120 – Basics of Debt
Episode Transcription

"What we want to reflect on is... optimism oftentimes is what these other institutions, these large corporations use to market to get you to make decisions that may not be good for your long-term future."

Paul Adams: If you had a tank of money that represented every dollar you were ever going to earn, and you never had to work again so you couldn't trick yourself into thinking that just we're going to have pure optimism, I'm currently making $400,000 or $500,000 a year, that's going to continue in the future, I'll be making a million soon. That may all be true, but what we want to reflect on is that optimism oftentimes is what these other institutions, these large corporations use to market to you to get you to make decisions that may not be good for your long-term financial future.

Announcer: Welcome to *Sound Financial Bites*, where we help you with bite size pieces of financial and life knowledge to help you design and build a good life. The knowledge that has been shared from stages at conferences, pages of national business magazines, and clients living across America, our host Paul Adams now brings directly to you.

Paul Adams: Hello and welcome to *Sound Financial Bites*. I'm so glad you could be with us today. This is episode number 120, and we're talking about being able to borrow. How to borrow money, think about borrowing, and dealing with it as a beginner because we're going to talk about car purchases. Now here's the thing before you tune out today. I want you to realize that this borrowing episode we're calling borrowing a beginners guide because we're talking about cars, but I don't care how long you've been buying cars, you're going to learn something unique today. Like the fact that 0% is not 0% and leases cost you far more than you think. If you're driving down the road right now in a screaming leased car, perhaps German of variety, you're going to want to listen to the rest of this episode.

Now welcome to *Sound Financial Bites*. My name is Paul Adams, CEO and founder of Sound Financial Group. I'm really excited to have the chance to introduce to you Cory Shepherd who does all the heavy lifting here at Sound Financial Group. I just get to be the voice and the beard. Cory, so glad you could be here.

Cory Shepherd: Well don't we all feel like we got shot out of a cannon already. This is going to be a good one.

Paul Adams: Well I think Cory we want to start first just talking a little bit of high level about money, how people think about borrowing, how people are traditionally taught to borrow, and here's where I think most people live everyday right now. I think where most people are right now is they feel like, and I even remember back to some basic finance classes in college, that the way that they taught you to deal with it was you're borrowing money on the

"We're not borrowing against the home. We're not borrowing against the car. What we're borrowing against is our future capacity to earn income."

car. You're borrowing money on the house. The reason we get to borrow money is because of the thing that we're buying.

Here's the thing, we know our listeners and our profile of our listeners have high income. It is kind of funny how when you make more income you can get a bigger better home, you can get a bigger better car, but Cory if that's the case why is it that I can't just buy the home where if I buy the home and it doesn't work out the only thing they can take is the home? Why can they still come after me personally?

Cory Shepherd: Well because you've got a stream of income off into the future. You've got that potential built up inside. It's also the reason why if you've got a home with equity in it and you were to lose your job, lose your income stream, no one is giving you a home equity loan anymore.

Paul Adams: Right, and it's because we're not borrowing against the home. We're not borrowing against the car. What we're borrowing against if our future capacity to earn income, that's it. We're only borrowing against our future capacity to earn. Here's what I have everybody think about when you think about borrowing period. I want you to imagine you're not making a paycheck right now. I want you to imagine instead that you're going to make a deal that you can never work again. You're making $350,000 a year as a household right now or $800,000 a year, and somebody comes to you and says, "Here's what we think your income is going to progress like for the rest of your life. If you'll sign this agreement right now we will simply give you" ... I'm going to pick $600,000 a year. "We're just going to give you $600,000 every year and it's going to go up a little bit with inflation every year for the rest of ... Well not the rest of your life, just until age 65 or age 60. Some predestined amount of time you're going to get it."

Now you'd have a full realization that when you're borrowing money you're borrowing against a finite future number, which by the way is what you're doing anyway when you're borrowing but you don't know it. Think of it like you've got a tank of money and that tank of money you're going to draw down on, and when you borrow money you're collateralizing this tank of money you're going to earn. Now the only difference between this hypothetical scenario I just gave you of somebody saying I promise to give you this amount of money every month for a period of time, the only reason that you treat that differently is because it feels indefinite. Because of our eternal optimism, when you're earning top 1% income you feel like it's all going to go great, right?

Cory Shepherd: It's going to go great forever, why would it ever go bad?

