

What Assets “Count” as Part of Your Total Investment Portfolio?

By Maria Crawford Scott

Howard and Thelma Morrison were recently married. They are both in their early 30s, and each has brought valuable assets into their marriage. Now, they are in the process of consolidating them.

At the same time, they are starting to take a serious look at setting up an investment plan. Neither had really given much thought to investing before they were married; they simply made decisions about individual investments as the need arose, with no overall plan in mind. Now, they have decided that the best approach is to determine an appropriate asset allocation and try to refocus their investments according to the plan.

First, however, they need to take stock of where they currently stand—the current allocation of their investment portfolio. And that has led to some confusion: Which of their assets should they include as part of their “investment portfolio?” Some of the assets are relatively clear, but others are less so.

The Morrisons’ Assets

Table 1 shows the assets that the Morrisons think may “count” as part of their investment portfolio.

Thelma has a checking account with a balance of roughly \$500. She also managed to save \$15,000, which she invested in a five-year certificate of deposit. Thelma’s employer sponsors a 401(k) plan in which she participates. Her own contributions and the vested portion of her employer’s contributions total \$30,000, and she has invested these assets in a stock fund (\$18,000) and a GIC (guaranteed income contract) (\$12,000). She also has unvested employer contributions, to which she will be entitled if she stays with the company for several more years. Thelma owns a condominium in which the couple

is now living; her equity investment (estimated market value less the mortgage) in the unit is roughly \$65,000. And Thelma has brought some “hard assets” into the marriage—she has about \$8,000 worth of jewelry and \$20,000 of antiques, which she enjoys collecting.

Howard has a money market fund totaling \$10,000, and a small life insurance contract that he was talked into purchasing several years ago. He managed to save \$15,000, which he has invested in a stock fund. His employer also sponsors a 401(k) plan in which he participates; his vested portion currently stands at \$33,000, of which \$25,000 is invested in a stock fund and \$8,000 in a balanced fund (with a 60% stock/40% bond investment objective). Howard’s company also sponsors a defined-benefit pension plan, although he has not been with the company long enough for his entitlement to amount to very much. Howard owns a condominium, which the Morrisons rented out once they decided to move into Thelma’s unit. His equity investment in the condo is \$50,000. Howard has a relatively new car that is worth about \$10,000 and a stamp collection, valued at about \$8,000.

The Morrisons also expect to receive certain assets in the future. Thelma’s grandmother recently died and left her five stocks valued at \$50,000, but the estate has not yet released the shares. In the more distant future, they hope to stay with their current employers and receive the unvested portions of their employers’ 401(k) plan contributions and pension plan. Of course, both have been contributing to Social Security, and they hope to receive some payments once they retire—assuming Social Security still exists.

The Morrisons’ Investments

While the Morrisons have been able to identify most of their assets, they are uncertain what they should con-

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Table 1.
The Morrisons' Investment Portfolio: What's Included?

	Current Market Value* (\$)	Include in Investment Portfolio?	Comments
Thelma's Assets			
Checking account	500	No	Inconsequential
5-Year CD	15,000	Yes	Category: Fixed income
401(k) Plan:			
Stock Fund	18,000	Yes	Category: Stock
GIC	12,000	Yes	Category: Fixed income
Condo	65,000	No	Consumption item
Jewelry	8,000	No	Consumption item
Antiques	20,000	No	Consumption item
Total	\$138,500		
Total "investments"	\$45,000		
Howard's Assets			
Money market fund	10,000	Yes	Category: Cash
Cash value life insurance	8,000	Yes	Category: Fixed income
Stock fund	15,000	Yes	Category: Stock
401(k) Plan:			
Stock Fund	25,000	Yes	Category: Stock
Balanced Fund	8,000	Yes	Category: Stock/Fixed Income
Condo	50,000	Yes	Category: Real Estate; not a consumption item
Car	10,000	No	Consumption item
Stamp Collection	8,000	No	Hobby
Total	\$134,000		
Total "investments"	\$116,000		
Expected Future Assets:			
Thelma's Inheritance: 5 stocks	50,000	Yes	Category: Stock; expectation is soon and certain
Social Security	??	No	Distant and uncertain payments
Unvested pensions	??	No	Distant and uncertain payments
Total "investments"	\$50,000		
Total of all "investments":	\$ 211,000		

* Illiquid assets are valued at estimated market value. Condominiums are valued at estimated current market value less outstanding mortgage.

Asset Allocation of Combined Portfolios:

<i>Allocation:</i>	
Cash	5%
Fixed-Income	18%
Stocks	53%
Real Estate	24%
	<u>100%</u>

sider as an "investment." The issue is important, because it will affect their asset allocation decisions.

