# Sound Financial Bites 026 - Paul Adams

*Episode Transcription*

*"The way you build wealth is with your spending, not with your investing."*

Years ago, a large financial institution quoted Einstein. As Einstein having said that the compounding of money is the eighth wonder of the world. But he didn't say that, what he said was "The compounding of numbers in a vacuum is the eighth wonder of the world," and this is the compounding growth of your money in a vacuum.

Hello, this is Cory Shepherd, vice president of Sound Financial group and I'm excited to welcome you to Sound Financial Bites, where we bring you bite-sized pieces of financial knowledge to help you design and build a good life.

Welcome to the video version of Sound Financial Bites this week. It's great to have you all. We decided to do a video version of this Sound Financial Bites simply because, we're going to go on something a little more complex than usual. It's going to require some bit of analytical horsepower on your part, and we're going to use visual to make all of it much easier. My name is Paul Adams, I'm president and CEO of Sound Financial Group, and what we're going to talk about today is the idea that cash flow trumps rate of return. You know, more of our other podcast, a guest of mine, Krisstina Wise, talked about the way you build wealth is with your spending, not with your investing.

We're going to go deeper into that today that it really is the way you control household cash flow, it makes all the difference in the world, not necessarily going out and getting a shoot the lights out rate of return on your money. Now, if you haven't had a chance to get to know us yet, I'd highly encourage you to go to sfgwa.com, that's our website. You can get there, you can download the first 3 chapters of my book for free. Register for our newsletter, if you register for that we're going to let you know about our live upcoming events. Those are educational events that we use to pour into our clients' lives, to do everything we can, to help educate people more about money because frankly, we think people become better clients that way, and we'd even be honored to have you as our guest. We're great hosts, we'll take great care of you, and we always bring these great 1 hour focused learning sessions. We'll bring your community of people together, that really care about their money, care about their future, and fundamentally, care about designing and building a good life.

Now, some of you have heard us talk specifically about designing and building a good life, but let me take a moment to go a little bit deeper into that before we get in today's topic. You see, too often what people do is they kind of move through life, hoping that they're going to get a default future. You know on the default future's going to work out okay but often it doesn't. Often the default future is not the future we would choose. The statistics on the amount of baby boomers that are going to retire, or at least stop working one day, but not half of the amount of money that they thought they would have wanted is astounding. Now this is the wealthiest generation ever to live on the planet, but the greatest access to information and the greatest access to financial markets. But there's tremendous fallout and failure when it comes to their retirement. So what can we do? Well, number 1, we need to make sure that we are actually designing our future, which means in our busy, hurried lives we need to stop long enough to do some design. You see if you design what's a good life for you, meaning you've thought it through, you've had a little bit of reflection, then as things come up in life it's easier to build your good life. It's easier to build your good life because you're focused on what's important to you because you took long enough to reflect and say what's important to you. I'll give you a couple of tips on that today throughout this video.

So, why is it so important that we look at savings and investing not just one or the other. It really has to do with the fact that really how our industry, generally, teaches us to look at money, certainly the way I was originally taught to look at money and even look at most of what the financial does in a way of marketing. Most of it has to do with rate of return, and if it was all about making appropriate control of cash flow, all of the fund magazines that come out that talk about the importance of this investment or that investment or the best fund managers would be a lot less boring and probably much more difficult to sell those magazines, if what is said on the front was "Be sure to save 20%," and then you picked up the next magazine it says "Be sure to save 20%," then you picked up the next magazine it says "Be sure to save 20%," that would never sell magazines.

So there has to be all these hot topics that they're marketing to us, we just need to be clear as we design and build a good life, that it's not about the marketing of those topics, rather, it's really important that we understand what our strategy is and what we can do to impact. So I'm going to give you an example today. I'm going to show you our tool The Living Balance Sheet. Now we use this tool to do planning for our clients. As we do planning for our clients we take this large holistic view, now this is a sample client, just something that we built to be able to communicate to all of you, how our planning works. Now in this sample client, this is a client with a fair amount of net worth and cash flow. We're not going to get into that now but I just want to focus that we're having a cash flow conversation today. Everything we're going to talk about for the most part today is cash flow based as opposed to any of the other components of somebody's financial life.

