Understanding Your Assets

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Introduction

A few years back I heard a story describing how some European 'old money' families keep their wealth intact from one generation to the next. In America (and especially here on the West Coast) we tend to have a very short-term view from a historical perspective. We like to say a house is old if it was built in the thirties or forties, and when I lived in San Luis Obispo if I stumbled across one built before 1900 it was likely to have a plaque proudly commemorating its age. But when I first started travelling abroad I learned what history and old really meant; often when meandering the mazes of European cities I would turn a corner to unexpectedly stumble upon a place hundreds of years old that had been used for dozens of different reasons. In a small fishing village I once stayed a home claimed to be here before Christ. Now that's old. So it's no surprise that some of the families overseas have managed to preserve their wealth for far longer than America has been around.

According to the story, the dynastic European families were said to preserve their wealth according to the breakdown of 'a third, a third, a third' – that is, a third in land, a third in gold, and a third in fine art. The thought behind this was that gold could hold its value acting as a medium of exchange while art and land deeds could easily be transported if a swift escape on the back of a horse was necessary. Today society has evolved to allow for many alternative ways to safely store one's wealth, but it remains an interesting thought that comes with a few important takeaways, namely the importance of diversification.

The problem with diversification is we seem to have too much of a good thing, and it can quickly become overwhelming when evaluating your choices of how to invest. To make things worse, there are new products constantly being rolled out to further muddy the waters – just when you start to understand VAs and CDs suddenly you have to deal with CMOs, CDOs, ETFs, MLPs, and ADRs… what's an investor to do??

That's where this book comes in. What I have put together is what I intend to be an easy to understand breakdown of all the different options you have for investing your money. I will briefly cover each category, a high level historical review of what it is and how it works, and some of the pros and cons of that asset class. At the end of reading this you will not be a CERTIFIED FINANCIAL PLANNER™ professional or Certified Financial Analyst. You will not have a sure-fire strategy that is guaranteed to always make you fistfuls of money in every situation. But what you will have is an excellent starting point that will launch you into the right framework and help you know the right questions to ask when working with your CERTIFIED FINANCIAL PLANNER™ professional. It will help you understand the financial roadmap necessary for picking the route best suited for your personal needs and tastes.

A Word About You…

Before we jump into the traditional list of assets, I wanted to take a moment to acknowledge an asset often overlooked but by far the most important: you. You are your most valuable asset as it is from you and your earning capabilities which all other assets flow and serve. It is all fine and good to accumulate and sustain wealth, but it is important to remember wealth is not the means in and of itself but rather a tool to use for yourself. You are responsible for taking care of yourself, and ultimately you are accountable for how you conduct yourself and the impact you make. I firmly believe health to be far more important than wealth and would advise anyone pursuing wealth accumulation never to do so at the neglect of his or her own well-being; until we perfect cryogenics this is the only body you get.

Practically speaking, you are also your most important asset because of the ability for you to go out and work. If you lost everything you still have the opportunity to go out and get a job, to start your own company, or to create something that will generate income for you. In that regard nothing is more valuable or renewable than the asset of yourself. This often gets overlooked, but it is an important fact to remember. So as we go through this book, keep in mind you are your most important asset, and one of the best ways to invest your time is by working out, eating right, reading new material, and carefully monitoring what goes into your body, mind, and soul. With that in mind, lets jump into the more traditional assets, beginning with cash.

Cash and Cash Equivalents

Cash is king. By far the easiest asset to understand, cash exists as a middle man of sorts for turning wealth into consumable goods and back again. If you dust off your old high school economics books and dive in you will find cash exists to serve three main functions: a medium of exchange, a store of wealth, and a unit of account. Thanks to a pro-inflationary policy established by the Federal Reserve Bank (or Fed as it is known), cash has become an expiring asset that no longer serves as a store of wealth. That is to say inflation hurts cash with the result being the amount of goods you can buy this year is likely going to be less next year at the same price and certainly going to be considerably less in ten years from now. In fact, just six years after the rollout of the Fed, people saw the value of their dollar decline over 50% as inflation averaged over 11% annually (they also saw the introduction of a permanent Federal income tax to take those less valuable dollars). So cash is not the store of wealth it once was, but it still serves as an excellent medium of exchange and unit of account. A medium of exchange just means we are not going around bartering, trading the proverbial sheep for a loaf of bread or oil change. And the unit of account means we measure our consumptive habits and savings by dollar amounts.

