THE HOLISTIC BALANCE SHEET

Bill Lyon

Most of my days are spent in conversations with people about things that matter deeply to them. Commonly, we develop and work from their "balance sheet". However, most of us initially think only in terms of a financial balance sheet – the one with financial assets on one side and liabilities on the other. It's an important and helpful tool to be sure. But I work from a different balance sheet – I call it "The Holistic Balance Sheet".

If I asked you to develop your own balance sheet, you'd start by thinking of the things you own. You would likely rattle off the same things that appear on a mortgage application -- your home, 401K balance, business interests and automobiles come to mind pretty quickly. If you are detail-oriented, you might even list the specific stocks, bonds and mutual funds in your portfolio. You may or may not readily know the value of each of these but you could look them up online or on paper statements. What you would have identified is your Financial Capital. These are your most valuable assets, right? Or are they?

Traditionally, there are a number of items that are totally ignored – either because they are a bit tougher to put a price tag on or because they don't fit within the constraints of conventional wisdom. In many cases they are of significantly greater value than the ones that individuals and their financial advisors typically track. For example, what is the value of a defined benefit pension plan (the kind that provides a monthly retirement check for life)? Yes … some people still have them! What is the value of a lifetime of future Social Security payments? Each of these may be a very valuable asset as it provides a future stream of income – potentially for a lot of years. The length of that future and the value associated with payments for life depends on your genes, your lifestyle and – perhaps – fate.

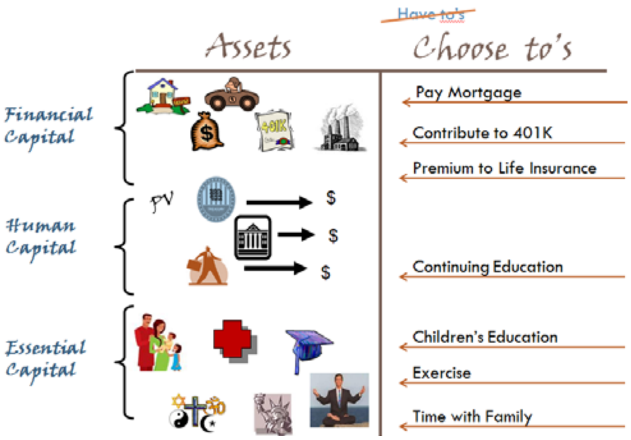
There's even a nifty computation called a Net Present Value (NPV) calculation used by us financial types that helps express the value of an income stream in terms of an asset value. I think of the Net Present Value calculation as the E=mc2 of finance. If we used that calculation, we'd find that the value of Social Security for someone retiring today at normal retirement age, might be as much as five or six hundred thousand dollars. For those lucky enough to work for an employer offering a defined benefit pension, the value might be many times that depending on the monthly benefit.

Others of us have quite a few years until retirement. For us there is another huge asset to consider – our future earnings. How much is the stream of your future earnings worth? It depends on how much you earn, of course. The likelihood that the income will grow over time matters, too. And we can't ignore the fact that some types of jobs are more secure – produce more dependable income – than others. Consider the dependability of incomes from two professions. A NASCAR driver might win big next year or he might crash and burn (figuratively or literally). His income is like a stock. A tenured professor at a well-heeled university knows pretty well what she's going to get. Neither bonuses nor pink slips seem likely. Her income may be more bond-like. Not all income streams are created equal.

That being said, there is still significant value associated with future earnings capacity. An individual earning $100,000 per year today might actually earn two or three million dollars over her lifetime. When combined with the pension and social security that are based on what those future wages produce, she may indeed have Human Capital that equals or exceeds her Financial Capital.

Beyond these two quantifiable types of capital, I think it is interesting to ask the question, "Have you truly identified the most important things? Is there anything more important than the things you have listed so far on the left side? Is there anything you wouldn't trade for the things you have listed?" And usually there is. It may take a while, but eventually people get the point. You might respond, "My family, my friends, my faith, my education, my experiences, my health, my … you-fill-in-the-blank."

At our core, we recognize that money isn't the only thing that matters. Often, its value pales in comparison to important relationships, health, faith, and life experiences. In times of catastrophe, we are reminded that these are the truly essential things -- our Essential Capital. But most of us forget this from time to time. Don't we?



