Wealth Creation is about Better Decisions, not Financial Products

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A quick Internet stroll down the Amazon search aisle for Personal Finance and Investment yields a long list of popular book titles—*Rich Dad, Poor Dad: What the Rich Teach Their Kids About Money*; *Total Money Makeover*; and *Getting Back to Even*, to name a few. While I have found many of these books enjoyable reading, most of the current universe of financial planning advice disappoints.

Oversimplified, "how-to" approaches to financial goal setting or technical advice focused on a specific financial activity are not conducive to overall financial planning.

Simple goal-setting without tools to promote good decision making will not create wealth, and getting into the weeds of buying specific stocks is a diversion best avoided given your limited chances of beating the market. Creating wealth and financial security for yourself and your family is not derived from purchasing specific financial products, but by employing a holistic framework that results in good, consistent decision-making throughout your lifecycle of financial needs. As a professional investor and young professional trying to make sense of my own financial decision making, I realized along the way that many of the financial principles employed by successful companies are also relevant to personal financial planning and management.

Many of us go to great pains to separate our work life from our family life, and to leave "business" out of the family equation. But doing so diminishes our ability to make sound decisions about our financial future—and the financial future of each of our family members. When you think of your family like a business—"Family Inc."—you can apply the proven principles of corporate finance to develop a decision-making framework for your personal finances and more effectively manage the risk and opportunities that impact your wealth and financial security.

You are a business owner, and your family needs a chief financial officer. Asset and liability management, practical financial statements, control of risks, asset diversification, and tax planning—all are tools in the world of corporate finance that help companies achieve their goals. And there's no reason these techniques can't be adopted for your personal use. Every business has a CFO—a chief financial officer—and every family needs one, too.

Good financial decision-making begins with this key insight: you own not just one but two distinct businesses; a temporary labor business and an asset management business, which together comprise Family Inc.

1. **Your temporary labor business.** Each of us is born with a finite amount of labor potential to be harvested over a lifetime. Regardless of whether you are an employee in a large company, a soldier in the Army, or a small business owner, in all cases you are in the same basic business—converting your labor into money. Like natural resources such as coal, natural gas, or gold, your labor potential is finite and depletes over time. As part of a family, it's not just your own labor you need to consider, but that of your family members as well. The financial objective of your temporary labor business is to convert your skills and energy into financial assets as efficiently as possible.

2. **Your asset management business.** The second business is an asset management business that manages the assets you have acquired through your temporary labor business or by other means, such as inheritance. These assets might include your home, your savings, your 401(k), and more. Your objective in your asset management business is twofold: (1) manage and enlarge your portfolio of assets; and (2) produce adequate cash flow to support both your consumption needs—everything from groceries, clothes, and car expenses to recreation—and investments to further your labor business, such as returning to graduate school to enhance your earning power.

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These businesses are complementary and interdependent, and they must be managed in a coordinated manner. Your objectives as CFO in managing these two businesses can be simplified into three basic goals:

