The INVESTMENT LETTER

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When Am I Rich?

One question that people frequently ask is: what is the definition of "rich." A quick Google search will turn up several definitions. Some say $1 million dollars; others say $1 million dollars in liquid assets and owning your home; while another group vaguely claims "double your current salary." It becomes clear there is no single definition of rich that is widely accepted.

Increasingly, there also seems to be a negative connotation associated with being "rich." Our definition, however, takes a positive view on the topic. Rather than defining richness by the amount of possessions one owns, Investment Counsel believes being "rich" is closely related to security and stability. We want to take this opportunity to discuss our definition more precisely and the three steps to guide you there.

What is "Rich/Secure"?

We believe that being "rich" is having the ability to derive enough income to sustain your current lifestyle without the need for earned income. Under this definition, someone is considered rich when they are able let their investments work for them. A rich person can generate enough passive income to be stable – they can do the things they want to do, when they want to do them – without having to earn more.

Under our approach, material possessions do not necessarily make you rich. For example, if a person owns a $10 million house outright, but has no other liquid assets, they would not be considered rich. This is because the house does not produce income (outside of taking an additional loan out using the home as collateral) that will allow that person to maintain his or her lifestyle. On the contrary, that person will have to pay for upkeep, property taxes, and possible renovations even in light of not having a mortgage payment.

The next question becomes: how does someone reach this point? Our definition is not in absolute terms – there is not a magic dollar threshold that makes someone rich. Instead, we look at the definition in more relative terms with a focus on the particular individual.

As a general rule, the best way for you to reach this point is to increase the size of your investment portfolio – to make your money work for you. We believe that a general formula is: Rich/Secure = (Savings) x (Returns) – (Needs/Wants). When this number is positive, you are considered rich/secure.

1. Calculate Your Standard of Living

The first step is to calculate you and your family's current standard of living. Here, you can calculate how much money it takes to support housing, transportation, entertainment, food, health care, travel costs, or other anticipated expenses.

This is an excellent opportunity to get a sense of whether you are spending too much, or even too little, given your current portfolio and investment gains. Intuitively, if you have a more modest standard of living, the amount needed to be "rich" will be smaller. On the other hand, if you live a more lavish lifestyle, you would need a larger portfolio to meet the definition.

2. Anticipated Rate of Return

The next step is to calculate your anticipated rate of return, which will be significantly influenced by your risk tolerance and age. In general, if you take more risk, you can anticipate a higher return (but also stand to risk more). If you are risk averse, your anticipated rate of return will be smaller, but your risk of loss will also be smaller. This is an important step in the investment process, and each person's risk tolerance will differ with investment goals, personal attitudes, and age. Currently, a no-risk rate of return is less than 2% and anticipated long-term returns in excess of 7% may be unattainable.

When your anticipated rate of return is lower, all else equal, you will need a larger portfolio to be considered rich. The opposite holds true with a higher anticipated rate of return – all else equal, a lower valued portfolio is needed.

Finally, you may also include any pension or anticipated social security payments when calculating the amount of returns you may expect in a year.

3. Determine the Level

The final step is simply completing the process and putting the first two steps together. Essentially, after steps 1 and 2, the process becomes a math problem. You can first start with the amount in your portfolio and then calculate the dollar amount that it produces per year (Step 2). From there, simply compare this number to your standard of living cost (Step 1). If this number is larger than the number in Step 2, you meet the definition of rich.

For example, imagine a couple that owns their home and has $2 million in their portfolio. This couple spends around $200,000 per year to maintain their standard of living. This hypothetical couple is risk tolerant and invests a majority in stocks, expecting around a 6% return on their portfolio. To be considered rich, that couple must keep their cost of living around $120,000, an $80,000 per year deficit. Because the couple's investment income is less than the cost of living, by our definition, that person would not be considered rich.

Now imagine that couple reduces their expenses to $150,000 per year and puts the excess funds into their portfolio. After five years, they would have put an additional $250,000 into their portfolio. Excluding gains, the couple will have around $2.25 million invested in five years. They also change their portfolio, anticipating around a 7% return on their investments. Now, their portfolio produces an anticipated $157,500 in gains per year, exceeding their cost of living. Under our definition, that couple is now "rich."

Conclusion

Many people dream of becoming rich, though few people have an idea of what rich actually means. Under our definition, we focus on being stable and secure instead of on material possessions. Through working with clients over the past 90 years, we believe this is the best way to approach the topic. We have worked with people who think they are rich, but are only focused on what possessions they own. We have also worked with people who maintain a healthy standard of living and who have earned security and stability by the portfolios they have maintained. We believe the latter to be "rich."

Of course, reaching the suggested, relative threshold is a difficult task. It requires years of discipline and a focus on the long-term. At Investment Counsel, our goal is to help our clients during their journey and help them become "rich," and, more importantly, secure. ■

TRY IT YOURSELF!

Step 1
Portfolio Value:

$

Step 2
Anticipated Rate of Returns:

%

Step 3
Anticipated Gains Per Year (1)x(2):

$

Step 4
Cost of Living:

$

If the amount in Step (3) is greater than the amount in Step (4), consider yourself rich!

Investment Counsel News

Outside the Office

Chris has been elected a Governor of the Michigan Seniors Golf Association. This really means he joins others with recruitment responsibilities for this distinguished organization established in 1923 - predating Investment Counsel, Inc. by six years!