If the truth be told, we could better focus on these really important things if we could get a better handle on the areas of Financial and Human Capital. Disruptions in our financial or career structure affect our relationships and our ability to enjoy our experience on this Earth.

For years the experts have told us that we should diversify our assets. Until recently, that meant mixing different proportions of stocks and bonds or the mutual funds that invest in them. However, this approach addresses only a limited number of economic assets – usually the ones his or her advisor gets paid to manage.

In recent years with some technological breakthroughs, we've seen the ability and wisdom of blending in some "alternative asset classes". These generally refer to such things as real estate and natural resources but can also refer to strategies not usually employed by traditional mutual funds. To be sure, this is an improvement. Doing so generally reduces the volatility our portfolio is likely to experience because it is unlikely that such a wide range of different investments will all move in the same direction or to the same magnitude for any extended period of time.

There's one big problem with this approach. It is still built on shaky premises. The first is the assumption that we are all perfectly informed and perfectly logical. Ha! The second is that only financial capital should be considered. The third is that asset allocation models can be produced and implemented in a vacuum – ignoring such factors as longevity risk, volatility in employment earnings, and desire (or lack thereof) to care for family members beyond our lifetimes.

If those assumptions were all true – and universally so – then perhaps we should all have the same investment mix. Maybe then, it would make sense for everyone to listen to and act on the advice of the same financial guru on television. We wouldn't even need to, because we would already be saving and investing the same amount in the same things because we are all equally as disciplined and logical. That, of course, is fantasy. The reality is that each of us is an individual. Our balance sheets are unique and the strategies that maximize them are too.

Consider the case of an enterprising middle-aged man – me. I'm basically an optimist – at least in the long-term. I'm comfortable with short-term ups and downs of the market but I'm not willing to take uncalculated gambles. My income potential is considerable but there can be significant variations in the actual income from year to year. That income is very dependent on my ability to speak and write. I'm relatively healthy and I have had family members live well into their nineties. I may die tomorrow, but I need to prepare for the possibility that I could be here for a while.

It is also noteworthy that I have a "non-working" spouse, which is a ludicrous statement when I also tell you that I have two fifteen-year-old sons. Thus, it is more accurate to say that my hard-working spouse labors her tail off without financial compensation. I desire that they not suffer a significant financial loss in addition to the emotional burden if my "Human Capital" checks out tomorrow.

What I've described is one person – myself. Not every 50 year-old looks just like me – financially, relationally or philosophically. That's why sole reliance on traditional balance sheets and cookie-cutter model portfolios seem so insane. They don't consider some of the most important factors that affect my financial and non-financial life.

Perhaps it is too much to ask that the Universe find a way to deliver to me a perfectly customized solution. I like to think that there is hope, though, that we might be getting closer to that point. Just in the last few years, some groundbreaking research by renowned economic and financial heavyweights (Ibbotson, Milevsky, Chen & Zhu) has proven that better portfolios can be built when they integrate a healthy consideration for the impact of Human Capital. Their book (Lifetime Financial Advice: Human Capital, Asset Allocation, and Insurance) just became required reading for all new Chartered Financial Analysts (CFA's). These are the credentialed professionals who do the serious analytical work that goes into designing portfolios. A step in the right direction.

Also of note, it is exciting that unprecedented strategic alliances are forming that have researchers and analytical powerhouses partnering with highly regarded financial firms. They are developing unique solutions that take into account not only risk tolerance but longevity, legacy desires and volatility of earning potential. The result? For maybe the first time, portfolios and financial recommendations are based on maximizing one's lifetime wealth. That's a much more enlightened perspective than the "one-pie-chart-fits-all" approach of the average retirement plan.

It may be a while before you see this in your 401K at work. Only a relatively small number of financial advisors, stock brokers, insurance agents or portfolio managers "get it" so far. That's changing though. Great ideas just take a while to become "mainstream" since old habits die hard. For those fortunate enough to have access to such expertise, the results are very encouraging. Such clients are empowered to focus on developing and growing the really important aspects of their Holistic Balance Sheets.