Speaking of savings accounts, when you put your money in savings accounts you earn interest. How many of us have been gathering our tax statements only to be amused by receiving a 1099 from the bank for $7.57 or some other ridiculously small amount? But the fact remains you do get interest from a savings account. You get even more if you put your money in a certificate of deposit, or CD. Not much more, but some. With a CD you are agreeing to leave your money with the bank for a set amount of time (anywhere from 3 months to 30 years), which allows the bank to turn around and loan it out to others thus making money on the difference between what they collect and what they give you. This is known as the spread.

CDs and savings accounts are very secure; in fact, if you bank with an FDIC insured institution (NCUA for credit unions) than the government is guaranteeing you will not lose your money, up to $250,000 per registration. That is a great promise, but you have to keep in mind that you are receiving a low nominal return, and in reality the real return (amount after inflation is taken into account) is almost always negative. Essentially you are locking up your money knowing that it will definitely be there at the end of the CD period but simultaneously knowing it will be worth less when that days comes. Not a good deal if you ask me!

Conclusion on Cash

Cash is a necessary evil – you need to keep some of your wealth in this highly liquid form for buying groceries, paying bills, and taking advantage of fluctuations in other assets (buying during the lows). The exact amount to keep in cash varies on your personal needs, but the art lies in keeping as little as necessary in cash so that most of your wealth does not suffer the eroding power of inflation.

- Cash Pros: Easily accessible, easy to evaluate, easy to convert to other forms of wealth
- Cash Cons: Low nominal return, usually negative real return with inflation

Debt

While it can be ironic to think of debt as an asset, in reality this is one of the most common types of assets people own. I am not talking about the personal, credit card, student, or housing debt they have but rather the debt on which they stand to collect the money. Although this can be done very informally via lending a friend or family member some money, you can also hold officially issued debt instruments with systematic payback timeframes. In exchange for loaning your money and essentially locking it up for a set period of time, you will receive more than you lent upfront which is your return on the investment.

Bonds

Most debt instruments are bonds. A bond is nothing more than a note in which the borrower promises to pay back the lent amount at a specified time that can range from a few months to 30 years or more. Usually (but not always) the borrower also promises to pay interest at regular intervals for the privilege of using your money; these payments can be monthly, quarterly, semi-annually, or annually. Some of the largest issuers of bonds are national, state, and even municipal governments who usually only collect revenue once a year but need cash flow every day to pay bills and keep infrastructure running. They either issue bonds to be paid by specific sources of revenue (like toll bridges) or more commonly are backed solely by the power of that level of government to collect taxes. These bonds often come with special tax advantages that allow them to offer a lower yield than would otherwise be demanded by the market.

Apart from sovereign debt, corporations also issue bonds. Because their debt is only backed by their ability to generate revenue, the interest investors charge a corporation vary widely depending on how likely that company will be able to pay its bills on time. For example, a large, established corporation is able to secure debt at a considerably lower interest rate than a bootstrap startup trying to launch its first project. The irony is the startup needs the money cheaper than an established competitor, but because of the high level of risk it will have to pay handsomely for those funds. In order to create an apples-to-apples comparison, several companies provide ratings on bonds that allow investors to quickly discern the likelihood that the issuer might not be able to make payments, resulting in a default of the bond. Top-rated bonds are deemed 'investment grade,' a label often required for larger investors like banks and pension funds. As you would expect, these investment grade bonds are sold with a lower interest rate than non-investment grade, or junk bonds.

There are many other types of debt instruments, but they all work in a similar fashion in that one person or group lends another funds in exchange for systematic interest payments and an eventual repayment of the principal. The differences occur on what the money lent is used for and can vary widely from real estate to stock investing even to covering personal consumption. As an investor, one important thing to understand about all debt instruments is the possibility of not being able to access your money. When you invest directly in bonds you will not receive your principal back until the maturation date, which can be thirty years or more in the future. If for some reason you needed the money sooner you would be forced to sell the note in the open market, potentially at a steep discount. One way around this illiquidity is to invest in a bond mutual fund, exchange traded fund (ETF), or other type of collateralized investment which can be redeemed in just a few days, but in exchange for the liquidity privilege you will see considerable more volatility from daily pricing. Like many of the other assets we will be discussing, one way of investing in bonds is not inherently better than the other; they both offer advantages that will weigh as more or less important depending on your specific situation. Be sure to talk with your financial professional to determine which route is best for you.

