Human Capital: An asset class in its own right

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You are wealthy. You just haven't realised it yet.

When we think about wealth we tend to focus on accumulated financial assets, i.e. savings, investments, pension, property or any other claim on ownership. Think of this as your financial capital. However, this is only one part of your overall wealth. The other component, often overlooked, is your human capital. Where financial capital is your accumulated monetary and physical assets minus liabilities, human capital is effectively your future earnings power.

In "Lifetime Financial Advice: Human Capital, Asset Allocation, and Insurance" (Roger G. Ibbotson, Moshe A. Milevsky, Peng Chen and Kevin X. Zhu) the authors note that *"the largest asset that most human beings have, at least when they are young, is their human capital—that is, the present value of their expected future labour income."*

Investing in your human capital

In 2009, I remember chatting with a good friend who was in Blackhall Place training to be a solicitor. Despite years of education, and having a primary and postgraduate degree, he was becoming disillusioned by the fact he was still struggling financially, living off the basic income trainee solicitors typically earn over the three years to qualification. He was tired of being broke and so he began to question whether all this education and training was worthwhile.

It was then I explained to him the concept of human capital. Rather than focus on his limited financial net worth at that point in time, I reassured him that he would be better served by considering his overall wealth with the inclusion of his largest asset, his human capital. Qualification as a solicitor would provide him with the potential to increase the value of this asset, a higher path of income growth and hence a higher present value of earnings. Effectively, this was an investment in his human capital.

As the authors I've referenced above point out: *"The education and skills that we build over this first stage of our lives not only determine who we are but also provide us with a capacity to earn income for the remainder of our lives".*

My friend is now a senior member of an in-house legal team at a prominent global asset management firm. He recently bought a home and his level of financial assets is increasing every year as he realises more of his human capital and plans for the next stage of his financial life cycle.

My anecdote is intended to highlight the importance of seeing the bigger picture in terms of your overall wealth and the benefit of investing in yourself to increase your future earnings power.

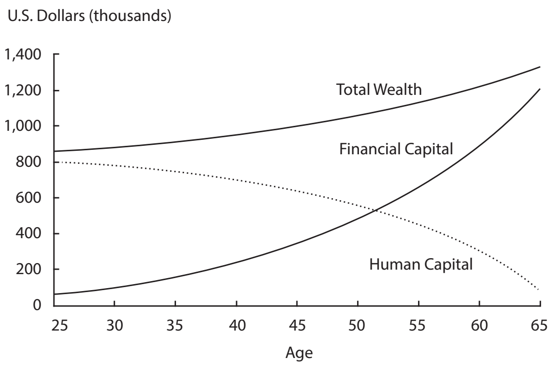
However, the concept of human capital also has important implications in terms of a person's overall asset allocation, as they move through the so-called accumulation working phase of life towards the retirement phase.

Human capital and asset allocation

"If asset allocation is indeed a critical determinant of investment and financial success, then given the large magnitude of human capital, one must include it."

Think of your human capital as a stream of future income, to be realised over time. For a young person in the early part of the accumulation stage, it will form a large part of their overall wealth. However, for someone close to retirement their human capital will make up only a small portion of their overall wealth.

Expected Financial Capital, Human Capital, and Total Wealth over Life Cycle with Optimal Asset Allocation



Source: "Lifetime Financial Advice: Human Capital, Asset Allocation and Insurance"

Ibbotson and his co-authors make the point that: *"Human capital should be treated like any other asset class; it has its own risk and return properties and its own correlations with other financial asset classes."*

The certainty of that stream of cash flows will also factor in to the risk level of that human capital. In other words, for someone working in the public service their human capital could almost be considered a risk-free asset, given the low likelihood of ever being made redundant. They should balance this by taking more risk with their financial assets in the context of an overall asset allocation.

However, if that same person was working in a job much more correlated to the stock market, human capital theory would suggest that they should invest much more of their financial assets in fixed-income or other asset classes less correlated to equities.

This idea might seem novel but the reality is that sometimes the best financial advice is simply common sense. Think about many of the builders burnt by the property crash. Their source of future earnings was reliant on the construction boom yet they continued to invest their realised earnings in assets highly correlated to the same factors, often more property and bank shares.

The same holds true for people who are awarded shares of their company, which can become a major component of their overall wealth. In this scenario, the value of those shares and the certainty of their future earnings are highly correlated. I recall advisors I worked with at Merrill Lynch in 2006/2007 who had the majority of their net worth in Merrill Lynch shares. Hence, they suffered on both fronts during the 2008/2009 crash. The value of their shares and their income plummeted at the same time.

"Think of financial investable assets as a defense and protection against adverse shocks to human capital (i.e. salaries), not an isolated pot of money to be blindly allocated for the long run."

Wealth is typically built by adapting a concentrated investment approach but wealth is protected by sensible diversification.

Human capital and financial planning

Human capital theory also provides a more holistic basis for financial planning. Rather than simply focussing on the diversification of financial assets, which is the focus under traditional portfolio analysis, human capital theory provides a framework that looks to hedge the risk factors associated with human capital:

1. Earnings risk
2. Mortality risk
3. Longevity risk

Earnings risk can be hedged by saving more and converting human capital to financial capital. As explained above, one can balance the implicit risk level of your human capital against the risk taken with one's financial assets.

Where one has dependents, life Insurance is the "perfect hedge" against the worst case scenario of death, whereby you have dependents reliant on your future earnings.

"Term life insurance and human capital have a negative 100 percent correlation with each other in the "living" versus "dead" stakes; if one pays off at the end of the year, the other does not, and vice versa. Thus, the combination of the two provides diversification to an investor's total portfolio."

The value of your human capital will provide a guide for the level of insurance needed.

The third risk to be considered is longevity risk - the risk of outliving your financial assets. Given the shift from defined benefit pension schemes to defined contribution pension schemes, members now have a greater personal responsibility to allocate retirement savings appropriately to generate enough income for retirement, in the context of increasing life expectancies. Ibbotson and his co-authors of "Lifetime Financial Advice" make the case for lifetime-payout annuities in managing longevity risk. However, there are a multitude of factors to be considered when determining their appropriateness.

Conclusion

Wealth is made up of two components, financial capital and human capital.

The working stage of life – the accumulation phase – is where individuals convert their human capital into financial capital. Saving is the method by which individuals replace depleted human capital with financial capital, to be invested to meet future consumption needs in the retirement phase of life.

A higher savings rate and an earlier start, to allow for the benefit of compounding, can help ensure sufficient human capital is converted to financial capital to meet retirement needs. Life insurance can protect dependents against an unforeseen death while lifetime payout annuities can help protect against longevity risk.

The proportion of human capital and the certainty of that human capital should be considered when making asset allocation decisions with your accumulated financial capital.

Investors are advised to manage correlations between human capital and financial capital, whereby a high correlation can result in a double hit for individuals in the event of an external shock, e.g. 2008/2009 financial crisis.

Finally, predicting the performance of financial assets over the coming years is notoriously difficult. However, the one asset you can control and influence is the value of your human capital. It is never too late to increase its value – through education, travel or any other form of personal development. Invest in yourself!