This emerging view of wealth as something more than the dollars on a brokerage or bank statement is important for other reasons as well. The most important reason is because it is more accurate and sane. Many of the people who spend their days either counting up or worrying about what is or isn't on the left side of their balance sheet can make themselves and the rest of us crazy! On the other hand, those who approach their wealth from a broader perspective not only find it themselves but inspire the rest of us too.

So how do we actually "build" holistic wealth? It starts by being mindful of all the things on the left side of the balance sheet. Just by acknowledging and appreciating the non-material things, we increase their value. By definition, "to appreciate" something is to increase its value. And we all know that thankfulness is good for the soul.

Consciously growing our holistic asset base also involves the "right side" of the balance sheet. Liabilities, debts, taxes due, etc. occupy the right side of most balance sheets. They are considered the have to's of life. They aren't much fun for most of us – uninspiring at best and ominous, at worst.

In my holistic balance sheet, I define this section differently. The term I use is "contribution" – or choose to's. I can't deny the reality that debts and taxes exist. I can choose how I view these things and other obligations though. In fact I actually have a choice in whether I pay them as long as I'm willing to live with the consequences. I choose to pay my mortgage because I happen to like living in my home. I choose to pay taxes because I happen to like not being in jail.

When I make a contribution to my financial assets, I expect a return or dividend. I may not always get one – or at least not the one I expect. But I invest in retirement and education plans in anticipation of a brighter future. I take on debt for my business or my residence because I believe they will allow me to build more value on the left side than they represent on the right. These are contributions – choose to's.

Likewise, I make right-side contributions that correspond to the other left-side "assets". Contributions to the "emotional bank account" in each of my human relationships help me better appreciate key people in my life. In turn, they better appreciate me. Quality time with my life partner, children, and friends is a contribution. Physical exercise is a contribution to my health. Involvement is a contribution to my community and to my life experiences.

I wouldn't trade my experiences or the wisdom I've gained from them for anything. I've known business people who have made and lost fortunes. They tell me that they were just as "wealthy" while bankrupt as they were when they were flush with cash. The reason, they say, is because they have an even richer experience of knowing how to rebuild the wealth the next time around.

To be sure, this is not the typical static, snapshot-in-time balance sheet from my old accounting texts. In fact, it is quite dynamic. Some financial purists would argue that I'm mixing balance sheet terms with income statement terms and throwing in some spiritual mumbo jumbo to boot. Yup! That's why I call it a holistic balance sheet.

The dynamic piece in all this is that each contribution from the right side increases the value on the left. The currency may not be U.S. Dollars. The result may be deepened friendships, magnified love, a greater sense of community, or the remarkable learning that only comes from temporary failure. The overall value of the wealth – the whole wealth – grows. Even though we may be totally oblivious to the progress, it grows just the same.

And it grows best when we contribute generously. The more I contribute to my 401K, the more it will grow in the long-run – despite temporary setbacks due to stock market fluctuations. The more time I spend with my son doing what he wants to do, the richer our relationship will be as we both grow older. The more involved I choose to be in my community, the more I'll appreciate it and enjoy the experiences.

My own Holistic Balance Sheet is a source of encouragement and strength even in tough times. A quick look around the world presents tragedy after tragedy. Economic uncertainty abounds. If I base my attitude only on my retirement plan balance or my short-term income projections, I could choose to be depressed. But why would I look at only one aspect – the least important aspect – of my holistic balance sheet? I have a beautiful family, decent health and a community that nurtures my soul by reminding me that I'm part of something bigger than myself. I am blessed indeed. I suspect that most of us would have to admit the same.

Each of our Holistic Balance Sheets abounds with riches most of the world can't even imagine. Some of us appear wealthy financially, yet are impoverished in our relationships. Others of modest means may bask in untold richness of unique experience that the rest of us may never know. None of us has everything we might wish for – and that's probably a good thing. Yet, each of us has much for which to be thankful.

To the extent that we consider our financial and non-financial lives in a more holistic manner, we can prepare more wisely. To the extent that we identify and engage professional advisors who "get it" to help us with the task, we can manage things more effectively. To the extent that in doing so we consider the impact on others -- on the whole -- we enrich our world.

I know a lot of planners. Some plan weddings. Some plan estates. Some plan careers. Some plan vacations. I encourage people to plan for life – because that includes it all. Essential Capital and Human Capital and Financial Capital together form the Holistic Balance Sheet.

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