> *"We do everything we can to help educate people more about money, because people become better clients that way."*

On a different day I will go into what's very different about this financial model than most firms, but what I hope you can see is that it gives you a 30,000 foot view where you can much better assess where it is, every asset is and how they're interacting with one another. As our advisers work to coach you to a better financial future, this is the main tool that we use to do that. So I want to go over here, and we're going to just look at wealth building potential. So as we go into wealth building potential, we're going to look at -- let's just take somebody who's 40 years old right now, and we're going to have this person making $200,000  a year. That's nice because it's an easy round number, if you are way above that, all this is still true if you're making a million dollars a year. If you're making $100,000 a year, everything here still applies to you, that's why we built it all based upon percentages so that it'll actually works regardless of where you're at.

So, what we're going to start with is just how much earnings is that? Well, it's kind of easy, it's 25 years X 200,000 which gives us a total of $5 million of total wealth building potential by age 65. Now if this person also is competent, they're getting increases due to inflation on their income, and they're also getting merit increases, meaning they're getting paid more every year simply because they're doing a better job, they're getting smarter, and they're growing as a professional. But for the sake of this conversation, I'm only going to put it in as 4% income increases, and let's recalculate again, well, where is this put somebody? Well now, total lifetime earning potential is 8.3 million, so now this person's going to earn 8.3 millions between -- million between age 40 and age 65.

Lastly, let's look at rate of return. Let's say this person is investing and growing money every single year, that what they do is they invest their money, they get a rate of return in the stock market, and along with just a allocated solid diverse portfolio, what we will call academically allocated globally diversified. But I want to be conservative here, this isn't somebody rolling a dice trying to shoot the lights out, we're going to use a 5% after-tax rate of return and recalculate it again. Now, here's what's astounding, again this would be a 40-year-old starting at zero, no assets to start with at the beginning of this scenario, just to look at their wealth building potential from age 40 forward and that puts this person at the ability to accumulate 15.13 million. Now, years ago, a large financial institution quoted Einstein. As Einstein having said that the compounding of money is the eighth wonder of the world. But he didn't say that, what he said was "The compounding of numbers in a vacuum is the eighth wonder of the world," and this as the compounding growth of your money in a vacuum. You see, we put no routing factor is working against this person's capital. Yes they could have a maximum, the most of 15.1 million, but it would require that every other routing factor was taken off to play for them. So let's just sit back and take a look at what this looks like when real life occurs to this person and his family.

So let's just start with taxes, and what we're going to do with taxes, we're just going to think of it as an all-in taxable situation, social security taxes, sales taxes, everything this person pays, and we're just going to put that in at 28%, and then we're going to put in debt. Now, the interesting thing is it's not uncommon at all that what lenders will do is lend to people 40 to 45% of their debt income ratio to buy a home. So what we're going to do for the sake of our conversation is just say between -- having a couple of nice new cars which is totally normal that people have, and a decent house that maybe they bought because they've been taught by the industry, maybe the housing and mortgage industry or that your house is your greatest asset, so buy a big one.

So here's what we're going to do, we're just going to put in that this person has a 35% of their income going toward debt, and then let's just look at lifestyle, and what his person does they also have about 32% of their income going toward lifestyle. That's just vacations and shopping, and where they take their kids for their athletics, all that stuff is in that last 32%. I'm going to recalculate. Now this should give you some pause, and why they should give you some pause is the entire $15 million is still here, but now only 700 in 56,000 is on your balance sheet, or on our sample person's balance sheet. But if you're thinking about this as you, that's a lot of money that's now in other people's hands. For instance, we have taxes that are to the state in the federal government and the local municipalities, of 4.2 million of that wealth is now on other people's hands, and we have a total of debts. So, that's GMAC that could be chase mortgage Visa is 5.2 million outside of our hands in someone else's', and last but the least is lifestyle. So in target's hands, in Caribbean Cruise line's hands we have another 4.8 million. This really stacks against us and what we don't think about is that all $15 million still exists, it just doesn't exist in our hands.

