Real Assets versus Financial Assets

1.1. Real Assets versus Financial Assets

The wealth of a company (for that matter an individual) is determined by its productive capacity—the goods and services that can generate. This productive capacity is a function of its real assets of the economy: the land, buildings, knowledge, and machines that are used to produce goods and the workers whose skills are necessary to use those resources.

In contrast to such real assets are financial assets such as stocks or bonds. These assets, are claims to the income generated by real assets.

When the real assets used by a firm ultimately generate income, the income is allocated to investors according to their ownership of the financial assets, or securities, issued by the firm. Bondholders, for example, are entitled to a flow of income based on the interest rate and par value of the bond. Equity holders or stockholders are entitled to any residual income after bondholders and other creditors are paid. In this way the values of financial assets are derived from and depend on the values of the underlying real assets of the firm.

Real assets produce goods and services, whereas financial assets define the allocation of income or wealth among investors. Individuals can choose between consuming their current wealth today and investing for the future. When they invest for the future, they may choose to hold real assets or financial assets.

If they choose real assets, then they shall invest in Land, Gold, and Building etc in expectation of some income/capital appreciation in future

If they choose financial assets, they invest the stocks and bonds issued by the companies in need of money. The company receives money by issuing securities (selling them to investors) and uses that money to purchase real assets. When the company makes money using real assets, it distributes the same to its stock/bond holders — as the returns on their financial assets. So the financial assets are the means by which individuals hold their claims on real assets.

Another way of distinguishing between financial and real assets is to note that financial assets are created and destroyed in the ordinary course of doing business. For example, when a loan is paid off, both the creditor’s claim (a financial asset) and the debtor’s obligation (a financial liability) cease to exist. In contrast, real assets are destroyed only by accident or by wearing out over time.
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1.2. The Financial System

At a given point of time, some individuals in an economy are earning more than they currently wish to spend. Others—for example, entrepreneurs—spend more than they currently earn.

Similarly, an individual, at a given point of time in his life (youth & Middle age) earn more than they currently wish to spend during retirement—spend more than they currently earn.

How can you shift your purchasing power from high-earnings periods to low-earnings periods of life? One way is to “store” your wealth in financial assets. In high-earnings periods, you can invest your savings in financial assets such as stocks and bonds. In low-earnings periods, you can sell these assets to provide funds for your consumption needs. Thus financial markets allow individuals to separate decisions concerning current consumption from constraints that otherwise would be imposed by current earnings.