After mulling over the issue for some time, however, the Morrisons reach some conclusions about what they will include in their "investment portfolio," what they will exclude, and how they will value and categorize their inclusions:

- **Their personal investments:** Thelma's checking account and CD and Howard's money market fund and stock fund are relatively straightforward, and for the most part will be included as part of their investment portfolio; they will be valued at their current market value, and categorized as cash (for the money market fund), fixed-income (for the CD) and stock (the stock fund). However, they decide to exclude Thelma's checking account, since the sums in it tend to be (and most likely will continue to be) inconsequential. In the future, larger sums of cash will be kept in the money market fund.

- **Howard's cash value life insurance:** This includes a savings component that they will include in their "investment portfolio." Of course, it also includes an insur-

ance component that should not be included. The amount they include, therefore, is the current surrender value less the premium they would need to pay for term insurance with equivalent coverage. Since the investment portion grows at a fixed rate, they will treat the savings component as a fixed-income investment.

- **Their 401(k) plans:** The amounts in their plans to which they are currently entitled—their own contributions and the vested portions of their employer contributions—are included as part of their investment portfolio and valued at their current market value. They are categorized based on how they are invested, with Howard's balanced fund investment categorized as 60% stocks, 40% bonds, and Thelma's GIC categorized as fixed income.
- **Their condominiums:** The Morrisons have decided that assets they are using primarily for consumption rather than investment will not be included in their investment portfolio. They are currently living in Thelma's condominium, and when they sell it, they will use the proceeds to purchase another home in which to live. Howard's condominium, on the other hand, has essentially turned into an investment, although he did not really intend it as such when he originally purchased it. Therefore, Howard's condo is included in their "investment portfolio," and valued at its estimated market value less the mortgage; it is categorized as a real estate investment.
- **Thelma's jewelry and antiques, and Howard's car and stamp collection:** The Morrisons decide not to include these in their "investment portfolio," since they are more for consumption rather than an investment—they are hard to value, they are illiquid, and the Morrisons are unlikely to sell them to meet future needs.
- **Thelma's inheritance:** Although Thelma has not yet received this asset, she is certain to in the near future, and thus the valuation of it is relatively straightforward and easy to include in their investment portfolio. It is categorized as a stock investment.
- **Thelma and Howard's unvested employer 401(k) contributions, pension plan, and future Social Security payments:** The Morrisons decide to exclude these from their investment portfolio because the possible payments are too uncertain and distant, and their current value is difficult to estimate and therefore meaningless. If, however, the Morrisons were just a few years away from the payments, they would be included, since there is much less uncertainty concerning the payments and the value can be estimated. [One approach to estimating the value of a stream of payments, such as pensions or Social Security, was outlined in the article "Re-Examining Your Asset Allocation in Light of Vested Pension Payments," in the January 1997 *AAII Journal*.]
The bottom of Table 1 shows the Morrison's asset allo-

cation based on their decisions concerning what to include and exclude. You can see that the resulting allocation would be quite different if, for example, they had excluded Thelma's probable inheritance or Howard's condominium.

Defining an Investment Portfolio

The Morrisons ran into a problem faced by many investors—although many "investments" are easily identifiable, some are not. It is important to carefully consider what you should include and exclude from your "investment portfolio," because it can have an impact on your asset allocation. If you misdefine your investment portfolio, you may wind up with an asset allocation that is less efficient in meeting your needs.

An investment portfolio should consist of financial assets that you would be willing to sell for spending money or that generate some form of spending money, either now or some time in the future.

Many items, such as mutual funds, stocks and bonds, are obvious. But other items, such as your house or pension payments, are less clear.

Here are some points to consider if you are uncertain about what to include or exclude as part of your investment portfolio:

- Is there a dollar value that you can attach to it? Some assets are difficult to value—for instance, stock options on your employer's stock. If the value is vague, its inclusion in your overall portfolio will add little meaning and would serve only to confuse your allocation strategy.
- Is it of substantial or material value? Some items may not be worth much relative to your other assets—for example, you may only carry small balances in your checking account. If the item is not worth much relative to your other assets, it is not worth the effort to add it to your overall portfolio.
- Is it an asset that, if not included in your portfolio, would cause you to structure your portfolio differently? An example could be pension payments you are receiving after retirement—excluding these payments from consideration may cause you to invest a substantially higher amount in fixed-income securities than would otherwise be the case; they should therefore be included.
- Is it an investment asset or a consumption asset? An investment asset is a financial asset that you would not mind liquidating for cash to spend and should be included in your investment portfolio. A consumption asset is purchased for purposes other than simply investment, such as your home (a housing need) or a collectible (a hobby or desire); these would be more difficult to part with and should not be included in your investment portfolio. 