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What does a strong personal balance sheet look like?

By Craig Gradidge, as published in the Business Day on 12 May 2020

The COVID-19 crisis has exposed many companies and individuals whose balance sheets are weak. Companies with high levels of debt have seen their share prices smashed more than their peers with stronger balance sheets. In some cases, companies have shut down permanently as they cannot weather the current storm. J.Crew in the US is filing for bankruptcy, and Edcon is going into business rescue. Both companies had relatively weak balance sheets and were directly impacted by the COVID crisis.

The same is true for individuals, especially those who work in industries which have been disproportionally impacted by the crisis. I am always struck by the increase in the number of expensive cars up for auction following past crises. Surely someone who can afford an expensive car can withstand a market, economic or business cycle. What exactly does a strong personal balance sheet look like?

There are several factors that we consider when assessing the balance sheet of an individual. These include; liquidity, debt sustainability, growth prospects, externalisation, and protection. We offer a high-level indication of where we think an appropriate benchmark should be based on individual circumstances and objectives.

Liquidity is arguably the key metric in the current crisis. For us liquidity refers to the ability to convert an asset into cash without having to offer a discount. Individuals without contingency savings likely fall short on this metric. Call deposits and money market investments offer the best liquidity options in that no discount needs to be offered to get one's cash. While shares are also liquid, investors must sell at discounted prices if they want quick access to cash. Typically, the more illiquid an asset the higher the discount that needs to be offered to convert the asset into cash. A strong balance sheet has at least 30% of assets invested in liquid investments.

Debt sustainability is another key metric given that incomes are under pressure in this crisis. Avoiding debt entirely is not an option for many and does not need to be. When used carefully debt can add incredible long-term value to any balance sheet. One way of determining an appropriate level of debt for an individual is to stress test the budget. If interest rates were to increase by 1%/3%/5% will the budget be able to accommodate the higher payments? Another assessment criterion links to the liquidity metric by considering how long the balance sheet can maintain payments in the absence of income. It is also important to consider the life stage of an individual in determining a suitable level of debt. Given the number of moving parts the answer is a range rather than a hard number. Here we recommend debt of between 30% and 70% of total assets.

Growth prospects refers to the exposure in a balance sheet to assets that grow faster than inflation. It should also refer to assets that can produce growing incomes over time especially as personal balance sheets should carry one into and through retirement. In the current crisis many of these incomes are disappearing as tenants default and companies stop dividend payments. However, a well-diversified portfolio of investments should mitigate this risk. We are not only interested in the amount of exposure to growth assets, but also in the diversity. We want to see assets such as physical and listed property, share portfolios, unit trusts, listed and unlisted equity, and alternative investments. Depending on individual objectives and risk appetite we would like to see at least a 50% to 70% exposure to a diversified portfolio of growth assets.

Externalisation refers to the percentage of the balance that is exposed to hard currency denominated assets. A strong balance sheet has assets domiciled in local and offshore currencies. This is a global principle and one that is becoming increasingly important for South Africans given the significant challenges locally. Here we advise a minimum of 30% to 40% of assets offshore, especially given an individual's objectives, risk tolerance and long-term intentions. We are careful not to simply make a full allocation offshore where there is little or no existing allocation. Individuals who went offshore in a panic in the early 2000's found their investments were under water for over a decade, and their long-term returns have been mediocre given the time needed to recover.

Protection is another metric that is usually not given attention until it is too late. Here we are looking at protection from creditors, tax and calamity. Retirement products are wonderfully tax efficient and protect against claims from creditors. This makes them an important consideration for entrepreneurs especially as courts can pierce the veil of protection offered by Trusts. Other tax efficient products can be incorporated into the balance sheet, but often need to be weighed up against liquidity requirements. The prevalence of scams and hot investment opportunities need to be considered to avoid calamity. Given the restrictions around investments that offer protection we typically look at a benchmark of 25% to 40% as a maximum exposure.

This crisis will pass but future crises lay ahead. Focusing on balance sheet strength will add a lot more value to individuals and help them weather future storms. Arguably this is more important than chasing the next best performing fund, or whether active will outperform passive, or if the Rand will recover or weaken in the next six months.

Craig Gradidge is co-founder of Gradidge-Mahura Investments and holds the Certified Financial Planner® designation.