Paul Adams: Forever.

Cory Shepherd: Right.

Paul Adams: In fact my income is this high now. I'm making $600,000 and I'm in my 40s. No problem, I'm just going to keep going.

Cory Shepherd: A million by 70.

Paul Adams: A million by 70.

Cory Shepherd: Yes.

Paul Adams: The thing is maybe you will, but as soon as you quantify as a limited amount of money you start to realize oh, wait a second. How am I doing on my other tanks of money to make sure that when the income stops I'm okay? That's more of an overall financial orchestration conversation. Here's what I want everybody to be present to. When you borrow money you're putting a lien against every dollar you will ever earn here forward and the courts give those collectors a lot of leeway in taking money against that income stream. You're not borrowing on the car, you're not borrowing on the house, you're borrowing against your future capacity to earn. You are engaging, to a small degree, in servitude for a horizon of time against a percentage of your work every time you borrow money.

Here's what we're going to cover today. Cory and I are going to go back and forth on should you buy new or used. Then Cory's going to talk about you being able to buy a car with 0% and whether or not it's really 0%. I'm going to take the conversation on how leases can sometimes have interest rates similar to credit cards, and then we're going to land this episode today. We're going to hit it fast, so stay buckled in and journey with us. Let's talk buying new or used.

Now this isn't going to take long. The problem is for most of you you're currently probably driving a new car because lots of people drive new cars. I don't mean to admonish you for having done that. I've done that. I have done it at record levels. I have been so inappropriate in my younger years in buying new cars that we literally thought we might need to make this an explicit episode on iTunes. We decided against going that far. I literally bought a brand new Lexus SUV. I drove it 1,000 miles in less than a month. Actually convinced the dealership to take the car back and give me 100% of my money back and then turned around and bought another new car that same month. I escaped the jaws and then did it again in my 20s. It was crazy. Here's what I want to communicate.

No one has ever heard someone that knows something about money tell you it's a good idea to buy a new car. Here's the thing, there are people who say, "Go ahead and buy a new car." Because you want a new car. Okay, there might be reasons to want a new car. That's fine, but no one has

"There's no debate. None. Nobody ever said that... you should buy new because its a good financial decision. It's always a better idea to buy used because the second you drive an expensive car off the lot you've lost money."

said ever, "It's a great idea. You should do it. It's good for your long-term financial well being. In fact, even if money's tight you should go ahead and buy a new car." There are people out there that say, "When money's tight, even if it's tight and you got to struggle you should put money in your 401K and get that match." Here's the thing. We can debate that one, but there's no debate, nobody ever said. Period, end of story, that what you should do is that you should buy new because it's a good financial decision, except for the car companies. That's it, the people selling your cars.

That's it, it's always a better idea to buy used because the second you drive an expensive car off the lot you've lost money. You can't get that money back. It doesn't matter how long you own it, it will never have been a better idea to buy a new car than a car that's a couple years old that's still under warranty. Period, end of story, I rest my case. Look anywhere you want and the only people telling you it's a good idea is the really good looking lady in the tight fitting dress on the car commercial that you should go buy the new car and get their financing. With that Cory, let me hand it to you. Would you please talk to people about the 0% financing deal.

Cory Shepherd: I would love to. I would love to. You're almost leaving me speechless, this is great. I just came up with an example that someone might be looking at like a 2018 Lexus RX 350. With my quick internet search for a really sweet car here is a MSRP of $43,470. That is the sticker price from the dealer and here's where the mathematical sleight of hand starts to come into play. You usually have a couple of options. You have a 0% financing deal or some dealer cash.

Let's say it's something like $5,000 or $6,000 of dealer cash, so your choice is pay $43,000 for that car at 0% finance or $6,000 less with whatever financing you're going to do. From your pocket, get a deal from your bank, etc. Here's what's actually happening. Lexus decided what they needed to sell the car for to make a decent profit was the $6,000 less than this MSRP, and so that if you're buying at the MSRP with 0% interest than you're paying more than you had to for the car, more than they needed you to, and so that's where the 0% interest comes in. They're still making money. You're not getting something for free. Let's do the math to prove that out.