Conclusion on Debt

Next to cash, debt instruments are some of the easiest investments to understand – you lend money for which you receive systematic interest payments until the borrower has paid back the money. Most commonly in the form of bonds, these are traditionally viewed as relatively safe because you are not partaking in the potential profits and losses but rather acting lender providing a needed source of funds. Because of this relative safety, bonds tend to offer a lower rate of return than can be found elsewhere.

- Pros: Easy to understand, relatively safe
- Cons: Money can be tied up, relatively lower returns

Real Estate

It has been said that people do not get in to real estate because they like real estate but because they like what real estate can do for them. Along that line of thinking there are countless different ways to invest in real estate with new innovations constantly emerging, but most people find their experience in real estate begins by owning their primary residence.

Owning your home can be a great way to build up equity. If you buy a home using a mortgage then every month a portion of your check goes towards paying down the loan, meaning a little more of the house's equity becomes yours. This is obviously favorable when compared to giving rental money every month without receiving anything in return, but it also comes with a huge increase in responsibilities and liabilities. Home owner's insurance, mortgage insurance, property taxes, home owner's association fees, and additional utilities are only the beginning. Anyone who has owned their own home will be quick to tell you the work is never finished as they have a constant stream of projects for upkeeping the place. On one house I bought I had been the owner for less than two weeks when my neighbor's tree fell, crushing my fencing and leaving me with a huge clean up job. Nevertheless, owning your primary residence is the desired path for millions and can serve as an entry point into real estate.

Historically, homeowners have found a significant portion of their wealth locked up in the primary residence without an easy way to access that, but today there are a few options available. Two of the most common ways to access your home equity are a home equity line of credit and a reverse mortgage. Reverse mortgages in particular have undergone a major makeover in recent years making them much more appealing then they once were. These products are not for everyone, and you should definitely talk with a financial professional when considering them, but they have created a way to access they equity in your home without having to sell.

After seeing the favorable growth of one's own home (usually multiplied by the leveraging power of a mortgage), some people like to venture into owning rentals. Often this means moving into a new house and keeping the old one to rent out, but there are plenty of other options when exploring the world of property management. Traditional homes, or single-family residences as they are known, are only the beginning – you can also own multi-family dwellings like duplexes, triplexes, and fourplexes in much the same way as a single-family dwelling. However, once you increase the number of units beyond four the property becomes known as commercial property (think of the large 100+-unit rentals in major cities); commercial property can also include stores, malls, office buildings, storage units, industrial parks, or any other non-residential property. At the opposite end of the spectrum you can purchase raw or unimproved land. Raw land is often considered speculative in nature because you will not be collecting any rents on the property but rather are betting the piece will be worth more after adding improvements, subdividing into smaller pieces, or merely waiting for surrounding developments to raise the value of your land.

Like owning a primary residence, each of these types of ownership come with immense responsibilities. On top of the costs mentioned before, a landlord is responsible for finding and screening potential renters, signing and maintaining leases, collecting rents, and complying with local regulations and common decency when going through a turnover. If the tenet decides to stop paying it often takes months to get them to vacate, and if they disappear in the night the landlord is still responsible for the bills. And speaking of night, you as the landlord need to be available for a call in the middle of the night revealing the toilet is broken and water is shooting everywhere. If a landlord does not want these responsibilities they can hire a property manager, but it comes at a very steep cost (in my area the standard is 10% of rent collected in addition to miscellaneous expenses) that quickly erodes the return from the rents. Although every real estate guru will preach the importance of only buying real estate that provides a positive cash flow from year one, it is not uncommon for landlords to spend the first ten years or more putting money into the property before ever seeing a penny. Fortunately, there is an alternative for those not keen on devoting countless hours but would rather relax after working so hard to earn the money in the first place. Pooled funds which are professionally managed provide a passive option for investing in real estate as well as give access to the larger scale commercial properties otherwise beyond the reach of all but the wealthiest. Real Estate investment Trusts, or REITS, are by far the most commonly known option; these investment vehicles can be publicly or privately traded and offer varying degrees of flexibility on how often someone can buy into or cash out of the REIT. They provide prospectuses that detail exactly the trust's targeted type of real estate, geographical constraints, and everything else you need to know before handing your money over to the professionals. REITS are required to pay out at least 90% of their income to unitholders and as a result do not receive the double taxation of corporations (discussed later). For those looking for passive investment into the area of real estate, REITs can be a great option.

