the periphery, leads to other insights as well, Chen pointed out.

Guaranteed products

By defining expected income and expenses, both before and during retirement, it helps people determine how much life insurance they should buy during their working years and how large an annuity they might need during retirement.

Chen also demonstrated that retirement requires a new way of thinking about the traditional efficient frontier of investments. In retirement, the efficient frontier chart must incorporate considerations like how much income the retirees will need, how much risk of an income shortfall they can tolerate, and whether they want to plan for a 20-year or a 30-year retirement.

For instance, a 20% equity, 80% bond portfolio might easily produce 20 years of adequate income, but not be as reliable over 30 years. Guaranteed products, such as immediate annuities or deferred variable annuities with lifetime income benefits, might be too conservative for a 20-year retirement, but essential for a 30-year retirement.

"Longevity risk is the biggest fat tail for individual investors to manage during retirement," Chen said. "If you're planning for 30 years, it would be foolish not to be looking at [annuities]."

Human capital has been the subject of research papers by Chen, Moshe Milevsky of York University and others in recent years. It is also the central theme of Milevsky's book, *Are You a Stock or a Bond: Create Your Own Pension Plan for a Secure Financial Future* (FT Press, 2009).