Paul Adams: As you're bringing this up give people a little bit of context in case they're not watching this on video, instead they're listening to the podcast. Think of it this way. The foregoing of the cash back or the rebate or customer cash or whatever they label it, you're effectively letting them have all the interest at the very beginning of the loan. That's how this is happening is it's like you're paying extra right at the beginning and you're financing all of the interest for the entire loan but they don't have to wait for the money.

Cory Shepherd: Here's why our loan payment calculator, if you've got a $43,470 loan balance over 60 months with a 0% interest rate, which is an offer that's on the Lexus website for this car right now, by the way. Then your payment would be $724.50 a month for that time period. Just to make sure that we're really doing it right we can go and calculate in the other direction $43,470, $724 monthly payment, future value of zero over 60 months, 0% annual interest rate. The math is right, but here's what it would look like if you went to the bank. You should be able to pay that $6,000 less.

Paul Adams: Meaning you go to your credit union, secure the financing ahead of time, you're financing it elsewhere. Now maybe at the credit union you're going to have to pay 4% or 5% at your credit union. It doesn't matter what you're paying for it, let's look at what happens on the other side of the transaction and how much in reality the 0% loan is costing.

Cory Shepherd: Right, so in reality if we had, so let's do our calculator here. We go $43,470 minus let's say $6,000 was the rebate on the cars. December 31st they're really eager to get that one more car sold, so $37,470 is actually the financed amount, and if we use the same annual payment, that $724.50, negative zero future value, monthly 60 months, $724.5, 6.22%.

Paul Adams: Here's the thing, that may not be a bad deal. It's not awful, it's just full disclosure, it ain't zero.

Cory Shepherd: It ain't zero. Because you're not necessarily do the math every time. Everyone listening isn't going to have that calculator handy but just ask yourself the question where they making their money? Because they got to be making that money to offer you that deal. They're not doing it out of the goodness of their hearts.

Paul Adams: That's it, and by the way, 6.2% is probably a decent interest rate for somebody with good credit so they don't mind doing that. That's why if you don't have good enough credit you can't qualify for 0% because you're actually qualifying for a 6.2% loan in that case.

Cory Shepherd: But if your credit union was offering you 4% you'd be better off getting a loan at 4% to buy that car than taking the 0% financing.

Paul Adams: Yes, or if you had money in the bank that's offering you 1% that's extra, how many people say, "Well I'll just leave my money in cash because I'm getting 0% financing." But you're not getting 0% financing, you're getting effectively 6.2% financing.

Cory Shepherd: That is new versus used and financing your car Paul.

Paul Adams: Hey everyone, I want to let you know I'm interrupting this podcast for a good reason. If you're someone who's enjoying this podcast, if our philosophy is helping you better think about money then this offer is for you. We've opened up a financial inquiry call for our listeners of *Sound Financial Bites.* Our financial inquiry call is 15 minutes where one of our team will ask you some key question, understand your concerns, and if appropriate schedule you for a philosophy conversation with myself or Sound Financial Group's president Cory Shepherd. If you email us at info@sfgwa.com with inquiry in the subject, we will reply back to you with a link to our team calendar so you can schedule a call at a time that's least invasive for you. Even if we're not a fit, the team member having the call with you will point you in the direction of resources we have that can help you in whatever the next step for you in your financial journey is. Now back to your podcast already in progress.

Cory thank you for doing that, walking us through the purchase. I'm going to take us out on this lease conversation because I think oftentimes when people buy a car on a lease they don't understand all of the moving parts or even how to calculate the moving parts and how they would be impacted. We're going to look at, right off the website, is the 2019 BMW i8 roadster. This car is the R8 but electric, super fast, really expensive car, which is going to make doing the numbers that much more fun, but not that much different when you buy other vehicles. In fact, the math I'm going to show you today I used when I considered leasing a very inexpensive car just absolute bottom line hybrid when I used to have a big diesel pickup to pull the camper trailer with the family, I leased a car.

When I went in the dealership and showed them how I did this math they were shocked. Nobody had ever done it before, so that's how rare this is. In fact that was back before I had a beard. Four years later I go into the same dealership to get the vehicle I have now, a used Ford Explorer that we tow behind our RV and nobody remembered me. Until I brought up having been the one that brought up the conversation around the lease and the real interest rate. Instantly the finance manager remembered me, instantly the salesman remembered me, and they said that even since then, four years later, nobody has ever done this. Let's dig into it.