With all those advantages, why would anyone prefer owning the actual (albeit smaller) rental unit? Some people prefer to only own what they can physically get their hands on, but the much more common reason for owning real estate directly is the tax advantages it offers. The tax code is always changing but consistently provides a number of advantages tied to real estate, the biggest two currently are the mortgage expense deduction and the noncash depreciation expense. Talk to your tax professional to understand the nuances of how these tax write-offs work because if you are in a high enough tax bracket the savings can be worth the extra effort of owning rental units. Just know there will be plenty of extra work!

Conclusion on Real Estate

Real estate is an excellent vehicle to use to increase your net worth, even if the only real estate transaction you ever make is buying a primary residence. Beyond a primary residence the options for involvement are wide, ranging from investing in Real Estate investment Trusts to dedicating your full-time job to managing properties. Remember though that while this is an important asset class, it is only one of them.

- Pros: Great for building wealth through a primary residence. Tax advantages to leveraging and depreciation
- Cons: High levels of maintenance; often negative cash flow initially

Commodities

Commodities are the raw materials and ingredients that are used to make the modern world as we know if. By that account they can include almost anything, but there are a few categories people who invest with commodities commonly deal in; the other areas are generally limited to individuals who work in that specific industry and are more likely stockpiling inventory. Commodities are often touted as advantageous when other assets are declining in value because people still need to consume the underlying assets. Consequently, many professionals advocate for including a portion of your portfolio in this asset class if you are in a position where minimizing volatility is a priority.

Gold and Precious Metals

For the sake of simplicity I am only going to discuss gold here, but bear in mind this applies to all precious metals. Gold is one of those unique assets that has trouble perfectly fitting into a specific category. On the one hand, people can and do argue it should be considered a cash equivalent for its historical usage as a medium of exchange. However, ever since 1971 the United States has not had its currency backed by gold, and the reality is if you went to your local Starbucks and tried paying for your tall, non-fat latte with caramel drizzle by shaving off a sliver of a gold nugget things would likely not go smoothly (although I encourage you to try). Even after you have determined gold is a commodity there is still discussion as to its usage, whether it is better off conducting electricity or being beautifully sculpted. But whatever side of the argument you decide to fall the fact remains gold is one of the most commonly known and subsequently most frequently held commodities in individual's portfolios. Like religion and politics, how much gold to hold is a deeply controversial subject depending on your views regarding future inflation, general economic trends, and state of the government in general. We all know someone who believes the country is on the brink of collapse and gold will be the only medium of exchange offered. But at the end of the day gold is just a commodity with its positives and drawbacks, and it is important to talk to a financial professional to get a better idea of how much is optimal for you.

Energy

The next most well-known commodity after gold and precious metals is energy. Most commonly crude oil, energy can also include (but is not limited to) heating oil, natural gas, gasoline, and alternative energy sources. Prices for oil can fluctuate based on supply and demand as well as speculation, just ask anyone who had to wait in line to fill up their tank of gas during the 1970s gas crises. In fact, oil often carries the distinction of being thought of as the most volatile asset, a fact compounded by the high levels of leveraging that take place when trading oil.

Livestock and Agriculture

The last major area of commodities is livestock and other agriculture. As an interesting side note, coffee is the second-most traded commodity in the whole world, second only to crude oil. Other common types include wheat, cotton, sugar, beef, poultry, and eggs. As is the case with the other categories, it is important to keep in mind that people who deal in commodities are not stockpiling for their own personal consumption but rather to eventually convert into cash. You do not collect gold bars with the intention of melting down to build jewelry or plan on refining a barrel of crude oil to power your car anymore than you trade coffee bean with the goal of roasting your own cup from them. Of course, any of those practices are eventually necessary, but at that point you are no longer talking about commodities as assets but rather using them in your business, an area we will discuss later.

How to Invest in Commodities

So lets say you want some of your net worth to be stored in commodities; the logical question becomes how to do just that. Luck for you there are a number of options for investing in commodities. The simplest and least common would be to actually hold the physical item itself. This of course has the benefit that you know the goods exist and are physically able to keep tabs on them – much in the same way as people who own rentals like their money tied up in something they can touch. However, also like rentals there can be very high holding costs associated with commodities; just because you know the goods are, well, good does not mean anyone you want to do business with will take your word. Often you have to verify the quality of the commodity through a third party when divesting of the item, a process which can be quite expensive.