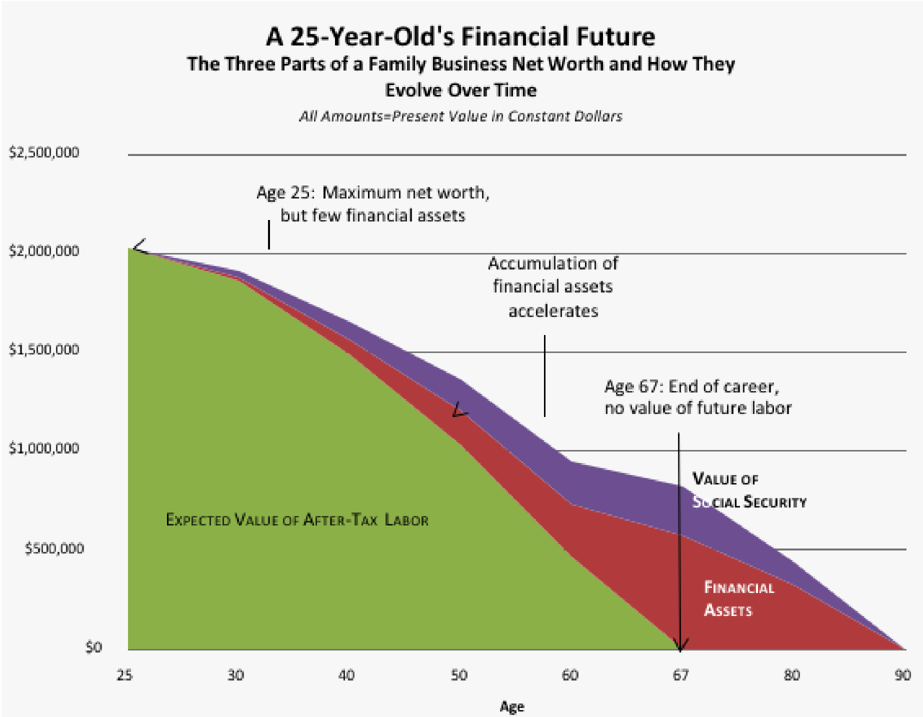
1. **Provide adequate cash flow** to support your spending, now and in the future, while allowing necessary investments to enhance those two businesses of yours: labor and asset management.

2. **Maximize your “Family Inc. Net Worth”**—the sum of your labor and financial assets after taxes.

3. **Manage your legacy** by maximizing what you can leave to family members (and their ability to manage these assets) or to worthy causes. While this goal is worthwhile, it is a distant third in priority. You can’t do number 3 without first accomplishing both 1 and 2.

To illustrate the interaction between these businesses over time, let's take a simplified snapshot of one young man's current financial situation, encompassing all the assets he has to work with, which include estimates of future compensation for his work, future returns on his investments, and future Social Security payments, based on assumptions that are reasonable today.

These assumptions allow us to generate the holistic view in the figure on the next page of the young man's projected Family Inc. Net Worth over his lifetime, including the value in today's money (that is, 2016 dollars) of the expected future assets generated by both of his businesses after all of his spending. For example, the figure shows that at age 25 he estimates his expected lifetime labor value (compensation for his work, shown in green) at about $2 million. By age 40, as the chart indicates, he will have received almost $500,000 of that value, so his remaining labor value has shrunk to $1.5 million. However, that $500,000 of used-up labor has funded his living expenses for the past 15 years while also allowing him to accumulate over $75,000 in savings and other financial assets (shown in red). By age 40 he has also paid enough into Social Security to earn some $95,000 in expected future Social Security payments (shown in purple). By age 67, he will have retired, so he'll have no remaining earnings—he depleted the $1.5 million of potential earnings over the 27 years since he was 40—but his financial assets have increased to about $570,000 and his expected Social Security value to more than $250,000. At 67, he will have to use these assets to support his spending for the rest of his life.



*The assumptions: He is 25, has no financial assets—or liabilities—and a starting job that pays $44,500 per year, the average salary for college graduates in 2013. We assume he will work for 42 years. As his skills develop, he expects his salary will grow at 2.0% annually in "real" terms (adjusted for inflation) through his retirement at 67. His annual contributions to taxes, Social Security and other required deductions approximate 30% of his gross salary. He saves and invests 10% of his after-tax salary throughout his career and estimates his investments will provide an annual return of 5.0% after inflation, fees, and taxes. Today's Social Security eligibility rules apply with an assumed benefit equal to the average 2014 benefit for a single income earner. He plans to consume all his savings during retirement through level, inflation-adjusted annual consumption through age 90—the financial equivalent of a 23-year annuity.

As the figure demonstrates, Family Inc. Net Worth embodies three key components: (1) the value in today's money of expected after-tax labor income; (2) the value in today's money of after-tax future Social Security benefits; and (3) net financial assets (financial assets minus financial liabilities). In summary, the family converts labor into money and future Social Security payments during working years so it can use these assets to fund consumption during retirement. This graphic is oversimplified, and the assumptions, based on today's realities, are certain to be off base because circumstances will change. Yet the concepts, insights, and planning tools that it facilitates remain powerful. This graphic represents the "financial game of life" that all of us must play.