This BMW i8 has a leasing option, and where you want to start to try and understand this, and you could do this for yourself, just practice it. You could click in here and see the full disclosure on the lease. It's going to tell you how many miles a year, how far you can drive it each year on average, and it's going to disclose the upfront and the residual buy out. If you want to buy the car out at the end that number's right here. Now the real amount that is effectively financed by a lease is the difference between the MSRP and the purchase price and the residual at the end of that period. We have a car that has $166,795 purchase price, MSRP, and a residual buyout of $96,741. Now what we're going to do, that difference, that amount is the loan effectively that we're paying on for $2,000 a month. We really have a three year loan that's covering the difference between the purchase price and the residual.

Let's start looking at the actual calculation. Well to start it looks a little bit like this. We have an MSRP of $166,000, $6,000 down, a lease fee of $995, a residual of $96,741, and this thing called the dealer contribution of $5,200. Let's do the full math. When you get this vehicle you're going to feel like this. The difference initially between the 166 and 196 ends up being about $63,000. The first thing you're going to see is the $70,000 note. This is the first one that they recommend, and not recommend like a negotiation the way you might calculate it, this is the default way you begin to think about it. Oh it's $70,000 difference, purchase price to end result, 36 months, I'm paying $2,000 a month, it makes an annual interest rate feel like 2.5%.

To start with, that's not counting the fact that I had to put $6,000 down or pay a lease fee. How I corrected for that is I made the loan that is effectively the lease term amount, the difference between the purchase price and the residual, and reduced it by the amount of money we put down on the car and the lease fee. Now we have $63,000. Now when I did this at Ford years ago it was considered zero down but $3,500 up Ford credit lease fee. You got to be careful how they really frame these up. The amount we're putting in, paying towards it, $2,019 a month for 36 months. Now suddenly this is a 9.9% loan. You see, suddenly even though it looks like 2.5 on the surface, even though most people don't even do the first calculation, why? Because we're just focused on payment and how far we're going to drive and if we feel good about it. Well these numbers are going to really cause some significant erosion to your wealth even if you're getting a BMW i8 because you may not realize what you're actually paying is 9.9%.

It gets a bit worse than that. Because if on top of taking into account our down payment, on top of taking into account the lease fee. If we also take into account that there's dealer money that we gave up, we're now up in credit card rate ranges and that can be I've got it here at 19, but it's about 15 to 19% is the total amount that we end up paying toward this vehicle over three years on an enormously expensive vehicle on top of everything else. We have to be really aware of what it's actually costing us to lease this car.

There's even a few times it can make sense from a tax perspective, but this is why it may sound silly, even if you're only getting a $50,000, $60,000, $70,000 car, it might be like, "Oh, it's not a big deal." I would encourage all of you, these are big deals, these are five figure purchases, to pause long enough, look at your balance sheet. If you don't know how to do the math we're doing right now Google, find some calculators, lease versus purchase calculators, or if you're a client of ours reach out to us, we're happy to walk you through this math, it doesn't take that long. You can always walk away from the dealership, do the math later, and then come back and buy the car. Despite all the techniques of trying to keep you in the dealership and make a decision, you really can wait a day, make the decision, do the math, and then be able to go back well informed. If you don't get that car there will be other cars.

"You can always walk away from the dealership, do the math later, and then come back and buy the car."

I want to encourage all of you to not just think about I'm in a buying decision. In fact you're not in a buying decision for a car, you're in a transaction that affects the rest of your financial life. The bank is not lending you money on the car. What are they lending you money on? It's a lien against all of your future income. We've talked before about money not being math and math not being money. We've got a great white paper on that that Cory has written. If you've not read that I would encourage you to go to this episodes page, borrowing.sfgwa.com. Get in there, look at this paper, download it, read it.

Because what you start to understand is that money's not math, math is not money. It really does, I think in a way most people don't understand, weighs on our ability to do the work that we would do every time we put a lien against our future income. Going all the way back, if you had a tank of money that represented every dollar you were ever going to learn and you never had to work again so you couldn't trick yourself into thinking that we're going to have pure optimism, I'm currently making $400,000 or $500,000 a year, that's going to continue in the future, I'll be making a million soon. That may all be true but what we want to reflect on is that optimism often times is what these other institutions, these large corporations use to market to you to get you to make decisions that may not be good for your long-term financial future. I want all of you to think through one, if I'm going to buy a vehicle. Really go down the path of getting used, and why getting used is a big deal.

