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"STUFF" DOES NOT EQUAL WEALTH

by Karen DeCoster

People often spout off about someone they know—a friend, acquaintance, neighbor, or colleague: *He's got a lot of money, or She's loaded.* They assume, based on what they can see, that a person has personal wealth and is genuinely prosperous. But is it true?

As a Certified Public Accountant who knows from experience that looks can be deceiving, I quickly kick into skeptic mode when these comments pop up. In fact, I routinely stop the conversation and ask, *What makes you think he or she is loaded?* I ask them what evidence exists that lead them to say this, or, what do they think conveys the wealth?

The typical reply is: *They live in the __ subdivision of __ and go on a cruise every year to ... or He's an engineer for GM, and she's a __, and*

they've got the most beautiful cottage up in __ and they both drive ...

The responses vary, but the perception of another being 'rich' is inevitably tied to vacations, things, cars, bragging on the part of the 'loaded' person, and, of course, the house, which has come to define a person's existence. Unfortunately, it's a flawed perception of personal wealth.

"Hmmm," I then ask, "*are these assets encumbered by debt, or is there really substantial personal equity?*"

At this point most people become a bit tongue-tied. They can see the assets and observe the consumption of the 'rich' person to whom they refer. Yet without looking at a balance sheet, there is no way to know to what extent the consumption and accumulated assets are being

financed by debt, or to what extent equity has been sacrificed to fund the purchases. In other words, they can't know the person's true *net worth*, i.e., whether he or she has *positive equity*, or even *negative equity*.

A *balance sheet* is a summary of an individual's assets, liabilities, and equity at a specific point in time (for example: as of December 31st, 2009). The term "balance sheet" sounds mysterious to most people, but it needn't be. Think of a balance sheet as a check-up of one's "money" condition as of a specific date – this is as important to personal financial health as a medical check-up is to physical health.

In its simplest form, a personal balance sheet is merely a list of assets and liabilities that reveals a person's financial net worth. Anyone can do it:

- Draw a line down the center of a piece of paper.
- Label the left column "Assets" and list the current dollar value of each asset owned: liquid assets (cash, checking and savings accounts), retirement plan, common stock, home and other real estate, cars, and any other personal property.
- Label the right column "Liabilities" and list the current dollar amount of each debt owed: student loan balances, credit card balances, mortgage and equity line balances, car loan balances, etc.
- Total each column.

The difference between the two totals is a person's true *net worth*. If assets exceed liabilities, the individual has a *positive net worth*. Conversely, if liabilities exceed assets, the individual has a *negative net worth*.

Equity affects a person's day-to-day life whether he or she knows it. It plays a role, for example, in

determining whether an applicant is approved for a credit card or a loan, and whether credit comes with a good (low) or bad (high) interest rate. It can also have an indirect affect on an individual's credit rating, something increasingly used by employers to assess job applicants.

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SO, IS SHE REALLY 'RICH'?

I am still puzzled by people—especially the college-degreed—who confuse consumption (accumulation or other spending) with wealth.

Remember that purchases of assets—the plasma TV, sports car, or the new house—if made from cash savings, is merely a reclassification of assets and is not a step up in real personal wealth. Cash expenditures for non-assets—the cruise vacation or pricey dinner at an overpriced bistro—is a decrease of an asset (cash) and increase to an expense, and thus is a negative hit to equity since it adds no assets to a balance sheet.

The 100% debt-financed Lexus is an equal increase to an asset and a liability that only increases one's debt-to-equity ratio. There exists a shiny new car (a depreciating asset), but there's definitely no wealth increase here. The purchase has only created the illusion of prosperity for those who don't understand basic financial concepts.

While hyper-consumers might be perceived as rich by envious acquaintances, their balance sheets would be just as likely to reveal that they are the opposite of rich: they have plenty of devaluing assets, high debt, negative personal equity, and little or no savings.

I refer to this group of people as *Two-Thousandaires*: They have lots of 'stuff', but only a couple of thousand dollars in cash or liquid assets.

In reality, many people have stuff because they don't save. They over-

consume in relation to their income, and more often than not they incur debt—lots of it—to get the stuff. As a result, they live paycheck to paycheck with no cushion to protect them from a temporary job loss or other financial crisis.

After all, in bad times, equity is

a means to self-preservation. Your equity is your stability and your safety net. Equity on your balance sheet is your real wealth.

THE TRULY WEALTHY

The accumulation of things can never be equated with personal wealth. A little book that spells out the difference between having wealth and having things is *The Millionaire Next Door: the Surprising Secrets of America's Wealthy*, by Thomas J. Stanley and William D. Danko.

The book isn't about pop stars,

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super-athletes, or mega-businessmen like Bill Gates. Rather it's about ordinary people—small entrepreneurs and frugalists—who consistently work hard, live well within their means, save, and produce in order to build real wealth. (Their practical examples of accumulating wealth are well worth the read.)

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Wealth builders spend a good portion of their income on assets that generate future wealth. *Two-Thousandaires*, on the other hand, live a life of false prosperity buying things that depreciate, subtract from wealth, and offer no future income streams. It's true that houses, cars, and appliances are durable consumer goods that everyone buys out

of necessity. But high priced "cribs," costly automobiles, and durable consumer goods don't offer a future return on investment. The same applies to giant plasma TVs, killer sound systems, and the latest tech gadgets.

Sadly, most of us were never taught basic economics—or the benefits of producing and saving—while in school. And long gone are the days when homeowners commonly threw mortgage pay-off parties to celebrate a major financial milestone in their lives.

Instead we've been taught to believe that buying and accumulating stuff through the use of debt is "good for the economy." Thanks to a massive disinformation campaign by media and repetition in casual daily conversation, such perceptions have become gospel. Unfortunately, those perceptions have fueled a tolerance for consumer debt levels that can't be sustained either personally or nationally.

Those who seek to build true wealth won't achieve their goal in the accumulation of non-producing assets. Rather, they will achieve it by understanding basic personal finance concepts, developing sound spending plans, and making their paycheck work as hard for them as they work for it.

These are the ones of whom it can honestly be said, "They're loaded!"



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