A far more common practice is to trade in commodity futures contracts. Originally created as a way for farmers, oil and gas producers, miners, and others whose business it is to produce commodities to hedge their bets and manage the risks associated with the uncertainty of volatile prices, futures trading can be a means for dealing in commodities without ever having to hold the underlying asset. Essentially, with a futures contract the seller agrees to provide a fixed amount of a certain commodity to the contract buyer on a particular future date and time. This agreed upon price allowed the farmer to confidently grow crops knowing he or she would make a profit regardless of spot price movements. Although one could deliver this as promised, in practice most traders today close out the contract by simply entering the opposite trade that they initially opened with. This option is much more common than actually holding the commodity, but it can quickly become a speculators game, amplified by the fact futures markets are highly leveraged.

For those who do not have the time or desire to be intricately involved in the time intensive options listed above, exchange traded funds (ETFs) and mutual funds exist that specialize in commodities. These options usually follow the underlying commodities the fund is named after (ie a gold ETF tracks the price of gold per ounce) or own stocks of businesses that create those goods. The biggest downside to these vehicles is that they do not also track as closely to the underlying asst as actually holding the commodity, a small price to pay for holding a highly liquid asset.

- Pros: Good way to store inventory in a business you are already engaging in. Future contracts are great to hedge against uncertainty.
- Cons: High costs to hold the actual asset, often speculative if not your main business

Collectibles

We started this journey with the ancient aristocrats who kept a third of their wealth in art – this is a classic example of a collectible. The reasons for it being so classic are twofold. First is the collectible item itself; art is one of the most cited and well-known collectibles. Regardless of their feelings for the Impressionists, people are not often surprised when they hear about a Monet painting selling for well north of forty million dollars. The other reason this is a perfect example is because collectibles are a usually niche type of investing reserved for the wealthiest. Although technically any item that increases in value due to its rarity or popular demand can be categized as a collectible (many of us remember the Beanie Baby craze of the 1990s), the list of collectible items that have survived over the centuries is much smaller, consisting primarily of coins and jewelry, fine arts and rugs, and spirits and wine. It is worth noting that while a very small minority have made their fortunes dealing in this arena and a slightly larger group have managed to store wealth successfully in collectibles, most have not fared well. For the majority of people the best you can hope for is the meaningful pursuit of a niche hobby, and there is absolutely nothing wrong with that. But do not delude yourself into thinking a trip to Napa is research for your investments, because it's not.

Coins and Jewelry

There are few better way of engaging in subtle flashiness and displaying wealth then wearing jewelry, but when some people hear that coins or jewelry are categorized as a collectible and not a commodity they get upset. Often their thought process is the underlying materials should be tracking the price of that precious stone or metal; unfortunately, the reality is these prices show very low levels of correlation. When the price of gold plummeted in 1980 from around a 2018-dollar inflation adjusted $2,200 an ounce to under $400 twenty years later the retail price of wedding rings did not experience a similar 80+% corresponding drop, in fact there was actually an increase in the average ring cost. This makes sense when you realize a large portion of the price comes from the labor to harvest, refine, mold, and deliver new jewelry; in fact, diamonds are actually the most common gem available on earth. It is the appearance of scarcity that keeps their values high, a fact which raises an important point – coins, jewelry, and all collectibles are only valuable to the extent they are deemed scarce (which is why coins with varieties, errors, or mistakes are ironically often worth the most), and if that deemed scarcity ever vanishes the value of the asset will plummet. In this sense storing your wealth in collectibles is a financial equivalent of playing with fire.

Fine Arts and Rugs

Fine arts and rugs are a little safer because the scarcity is not faked, meaning the quality comes into play much more. There are only so many Picasso paintings in existence, and since he has been recognized as a master painter and genius in his expansive imagination it would naturally follow those who appreciate art are willing to pay handsomely to own one. The concept holds true for all forms of art from a purely wealth accumulation and preservation perspective (which is a terrible way to view art I might add). The value lies in the recognized quality of both the work and the worker. Plus, as an added bonus you can easily transport art if you are a European elite fleeing plebian revolution on a horse.

Wine and Fine Spirits

Unlike paintings which can last for centuries, wine and fine spirits are one of the most unique collectibles as they have a relatively short life cycle. Therefore, it is imperative to dedicate considerable time upfront learning what makes a particular wine age worthy as well as when the peak time to sell, trade, or consume before the alcohol begins to break down. For most who do collect, it is more a labor of love that allows an opportunity to develop a personal style to be shared over communal events, and the decision to begin collecting often comes only after years of learning how to analyze critic ratings, point scores, vintage reports, vineyard location, tech sheets, tasting notes, and retail price as well as personal preference. On top of that there can be considerable upfront and storage costs to ensure the taste is not compromised. I enjoy wine as much and maybe more than the next person, but I strongly caution all but the most determined to avoid labelling their wine collection as a wealth accumulation or preservation vehicle.