Family Inc. Net Worth is an expanded definition of net worth (all your financial assets minus all your liabilities) that includes as assets the value today of anticipated lifetime after-tax earnings and Social Security benefits. Including these as assets highlights several critical principles that will influence your financial decision-making:

1. For most people, future earnings from work are the largest asset, so the greatest net worth is achieved at a time when financial assets are minimal. This dramatizes the opportunity cost (the value you give up to get something else) of wasted labor, unemployment, or "excess" schooling, as well as the negative implications of failing to save or invest some of your wages.

2. In the later years of your Family Inc., success is driven by the power of increased earnings and compounding financial assets. The figure above shows it takes this man about 25 years to accumulate $180,000 of financial assets, but in the next 17 years, those assets more than triple to about $570,000. For your financial assets to benefit from this exponential growth, you must start the saving and compounding process early. Delaying savings until later in adulthood puts you at a substantial disadvantage in the quest for financial security.

3. Money management skills are a critical and often overlooked precondition for financial security. As the figure suggests, savings and capital appreciation represent approximately 20 percent of the total assets available for consumption over a lifetime (including labor and Social Security benefits), yet most people spend significantly less time on managing this part of their business. Do you know anyone who spends 20 percent of his or her professional efforts on personal asset management activities?

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In the context of the Family Inc. Net Worth framework, Social Security should be viewed as nothing more than the mandatory purchase of an inflation-indexed annuity that is guaranteed by the government—just another part of your financial asset portfolio. By itself, this asset will not provide financial security, and future changes in policy are likely to decrease these benefits. Regardless, for most people, Social Security benefits are an attractive asset and an important part of a financial planning program.

Our labor assets are by definition finite—we all die sometime. However, capital assets (investments) can grow without limit and, if managed correctly, can provide a perpetual annuity whose annual gains and income exceed consumption. This is the ultimate accomplishment in achieving financial security because it means you've practically eliminated the risk of outliving your assets.

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The Family Inc. Framework Allows You To Clearly Identify the Key Variables that Impact Financial Security.

Employing this Family Inc. Net Worth framework allows an individual or family to identify the key variables that ultimately influence their financial security and therefore make smarter decisions about education, career, spending, investing, insurance and retirement.

These variables include:

1. Labor wage rates: Salary and bonuses
2. Labor duration: How long can you work?
3. Savings rates: How much of your after-tax income will you save?
4. Consumption profile: How much will you spend?
5. Reinvestment rates: What return can you expect on your money after fees and taxes?
6. Life expectancy
7. Family inheritance
8. Tax rates on income, capital gains, and estates
9. Social Security eligibility and policy
10. Inflation rates

You can influence items one through seven, and with the benefit of more information, these business inputs can be adjusted over time to help you achieve your financial goals. You have no influence over items eight through ten, but they also have a significant impact on all business owners and must be considered in your financial planning.

Many people believe that if they can't accurately predict their financial future, a plan is of little use. In the investment business, we often joke that there are two types of financial plans: lucky and lousy. I expect every financial plan to be wrong. The value of the plan is the discipline of explicitly defining your assumptions (or business inputs in this case) and alerting you to changes in these assumptions so you can make decisions accordingly. A sound financial plan must be dynamic, evolving, and subject to frequent scrutiny with the benefit of additional information. Fortunately, several of the key drivers of Family Inc. Net Worth, such as retirement age, savings rates, and consumption levels, can be modified as needed to address failures in your estimates or your changing circumstances. For example, if your asset management business has accumulated less value than anticipated because investment returns were lower than expected, the Family CFO can address this shortfall through working longer, saving more during the working years or spending less in retirement. None of these choices are ideal, but they offer the Family CFO valuable flexibility to avoid financial distress.