We had one client started making more money than she'd ever made before, she was just cracking in the top 1%. She's in a high social pressure field, those are the fields where people feel like they have to have some amount of consumption, the cool house, the cool car, and they have to have that to be in a position that they're going to be able to transact in their communities. Those high social pressure occupations don't usually require that you own those cars for you to be successful. That they do require is that you be a really good professional in your field, and it's probably better that you're not driving a 1970 something rust bucket, but you don't need to be driving the newest best car. You can look at certain cars and if an import is important to you look for the cars where they don't change the body styles often, so that three year old car looks almost exactly like the brand new car. Don't worry

"You're not in a buying decision for a car, you're in a transaction that affects the rest of your financial life, and the bank is not lending you money on the car. What are they lending you money on? It's a lean against all of your future income."

about the technology in the car, there's only one company out there that's actually updating their technology quickly enough that it's not obsolete by the time it rolls off the line.

In the meanwhile, your cellphone has better technology than that car because they had to design it all two years ago. Really consider that used experience. Cars.com is a great place to search. Look at the new cars, you can look at those there and then back off and go wait, what if I got one just three years old? Especially after making those decisions for years, you end up with great negotiating capacity. Think about this for a moment. People go, "Well it takes too much time." Well I knew a guy years ago, he got one of those $100 and some thousand dollar Mercedes, the real fast AMGs and the big dog, the four-door beautiful car. He got it three years old. It took him a little time. He had the money in the bank, he was watching, three years old, 7,500 miles. The woman's husband had it for a year, he passed away, she had barely driven it over the last couple of years and it really was a beautiful, gorgeous car. He picked it up, super luxury car, retailed for $140,000, $47,000.

Now think to yourself, "It takes too much time." Well if it took him five or six hours more than it would have to go to a dealership let's think about this. He saved $100,000, that's $20,000 of compensation per hour after tax. Because when you save money on a consumer purchase it's the same as having brand new after tax money you didn't have before. Once again, encourage all of you, don't go down the path of buying new because it's "easier". Whenever in life have people told you the easier path is the way that yields the most results? If you're driving the new car now great, don't feel guilty about it. Enjoy that car. Consider though this conversation. Have your spouse listen to this. If they're not the one that's normally in all the financial decisions, forward this to them and say, "Hey, I think we need to rethink the way that we live our life around these new cars, simply buying two and three year old cars."

If it's in somebody's garage and it's a private sale you can absolutely pay a mechanic a couple hundred dollars and have them walk through the whole car for you. Anybody who doesn't want that mechanic conversation to come in is not the one you want to buy the car from anyway. We can produce more wealth on our balance sheet by simply controlling our consumption decisions. By controlling the consumption decisions we become more disciplined with our money, which then carries over to giving us more margin. This is counterintuitive, being more disciplined now gives us more margin where we don't have to be as disciplined later. When we're old, if we have enough wealth, you won't have to be disciplined with how much dog food to mix into your meat when you get older.

Anyway, with that I'll leave you with that light joke. I hope you guys have a great rest of your week. I know sometimes it can seem like I'm talking at you in these episodes. I don't want it to be that way. I want you to feel like we're sitting with you, we're asking you to reflect on new things that you might not have thought about before, coming alongside of you, outside of the marketing world, outside of all the commercials we hear, and really just helping you take a moment to think about the future you want, setting aside our current desires that are oftentimes driven by the marketing that we're getting exposed to, and really take the time to design and build a good life.

Announcer: I want to acknowledge you for taking the time to tune into *Sound Financial Bites*. You stopped long enough in your busy day to reflect on your finances and your future to help you design and build a good life. Please take a moment to subscribe to this podcast and follow us on social media. You can find us on Facebook and LinkedIn. If you have a topic you would like to hear us discuss please send us a note on Facebook, LinkedIn, SoundFinancialBites.com, or email us at info@sfgwa.com. Be sure to check out the show notes for links to any resources that were covered in each episode. For our full disclosure please check the description of this episode, the description of this podcast series, or you can visit our website. Make it a great day.

Each week, the Sound Financial Bites podcast helps you Design and Build a Good Life™. No one has a Good Life by default, only by design. Visit us here for more details: sfgwa.com