Conclusion on Collectibles

It is impossible to argue that collectibles are not fun. Without a doubt, people enjoy bragging much more about private wine collections or the trading cards now worth ten times what they paid compared to other matters of wealth preservation. But channeling a significant portion of your wealth into these vehicles not only locks them up due to high transaction costs but also puts them at risk of substantial price decreases if public opinion towards the items change. And to really have a go at it you need to spend considerable amounts of time learning the market. Treat collectibles as an interesting side project and you will never be disappointed if their value does not keep up with inflation.

- Pros: Can make a fun hobby or passion profitable
- Cons: Generally niche markets with intense level of time that must be spent before you have the knowledge to profitable invest

Business

By far the majority of wealth held in America and worldwide is the held in businesses. Business is a unique asst class because it is primarily a means of wealth creation, yet once a business reaches a certain maturity is absolutely can continue to preserve the owner's wealth. Most millionaires in America are self-made and did so through creating value through a business. Indeed, the number of business opportunities is limited only by the imagination and government regulation – if you can dream it up, odds are there is either a business or an prospect for one. However, the number of ways to structure or partake in a business is a far shorter list and thus will be the focus in this section.

Sole Proprietor

If tomorrow you were to go out and start selling the vegetables in your garden or the knowledge in your head you would be operating as a sole proprietor. In most places there is no specific license to run a business in this manner, and as long as you comply with regulatory guidelines for your industry the barriers to entry are relatively low. The money you make you report as personal income, and in years you lose money you report that loss on your tax return as well. Entrepreneurs who launch their own business and run everything themselves are affectionately called solopreneurs; however, a sole proprietor can have as many employees as necessary. Running a business as a sole proprietor is relatively cheap, easy, and unscalable. So as one grows they rarely stay in this phase forever.

Partnerships

Partnerships function similarly to sole proprietors with the ability to have multiple owners involved. Like a sole proprietor, there are usually very few barriers to setting up a partnership, but at the same time the responsibilities (and corresponding liabilities) are squarely on the partners shoulders. In part because of this there are a number of ways to setup a partnership. At the most basic level of partnership, two or more individuals agree to enter business and share the profits or losses an level proportional to the financial and human capital invested in the business. For example, two mechanics may want to open their own body shop and each pitch in $40,000 for startup costs. Each year after all the bills have been paid they would split the profit equally. Alternatively, a partnership could also occur if one mechanic wanted to open a shop but did not have funds to pitch in so he went out and found and investor who instead of simply loaning the money wanted to participate in the profits. Here a partnership would be formed where one party contributed the human capital (the mechanic’s labor) and the other party supplied the financial capital (the investor’s money); how the profits would be split would be up to the arrangement between the two.

These setups described above are known as general partnerships, and every partner who is a general partner is personally liable should anything happen. So theoretically if the partnership is sued and loses the lawsuit the partners can be forced to give up their personal belongings, even their house! To mitigate this risk, another type of partnership available is the limited liability partnership, or LLC. In a limited liability partnership, there is one general partner who is still liable if things go south, but everyone else is a limited partner with limited rights and responsibilities. Limited partners cannot partake in the day to day business (although they do still have a list of rights) and in turn are not personally liable. That is to say they can only lose the money or other assets they invested into the partnership. This is important for a number of reasons, not the least of which is that it attracts investors who are not looking to be as actively involved like the mechanic-investor example listed above. Instead of just two partners, a limited liability partnership quickly allows dozens or even hundreds of investors to share in profits and loses, which is essentially the idea behind Master Limited Partnerships, or MLPs. MLPs can participate in a wide variety of areas but are generally limited to finding, gathering, storing, processing, and shipping oil, natural gas, and other energy sources; it is also common to have real estate and agricultural MLPs. A major advantage these structures offer is a pass through on losses without all the liability which allows people to claim losses during the early years of an endeavor when the person is in a higher earning tax bracket and can benefit from the deductions but then enjoy high returns later when his or her earned income is significantly lower. MLPs can get complicated quickly, so talk to a professional if this is an area that has piqued your interest.

