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Human Capital and Integrated Financial Planning



As a financial planner I gained a whole new perspective on the importance of financial planning recently with the news that our first child is due this August. The prospect of being responsible for this impending bundle of joy has given me a new focus on how to plan for our future. I started to ask serious questions about how much financial protection we actually need and what is the most efficient way to put this in place.

I enrolled in the Graduate Diploma in Financial Planning partly to enhance my own knowledge and broaden my expertise, but also to move closer to achieving CFP® certification. I found it to be an invaluable learning experience and an opportunity to take some time out from a hectic daily schedule to look at our industry, and client recommendations from a different perspective. I strongly believe that as financial advisers, we should try to put ourselves in our clients' shoes as much as possible. We should, where possible, try out fact finding processes and products on ourselves before recommending them to the wider public. I feel we can better advise our clients if we have some personal experience of the products and structures we recommend regularly. Nothing replaces personal experience when it comes to understanding the core benefits of personal financial planning, but a constant process of personal improvement and education is also essential in these fast moving times.

It is with this philosophy in mind that I spent some time, after my wife's announcement, looking at our protection

policies and investment portfolio with a newly critical eye and using my expanded knowledge base from the course. In relation to our protection policies, the traditional rule of thumb of 4-5 times annual salary just didn't cut it for me so I was drawn to the theory of Human Capital, which was covered in great detail during the Risk Management Module of the Graduate Diploma.

What is Human Capital?

In the Risk Management Module, lecturer Brian Grimes introduced the theory of Human Capital in a very interactive manner, questioning our current thinking on life assurance and protection. Throughout these open debates he introduced a new way of looking at our clients' need for protection and encouraged us to open our minds to ideas beyond the existing standards of best advice.

The financial position of our clients can be split into two distinct parts, Financial Capital and Human Capital. We are usually very familiar with the Financial Capital of our clients. Financial Capital is an umbrella term which represents our clients' financial assets, investment, pensions and protection policies. We are trained to critically assess financial capital and so we become experts in valuing and projecting pension funds, assessing life assurance cover and comparing investment funds. However, this only gives us a partial view of our clients' financial position. We rarely assess in any great detail the most valuable asset our clients possess, their future income. Human Capital is defined as the present value of an individual's future income. It is therefore likely to be our client's single largest asset, particularly in their younger years.

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The chart at the bottom of this page shows a typical working life cycle and the inverse relationship between Human and Financial capital.

If we examine this chart closely, it opens up many new and interesting areas of discussion, a couple of which I will focus on for this article. Human Capital can help us address some very important and common questions in a new way,

- How much life assurance is enough to protect my family?
- Should I sell my stock options?
- Where should I invest my pension?
- Where should I invest my savings?

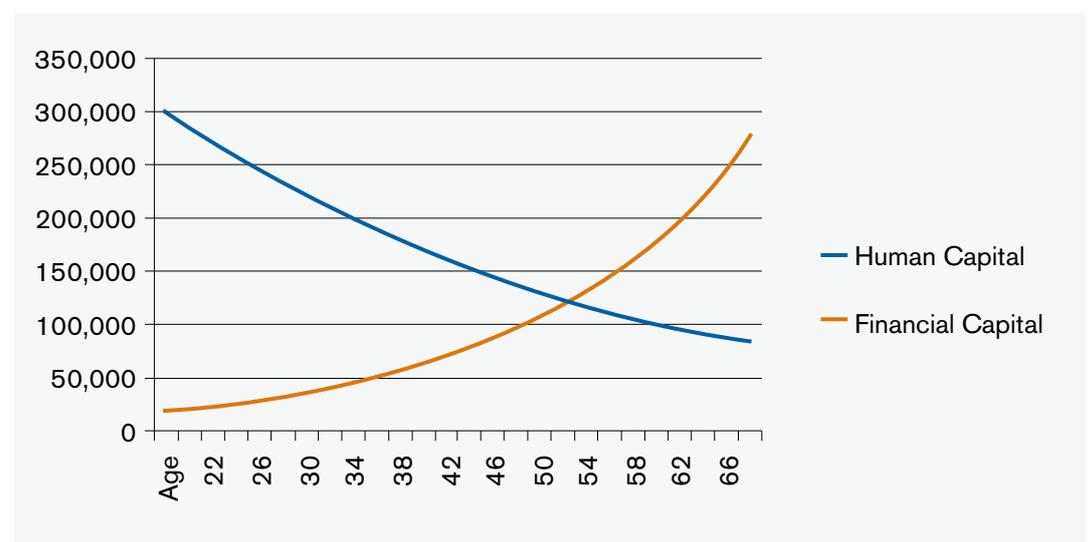
Investment Asset Allocation and Human Capital

Our clients are more informed now than ever when it comes to asset allocation and risk. This increased knowledge has challenges for the investment adviser but we must always try to give what we feel is the best independent advice, rather than what we feel the client wants to hear.

