How Do You Distinguish Good Assets from Bad Assets?

by Keith Wheelan

Article published on May 17th 2012 | Finance

At the height of the 1980s real estate bubble I watched a TV news interview with a new homeowner. She said her parents always told her: â€œBuy the biggest house you can afford.â€• And thatâ€™s exactly she did. She was beaming. It did seem to make sense, at least at the time. After all, homes were appreciating (increasing in value) on average over 5% per year in the 1980s and over 10% per year the previous decade.

I, too, found the advice compelling so I followed it and bought a house much larger than our family needed.

Shortly afterwards my wife and I saw the movie â€œThe Money Pit.â€• I canâ€™t say the movie was Osca worthy, but its central message did resonate: Sure, a home can be a large and often appreciating asset, but the bigger the home the bigger the mortgage. And the bigger the mortgage, the bigger the monthly expense. Nice that it appreciates, but not nice that it creates a negative cash flow.

We found that by committing all of our available income to paying the mortgage and other expenses associated with the home - by creating such a large negative cash flow - we were losing the opportunity to pay off other debts, or to use some of our income for better investments. In other words, being â€œhouse poorâ€• was keeping us from moving ahead financially.

After a few years in our McMansion we realized our (my) mistake and downsized.

The above example illustrates that when evaluating any asset there are two considerations: 1) Does it appreciate or depreciate? And 2) Does it generate a positive or a negative cash flow? The problem with the advice to buy a large primary residence is that this type of asset only passes the first test (appreciation). It doesnâ€™t pass the cash flow test.

By evaluating any asset on two dimensions - appreciation vs.

depreciation, and positive vs. negative cash flow - the asset can be

classified as either â€œBest,â€• â€œ 2nd Best,â€• or â€œWorst.â€•

So by evaluating an asset based on two dimensions - not just whether it appreciates or depreciates, but also whether it generates positive or negative cash flow - the asset can be grouped into one of three categories:

1) Assets that BOTH appreciate AND generate positive cash flow (Best)

2) Assets the EITHER appreciate OR generate positive cash flow (2nd Best)

3) Assets the NEITHER appreciate NOR generate positive cash flow (Worst)

A primary residence, then, falls into the â€œ2nd Bestâ€• asset category. If itâ€™s a 1-family primary resid that is. What if, on the other hand, itâ€™s a multi-family rental property? In that case the asset has the potential to appreciate and also generate a positive cash flow (if the monthly rental income is greater than the monthly mortgage, insurance, property tax and maintenance expenses). So a rental property is an example of a â€œBestâ€• asset type.

How about the bad kind - â€œWorstâ€• assets? Examples of these include cars, boats, furniture and household goods. They lose value and they donâ€™t generate positive cash flow.

You can find more information about the three Asset types and strategies to help optimize your asset and cash flow mix in our free e-booklet â€œWealth Is Good, Cash Flow Is Betterâ€•. In the meantime we invite you to share your thoughts - and your own stories and experiences - on this subject with other readers.

Article Source:
http://www.articleside.com/finance-articles/how-do-you-distinguish-good-assets-from-bad-assets.htm - Article Side

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Article Keywords:
Cash Flow, Financial Planning,Financial Management, Financial Independence, Financial Life Cycle, Financial Advisor, Personal Finance, Financial Plans, Financial Tools

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