Corporations

As a business continues to grow it is common to eventually file as a corporation. Corporations are significantly more complicated than sole proprietors and partnerships, and we will not get into all the details here. The barriers for setting up a corporation include filing a Certificate of Incorporation and paying any accompanying fees, creating bylaws for how the corporation should act, setting up and appointing individuals to a board of directors which meets at regularly scheduled intervals (in most states at least one year). With a corporation, shares of stock ownership are issued, and whoever owns the stock owns a percentage of the company. Another unique aspect is the requirement for the corporation to file a tax return, and depending on how the corporation is structured, it might have to pay taxes (not the case for a closely held subchapter, or S, corporation. The reasoning behind this is that a corporation is its own entity with many of the same rights as an individual – for instance it can sue and be sued and it continues to exist after the founders have stepped away. In a sense the business takes on a life of itself when incorporated.

Right about now you are probably wondering why anyone would ever want to incorporate their business when it comes at such a high cost both financially and time-wise. Well there are some major benefits too, not the least of which is flexibility in exit strategies. With a sole proprietor and a partnership, the only way to exchange ownership is through a negotiated selling off, and usually stepping away from the business results in no more income stream for the former owner. With a corporation, however, whoever owns the stock shares is legally entitled to any profit the corporation chooses to pay out. This can be beneficial when a founder wants to reward his loyal employees with direct participation in the profits, when a family owned business wants to seamlessly transfer ownership from one generation to the next, or when an outside investor wants to get involved with a company he or she otherwise might not be able to access. This exchange becomes even easier when a company is publicly traded on any number of stock market exchanges; indeed, investing in a publicly traded company is one of the most liquid forms of investing available. In fact, this structure is so important that as many smaller companies go out in search of funding, they find Venture Capital firms and angel investors will not commit any resources until the business is structured as a corporation. It is important to note that high liquidity can have negative repercussions if it causes the investor to irrationally react to negative news and pull their money out of the businesses when there is a temporary dip in pricing, but overall liquidity is generally an advantage.

Conclusion on Business

Business is a unique asset; more than any other asset class (with the exception of some collectibles) it has a lifecycle that rarely lasts forever. The sole proprietorship dies with the sole proprietor, and even corporations, the type of business built to last, eventually fall. Many of the largest market capitalized companies of today did not exist or were very tiny twenty years ago. At the other end of the cycle in 2018 General Electric became the last of the original members of the Dow Jones Industrial Average to leave that index, with many of the others no longer in existence. So ownership in businesses must be prudently watched by the investor or his or her financial professional. That being said, business is a tremendous opportunity to not only amass personal fortune but preserve it as well and almost always makes sense to be a part of someone's financial plan; the question is just in what capacity.

- Pros: Easy to start, tremendous growth and retention opportunity, publicly traded companies highly liquid
- Cons: Has lifecycle, daily values can be highly volatile

Umbrellas

Umbrellas have been around for a long time. There are documented accounts of people using umbrellas in ancient China hundreds of years before Christ. Whether it is raining or sourcing heat, umbrellas have their place and likely always will. But they are not what this chapter is about. I wanted to take a moment to briefly explain your options for how to invest, or the different types of accounts available to you. Within each large section, or umbrella, that are many products and structures available, and I will not be providing a comprehensive list. But this should give you enough of an idea to know what kinds of questions to ask next time you are sitting with your financial professional.

Taxable Accounts

Most accounts are taxable accounts, also known as non-qualified accounts as they do not receive any preferential treatment regarding taxes. These include your bank account, a trust account, and just about anything that you receive a 1099 tax form from at the end of the year. Although taxes must be paid annually on the recognized earnings in taxable accounts, the tax treatment of these earnings ranges widely depending on (among other factors) how long you have owned the assets, what type of assets they are, and what type of income has been produced (interest, dividends, or capital gains). The major advantage of taxable accounts is the ease of access to your money – there are no requirements for when you can pull your money out. This makes them ideal areas for store your wealth for shorter term goals like buying a first primary residence as well as working capital to pay for everyday items. When used right taxable accounts play an extremely important feature in your comprehensive plan.

Tax-Deferred Accounts

Some types of accounts and investment vehicles allow for the deferral on taxes for changes made to the portfolio. The most well-known of these is the traditional IRA, an investment vehicle that allows you to invest in almost anything, make changes as appropriate, and never pay any taxes until you pull the money out of the account to spend or put in a taxable account. Additionally, IRAs are unique in the fact they allow you to claim a deduction on your income tax for the year(s) you make contributions, subject to certain limitations and phaseout rules. With a tax deferred account, planning and rebalancing changes because you no longer have to consider tax implications from selling an asset that has enjoyed considerable appreciation. Since all assets coming out of the tax-deferred account are treated uniformly it can be advantageous to invest in assets with less favorably tax treatment through tax-deferred accounts and save the more favorable tax treatment for taxable accounts.