We can use Human Capital Theory to help with this. Linking investment asset allocation to Human Capital is new to most of us, but very relevant. If we agree that a client's Human Capital can be their most valuable asset, it should therefore be a dominant consideration in any analysis of asset allocation and risk. We have all come across clients who had amassed significant wealth through their employment, obvious examples being bank shares and property. We know

anecdotally that many of those that worked in construction re-invested their savings into property. We have also heard many stories of retired bank staff that still had a huge portion of their pensions and life savings in bank stock options or direct shares. With the crash of the past few years many have been hit twice with job losses and investment losses coinciding. These are extreme examples of those who did not diversify their Human and Financial Capital. Their future income (Human Capital) and current investments (Financial Capital) were not diversified. This 'familiarity bias' (preference for investments in an area we know well and understand), which is a very common factor in many investment decisions, can be very dangerous.

I would agree with those who promote the idea of Human Capital when they suggest we try to maintain a negative correlation between our financial and human capital. For example, theoretically, a career civil servant should have their Financial Capital invested in reasonably high risk asset classes, as their Human Capital is secure. On the other hand, a self-employed individual with a new business should have their financial assets invested safely, to compensate for the volatile nature of their future income. In reality, the opposite is often the case. Public servants by their very nature, tend to have a more conservative personality and invest safely, whereas anyone setting up their own business is usually less risk averse, and invests their financial capital aggressively.



Employees in technology companies should probably avoid having Microsoft in their portfolio and owners of filling stations should not be invested in BP! Whether you agree with this idea or not, it does make for an interesting additional discussion with our clients and allows us to gain a much richer understanding of their risk profile.

Human Capital and Life Assurance

Our clients can also benefit from a close examination of Human Capital when assessing life assurance cover. Traditionally we recommend a multiple of salary, on a level or indexed basis, for a set term. Exponents of Human Capital theory discuss life assurance as 'the business of Human Capital Securitisation' (Ostaszewski 2003). Life Assurance is really an insurance policy protecting against the loss of future earnings. However, as can be seen from Figure 1.1, a client's human capital reduces over time. This would indicate to me that reducing cover life assurance policies are actually more suitable for many clients. We tend to only recommend reducing term cover policies when linked to a mortgage, when actually they can offer our clients better value over a much wider set of circumstances. Obviously debt still has a large influence on the level and structure of any life cover recommendation, but it is not the only consideration.

This viewpoint would also indicate that individuals with young families in their 30s require more cover than those in their late 50s with older teenage children. Recommending this Human Capital approach has the combined benefit of closely linking life assurance to the future financial needs of a family and also saving them money through the lower premium cost of a reducing term policy. With this in mind, we should therefore use three basic criteria now when making recommendations to our clients:

- Debt Levels and repayment – General Rule
 - Interest only mortgages require a level term policy and Annuity Mortgage requires a reducing cover policy
- Human Capital – Project potential total future income for the family and assess how much life cover would be required to replace this, using present value calculations and realistic growth rates

- Financial Capital – Consider current financial assets when assessing life cover requirements. How much income could they replace themselves through current financial assets and reduce the life cover recommended accordingly.

Summary

As a primarily 'fee based' adviser, I feel I have to exceed my clients expectations when delivering reports and advice, in order to justify the invoice. Knowledge gained from the Graduate Diploma has helped me offer a more comprehensive, insightful and unique proposition. This will over time help me to increase my fee income and build a reputation for high quality advice. The application of Human Capital theory is one example of this. Using Human Capital benefits financial advisers and clients equally. Adding a discussion around the theory into our client meetings and reviews allows us to bring a new dimension to investment analysis and protection recommendations and enhances our service to the client. For fee-based advisers, it allows for a bespoke set of recommendations which have a clear and tangible basis. This clarity builds trust which as we know is the cornerstone of any successful adviser-client relationship.

Clients benefit from recommendations which are more closely linked to their personal circumstances, they may end up with lower protection costs in some cases and hopefully more diversification away from future economic shocks. Diversification of financial capital away from their income sources gives greater financial security while not necessarily sacrificing investment return.

Finally, as my friends constantly and enthusiastically remind me that my life is about to descend into chaos and sleepless nights, I will use my expanded knowledge of Human Capital wisely to organise my own and my clients finances while I still have my sanity!

David Quinn, was a student on the first Graduate Diploma in Financial Planning programme, which commenced in September 2009. He was recently awarded the Graduate Diploma in Financial Planning – a UCD award at Level 9 on the National Framework of Qualifications.

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