Business Standard

Networth = financial report card

Kiran Telang / April 17, 2011, 0:05 IST

Calculate your networth as it will help assess your asset-liability position and plan your finances better.

Your personal networth is important to your financial planning that you should be aware of. But, many of us either don't understand the concept or don't know to calculate it. You need to know how your personal networth as it tells you whether you are financially wealthy or not.

What is networth?
Your networth is the excess of your assets over liabilities. If your assets have more than the amount you owe to various entities, your networth is positive and vice versa.

What constitutes your net worth?
Assets: This will include your cash in hand and in the bank, property, vehicle, investments in stocks, mutual funds, bonds, precious metals, paintings, coins or any other collections and so on.
Liabilities: All your loans.

How helpful is it?
It tells you your financial position. It gives you a figure that can be compared year-on-year and show your progress in money matters. Let us see how.

Property: The biggest asset most people have is their home. It is usually balanced out by the dues outstanding on the home loan in the liability column. Property prices may appreciate over time, thus increasing your networth, as the loan outstanding will reduce with passage of time. But is this really useful to you? Are you creating wealth?

The answer depends on whether you are willing to sell your property to move to another one with a lower value. This will generate cash without increasing the liability.

Say your current house is worth Rs 1.5 crore and the loan outstanding is Rs 50 lakh. Will you sell this house and move to another one available at Rs 50 lakh? If yes, you generate a surplus of Rs 50 lakh, which can be invested in various instruments to create wealth. But in all likelihood, people will not move out of their primary residence just because the property value has gone up.

Vehicles: These usually cost a lot, but the value reduces drastically the minute it is out of the showroom. It is a depreciating asset. If you decide to sell it within a few years of purchase, you will not even be able to cover your loan. So, for all practical purposes, the value of the vehicle in your asset column will not add much to your personal wealth or networth.

Investments: Your investments in stocks and mutual funds will add tremendous value to your assets. As these are volatile, you should take its value at 70 per cent or less in your networth calculations. Bonds (if held till maturity) give stable returns, so you can take these at current value. These are safe, so there is little chance of the value being eroded.

Precious metals have been very stable over long periods. The current spike in the prices of gold and silver is unprecedented.

The real value of precious metals will be affected by the form you hold these in. The value of jewellery will be less than the same amount of metal held in bars/coins, which will be less than the value if held in the form of exchange traded funds.

In terms of liabilities, people usually tend to neglect the loans outstanding on their credit cards and also amounts they owe to friends or relatives. This can skew the real net worth.

So, how to create real wealth?

The basic idea is to increase your asset side and reduce your liability side. But be sure to invest in income or wealth generating assets. Like, property will create wealth only if it is not your primary residence - it should generate revenues in terms of rents and in the long-term, should be able to generate sufficient capital gains.

For many, this could mean taking a huge home loan. So, take care that you do not over-leverage yourself to create an illiquid asset. In adverse circumstances, if the real estate cycle takes a turn for the worse, your property prices and rental yields may fall while your interest rate on the loan might go up. This will put you in a tight situation in terms of cash flows and in a worse-case scenario, you might have to sell the property at a loss.

Diversify your investments in assets like stocks, bonds and mutual funds to create a solid base for your wealth. Keep investing regularly. Do not take loans to buy consumer goods that do not add to your wealth. Instead, look at accumulating funds to meet your needs.

Try to repay your expensive debts as soon as possible. If the rate on interest on your loan is more than what you can reasonably earn from your investments, then it makes no sense to continue the loan. In such cases, surpluses should be diverted to repay the loan, thus bringing down the liability and increasing the networth. Once the loan is repaid, the surplus can be targeted towards appropriate investments to increase the asset creation.

Review your networth annually. It will give you a fair picture of whether you are moving in the correct direction in planning your finances or not.

The writer is a certified financial planner