ISSUE 15 | VOLUME 3 | August 15, 2022

PFA

CELEBRATING 15 YEARS of Filipino Empowerment

YAMAN Coach™

EMPOWERING YOU

Owner Earnings

According to Warren Buffett, an investor should be looking at owner earnings. But to better understand the financial indicator, let's apply it first to household finances.

Consider a one person household. In any given day, the household owner will need to spend on certain things like transportation to and from work, food consumed at home and at work, mobile phone load, income taxes, mandatory contributions to government sponsored plans, or overhead costs, if you will. By the end of the day, the household would have spent its money. But it will not exactly be a zero sum game because the household should ideally have money left in the bank.

Even if the savings in the bank get spent down to zero, the household will still have cash from income to help it get through another day, week, month and year on assumption that there is no problem with cash flow timing. In a sense, the difference between the household's gross income and expenses is equivalent to its cash flow from operating that one person household. This is the same as net income plus depreciation, depletion and (non-debt) amortization charges for corporations. The household just does not need to account for the non-cash charges of depreciation, depletion and amortization.

But would not life be boring for that one person household if all it did was do the same thing over and over? That one person household will probably want to add a little excitement by way of a vacation, eating out, and partying with friends. And for those wanting more conveniences in life, buying a car to beat the hassles of the daily commute will be ideal.

In addition, the one person household will eventually realize that life is meant to be shared. Therefore, plans of getting married and raising a family, sending children to school, and buying a house enter the picture. And once the children have all grown up, the enjoyment of a long, healthy and still productive retirement would be top of mind. All of these can be had through delaying self-gratification. More particularly, the payout of cash (i.e. dividends to the household owners) that can be used to enjoy things on top of the regular operations of the household is delayed and invested in earning assets.

The household would need to just work a little harder because of the party pooper called inflation.

By the same token, companies dream of growing.

How will the growth be funded, and inflation be offset? Similar to delaying self-gratification, a company may opt to retain earnings by minimizing the payout of cash dividends and reinvest such amounts in earning assets. The other way is by borrowing to buy the same earning assets.

Whether funding comes from a company's own funds or from borrowings, such funding sources eventually need to be rewarded or repaid.

In both a household and company, the cash flow from operations minus investments in long-term earning assets is equivalent to owner earnings or what is also called free cash flow (FCF) from the asset perspective. This FCF can be used to pay household owners/shareholders in the form of dividends and creditors in the form of principal.

Would it not be great if a household or company can still pay dividends to their owners to enjoy whichever way their heart desires even after paying for overhead and investing for the future (and of course paying debts)? That is personal and corporate finance at its finest.

Buffett is exactly looking for companies who can, amidst efforts to invest for the future and service debts, still pay dividends to its shareholders consistently and ideally on a growing basis.

The chances of winning the lotto are ultra-slim. What are these chances? See the following chances of winning per lotto game:

Lotto 6/42 – 1 in 5.2 million
Mega Lotto 6/45 – 1 in 8.1 million
Super Lotto 6/49 – 1 in 14 million
Grand Lotto 6/55 – 1 in 29 million
Ultra-Lotto 6/58 – 1 in 40 million

So, why on earth do people still bet on the lotto when the chance of winning is almost next to none? The reason they still do is because they focus on the huge prize and not on the odds of winning.

On the flip side, the odds of losing life or being afflicted with a critical illness early in life is probably low (i.e. but not next to none). Therefore, people are willing to bet that they would have enough time to create the wealth that will serve as their insurance policy should they be called from life early or be afflicted with a critical illness. But this is where life differs from lotto.

A lotto game ends after every draw. Therefore, a bettor is in control of the risks he takes as he chooses when to bet or not. In life, the perils are continuing; there is no pause button. Moreover, no one can tell when life will be snuffed out or when financially debilitating illnesses will occur.

But here's the surprising thing. Life insurance companies actually are the ones betting when someone buys a life insurance policy. The life insurance company is betting that the policyholder will not die or be afflicted with a critical illness immediately after buying the policy and/or a young age. If that happens, the life insurance company will lose out.

On the contrary, the life insurance company is betting that its policyholder will live a long and healthy life.

Don't Bet with Life Like You Would on Lotto

That long period between purchase of and claim against a policy will provide the life insurance company enough time to make the premiums grow and allow it to pay out the claims with profit.

With life insurance policies, therefore, it is the life insurance company that is making the bet. The life insurance company is one with its policyholder in believing that the latter will live a long and healthy life. But just in case the policyholder does succumb to death or is afflicted with a critical illness early, the life insurance company stands ready to support the policyholder and his loved ones.

As an aside, the 2020 causes of registered deaths showed that 34% was due to diseases of the circulatory system (strokes and heart attacks), 18% was due to other diseases and health conditions, 15% was due to diseases of the respiratory system (mainly pneumonia), 11% was due to neoplasms (or the different forms of cancer), 7% was due to external causes of morbidity and mortality (including accidents), 7% was due to endocrine, nutritional and metabolic diseases (chiefly diabetes), and 7% was due to certain infectious and parasitic diseases. In other words, 92% of registered deaths was due to diseases and deteriorated health conditions, many of which are covered by health insurance.

There is no investment in the world that is fully guaranteed. In investing, the investor makes the bet that his investment will make money. With life insurance, it is the life insurance company that makes the bet.

In a sense, with life insurance, you always win.

Editor's Note

Efren Ll. Cruz, RFP®
Editor-in-Chief

High Interest with Digital Banks

In a time when the rate of inflation seems to be going through the roof, every little bit of recovery in the purchasing power of money would be of great help.

Enter digital banks with their high interest on savings accounts,. But even if digital banks boasts of lower overhead costs, thus affording the flexibility to offer higher interest rates, it must be noted that such banks still need to cover some costs and make a profit.

Two things need to be assessed before choosing which digital bank to park your hard-earned money. One is the maintaining balance to earn such interest. Some digital banks require maintaining balances in the hundreds of thousands just to earn their published high interest rate. Some even require continuous additions to the savings to earn even higher. And some offer further higher interest rates on the condition that the depositor will contract a personal loan and be on time loan amortization payments.

The other issue is the difficulty in withdrawing – the more difficult the better. Why? Because ease of withdrawal will also easily make savings account balances fall below the minimum balance required to earn the high interest rate. So, to maximize on such high rates, savings accounts with digital banks should be looked at more like time deposit placements with a high penalty for going below the said minimum deposit level.

www.personalfinance.ph

To know more about becoming a **YAMAN** Coach™, contact us at:
yaman@personalfinance.ph
+63917 505-0709 • +632 7218-0141