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THE HUMAN CAPITAL FACTOR

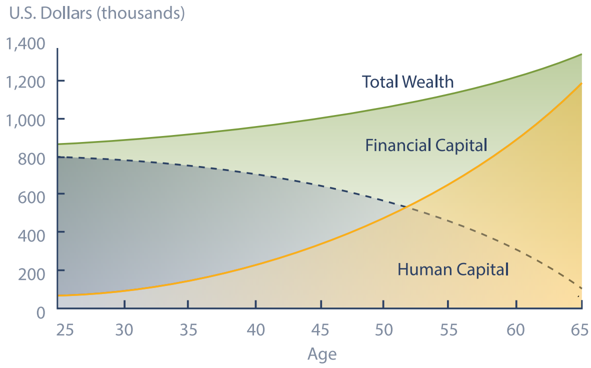
Conor Murray and Padhraic Kelly explain the importance of striking the right balance between our human and financial capital.

Most people measure their wealth in terms of physical and financial assets. They consider the value of their property, savings, investments and pension. Many will also consider their debts and borrowings to give an indication of what they believe is their net worth. This is known as financial capital. But it doesn't tell the full story. In order to get an accurate picture of an individual's total wealth we must also consider human capital.

Human capital is the present value of an individual's expected lifetime earnings. This may be dictated by age and profession, but an individual can also improve their human capital by investing in themselves through education and work experience.

Over the course of a career, we would expect earnings to increase, pensions to accrue and assets to accumulate. We would also expect debts such as loans and mortgages to reduce. In other words, financial capital is expected to increase throughout our working life. Conversely, our ability to earn future income diminishes as we approach retirement. As a result, human and financial capital should have an inverse relationship as seen below:

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"

The relationship between human capital and financial capital is a relatively straightforward one. However, it is important that one protects human capital in the event of being unable to work due to illness or disability or premature death. To ensure there is no material impact on your family's lifestyle, it is imperative that you incorporate both income protection as well as life insurance to hedge this risk.

All income protection should increase over time in order to keep pace with anticipated wage growth and average inflation. This ensures that the protection remains fit for purpose. The opposite is true for life insurance, which when analysed is a protection for our families against the loss of our future earnings due to death. As a result, the life insurance we put in place should mirror our human capital, with the greatest level required when we are young, diminishing over time as this need is replaced by financial capital.

This can be achieved by calculating an individual's current human capital (estimated future after-tax earnings), deducting any fixed expenditure that would be covered by other protection (such as mortgage protection and Death in Service benefits through employment) and finally, deducting an individual's personal spending need. This will give a good indication of the impact on loss of future potential earnings to the household in the event of death.

If we were to take a 30-year-old on a salary of €40,000 paying a mortgage of €700 per month on the family home, we would estimate that the need for life insurance would be circa €1,000,000 set up on a decreasing basis to age 65. While this seems a very large number, given the age of the client and the decreasing nature of cover, this plan could cost less than €50 per month.

We will spend much of our working lives converting our human capital into financial capital, and while this is hugely important, investing in our human capital is also essential. Further education, travel and gaining new experience through changing job or roles within the same company can enhance our human capital. This in turn improves our ability to build financial capital over the course of our careers. With so much personal investment and sacrifice, it is vital that we protect what may be our greatest asset.

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