Tax-Free Accounts

A tax-free account is similar to a tax-deferred account in the sense that no changes made in the account trigger tax considerations, but it actually goes a step further by having no tax repercussions for withdrawal from the account, subject to certain rules. all other things being equal, this is obviously the best scenario and unsurprisingly is also the least common type of account. An example of a tax-free account is a Roth IRA which allows tax free growth but does not offer the initial tax deduction often found with the traditional IRA. As with the tax-deferred account, special consideration should be given to the investment types and their tax treatment when deciding what to put in a tax-free account. Other restrictions apply, but the concept itself is fairly straightforward – growth for which you never pay taxes.

Conclusion on Umbrellas

There are really only three umbrellas when investing your money: taxable accounts, tax-deferred accounts, and tax-free accounts. None of these is inherently better than the other options; depending what goals you are trying to achieve each has distinct advantages over its peers. To make matters more complicated, there are scenarios when you can convert one type of account to another, so make sure you talk with a tax professional before making your pick. The fact is deciding which type of account to use in general can get tricky and is worth the price of engaging a professional, for more money can potentially be saved or lost when making this decision than the decision between two investment vehicles. That being said, a solid comprehensive financial approach will likely incorporate all three options at different periods over your financial career to ensure you literally get the most bang for your buck.

Conclusion

So there you have it. All the asset classes, cleanly laid out. Whether you are just starting out, have amassed a sizable nest egg and are looking to retire, or are somewhere in between you now know your options. The world is truly your oyster, and the only question left is where you will go from here. What will you do now that you are armed with this knowledge? The way I see it you only have three options – you can do nothing, try your own hand at managing your investments, or elicit help from professionals. Let's briefly explore each choice.

Do Nothing

This is the easiest option but ultimately the most painful. If you walk away from this read without altering your life in any way then my work here has failed – knowledge without action is useless except in bar trivia. But it is an option; you can choose to not make any changes to your life. And in twenty years from now you will be exactly where you are today, financially speaking. So if you are totally satisfied you're your current fiscal situation and not looking to improve then this is an option for you, but if not then one of the other two choices is preferable.

Go It Alone

Some people like to do all their own research before going off and managing their investments all by themselves, and for those willing to invest the time there is absolutely nothing wrong with this decision. I would argue it is not optimal unless you are willing to devote consistent time weekly and monthly for monitoring, but it certainly beats doing nothing and can even provide a deeper personal satisfaction than other routes. It has been my experience these people usually view managing their money as an enjoyable hobby in the same way others enjoy spending time fishing or reading, and in reality, most only manage a portion of their portfolio which they think of as 'play money'. If this is the route for you I hope this book has proven useful, and keep in mind there are plenty of financial professionals (myself included) who offer hourly consultation at a reasonable rate for the occasional question you want specific advice in handling.

Elicit Professionals

Occasionally I am asked if the service I provide can be replicated by the individuals who hire me to provide financial direction. Technically it can, just as technically I can write my own living trust or buy and sell my own home without a real estate professional, but there is a reason almost no one does (even for sale by owners use a real estate lawyer to draft the documents). Frankly, when it comes to something as important as your finances it is worth paying to ensure you are structuring your plan optimally. There are so many moving parts between contribution limits, advanced tax planning strategies, investment options, and the emotions invoked by volatility (no one likes to see their portfolio drop, but some people can stomach a 40% temporary decline better than others) that, in my admittedly biased opinion, you need professional financial involvement. Do your research into their background and education, and it never hurts to interview a few different advisors to determine who will work best with you and for you. By the way, my team and I are happy to talk with you – we even offer a complimentary initial consultation to see if a relationship would be mutually beneficial. I can be reached directly at daniel@freerfinancial.com. But no matter what direction you choose I wish you the best of luck and remember it's about the journey!

Cheers,
Daniel
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Investments are subject to risk, including the loss of principal. Because investment return and principal value fluctuate, shares may be worth more or less than their original value. Some investments are not suitable for all investors, and there is no guarantee that any investing goal will be met. Past performance is no guarantee of future results. Talk to your financial advisor before making any investing decisions.

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