Employ Family Inc. To Make Better Decisions While Purchasing Fewer Financial Products. Now that we have defined your family business and key inputs, we can apply the Family Inc. framework to our everyday financial decision-making. This framework allows us to remain focused on the big choices that drive financial security related to managing your labor and capital, managing your significant risks and making choices to help you win the "financial game of life." Focusing on these key principles as you serve as your Family CFO will ensure that your decisions among your priorities are complementary and you purchase only the financial products that make sense in the context of the big picture—your Family Inc.

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Managing Labor Capital

1. Your objective in this business is to convert your labor into money as efficiently as possible to support the spending needs of your family throughout a lifetime

2. There is greater opportunity to create significant wealth from investments in your labor and career management than investments in financial assets.

3. Your labor must be actively managed, and the principles of investing can be applied to your career choices to increase your expected lifetime compensation.

4. When managing your career, focus on skill acquisition, career flexibility, longevity and likely retirement benefits in addition to today's compensation.

Managing Financial Capital

1. Your objective for this business is to maximize long-term, after-tax, after-inflation, after-fee purchasing power.

2. The most important role for your financial assets is to provide a cash reserve and liquidity to buffer the family from unexpected setbacks like unemployment.

3. An effective asset allocation program must consider labor, social security and real estate assets.

4. In the long run, equities (stocks) are likely to deliver greater expected purchasing power with less risk than fixed income (bonds).

5. Low-cost, passive index funds are generally the best way to implement your investment strategy.

6. Not all debt is bad! Debt can minimize taxes and finance appreciating assets.

7. Buy real estate as a home—not an investment. The risks and returns are likely unattractive compared to your alternatives.

Managing Family Risk

1. Your objective is to protect your labor and financial assets from catastrophic loss through appropriate insurance.

2. Given labor is likely your most valuable asset, disability and life insurance are critical tools for managing risks related to your ability to work.

3. Insurance is a loser's game—a poor investment. Regardless, life, health, disability, long-term care and annuities are sound ways to manage risk and an important part of your financial plan.

4. The family's ability to manage risk or "self insure" increases with wealth.

5. The family business changes upon retirement and must be managed differently through asset allocation choices, a greater focus on liquidity and insurance to manage your risk.

6. The biggest risks retirees face are outliving their assets and inflation. An equity-heavy portfolio is the best way to mitigate these risks.

7. Life is uncertain—develop a will and determine your need for estate planning today.

Winning the Financial Game of Life

1. Entrepreneurship is an attractive way to lengthen your career while sheltering your labor and capital from competition.

2. It's easier (and more fun) to achieve financial independence through effectively managing your labor and capital than minimizing your spending.

3. Family Inc. does not manage itself—you must create a plan, track your progress, adjust to new information, and stick with it.

4. Surprises are part of the game—many of the assumptions of your financial plan will be wrong—get over it. Success requires establishing enough cushion and flexibility to overcome these setbacks.

5. The factors that effect your financial security are very broad and cannot be outsourced—Every family needs a CFO.

Key Conclusions. They say money can't buy happiness and I certainly agree. However, the lack of it sure can make life challenging. By approaching your family's finances using the principles of corporate finance, you won't have to think about the financial impact of every decision you make. Rather, you can identify the big decisions and their implications in your financial life so you don't have to dwell on money every day.

Financial security is not achieved through any specific product, but rather through a lifetime of identifying important decisions, developing a plan with enough cushion for surprise, monitoring your progress and modifying it with new information. **The Family Inc. framework will provide you a roadmap for your journey in the financial game of life.**

Info

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ABOUT THE AUTHOR | As a professional investor, Douglas P. McCormick has spent two decades managing money for institutional clients such as insurance companies, pension funds, entrepreneurs, and high net worth families. Unlike Wall Street money managers who seek to generate paper profits through passive investing, Doug partners with families and entrepreneurs to build and grow their businesses to create sustainable value. Holder of a BS in Economics from West Point and an MBA from Harvard, he is a cofounder and a Managing Partner at HCI Equity Partners. His motivation for writing this book started with his own challenges finding good personal finance advice as a young adult and his belief that financial literacy is one of the largest problems facing Americans today.

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