*"Be sure to save 20%."*

So, what do people do to try to solve this problem, well, often times we sit down with a financial adviser, or we go online and we try to run some math about what can we do, what can we do to make this better and get a better rate of return? I'll tell you what's not uncommon at all, is that what somebody might do as well, I'm going to really push to get a high rate of return. What I'm going to do is I'm going to work to get an 11% every year, never down your rate of return, and I'm just hoping that what I can do is have about an 8% after-tax rate of return. Said in another way what we're going to do is we're just going to take more risk. Now, before I hit recalculate remember at 5%, this was 756,000. So let me recalculate, the proportions don't look like that changed it all. Let's just go over here and take a look, our 750,000 became 1.1 million. We took exceedingly more risk and we didn't increase the amount on our balance sheet that much. Now, why does this happen? Why is this the normal procedure in our industry? What is this that we as investors normally get drawn to? And it's this. It's that most of the world, the financial world, does not actually look at their total assets, and their total lost opportunity costs. Then it'll look at the red, so I just kind of brought this other window here to block it, to give you a visual, but in reality, this green here, that right there is all people are looking at. Then they're trying to do the best to show clients what you need to do is maximize that green by getting a higher rate of return. Meanwhile, they ignore all the red and where we want to focus is what can we do during our planning process we call the Legacy of Significance Process, where can we help you focus in being able to recover some of these other areas and get that money back on your balance sheet?

So, remember this for a moment, that this is $1.1 million. I'm going to slide back over here, and let's bring this back down to 5%. This is where we found our imaginary client, and what we're going to do, is let's say I'm working with this client, we get a little more efficient. Just a little more efficient in taxes, and what we do is we take their total taxes down every year from 28 to 25. Okay, we just shave 3% off their total tax liability over their lifetime, and debt, that what we do is we do a couple of things. One, may be proper structuring of debt, maybe what somebody needs to do is make sure that they pay off some debt, maybe they need to be sure that their using debt to finance the right kind of things the right way, but we're just going to say it we're going to take the precision on their debt, and take it from 30 just down to 28. This person's still going to be -- still has that, we're not wiping all the debt out but we take them down to a 28% total debt income ratio.

Last but not the least, we just take their lifestyle. No huge budget changes, nothing like enormously strenuous on their lifestyle, the way they want to live their life. All we want to do is just take -- have them look at their spending and reflect, as our guest, Krisstina Wise talked about, that what they should do is look at that entire budget and say to themselves, "Is this something I'm spending money on that really brings me value in my life?" Because if we maybe spending money on certain things out of habit, but it's not really something that brings us value anymore. So let's just knock that down, of course it's going to make that 30. So we have 30% all in lifestyle, we only shaved 2% off of it. Remember we're back at 5% again, I'm going to recalculate. Now, suddenly this graph looks very different. Remember, when we started and we met this client, their entire wealth building potential only had them at 750,000. Then when we took them down that traditional planning path, that would have somebody take more risk and get more return to solve problems, it only got in the 1.1 million and yet, we now have this person at 2 and a half million dollars of capital on their balance sheet. Not because we pressed for higher rate of return, not because we took extra risk, but simply and only because we began to recapture some of the things that were driving assets off of their balance sheet. So we have less money going to IRS. We have less money going out the door to inappropriate use of debt, and we have less money going to the places of consumption on our life, where perhaps we're not getting the value we would want to have.

So really cash flow trumps rate of return. Well, what if we wanted to take even less risk, like what if what we did is we put our money in municipal bonds and got 3% after-tax for this 25 year period. We're still at $2 million, $2 million of wealth build simply because we controlled cash flow and that's instead of throttling on the risk. What if we wanted to just leave our money in the bank and CD's and we got 1% after-tax? Well if we got just 1% after-tax, be solved 1.5 million, 1.5 million. But if we buried our money in the backyard and got no rate of return, whatsoever, the total amount of assets, the wealth building potential for this person would still be 1.4 million, meaning, by controlling our own cash flow which is one of the things you have the greatest amount of control over. By controlling our cash flow, we actually produce an outcome that was far greater than throttling on the risk inside of our current cash flow scenario. One of the things I want you all to be able to reflect on is kind of just a second, all these advisers are telling me all the value they're going to bring me, but when I was originally taught in this industry, what I was taught was one of the things you could bring people a lot of value and this may not be taking as much risk as they could. As a result of the not taking as much risk as they could they're leaving money on the table. Well, I think we've just proven pretty definitively that that is not the case that you don't have to, absolutely do not have to take more risk to leave more money on your balance sheet because we can actually use rate of return as a complete secondary thing to cash flow control to spending control.

Having a spending plan and making sure that that spending does the best job of caring for you in your life. Now, before we end today, I want to point all of you to some resources that I think will allow you to be -- part of it is going to be a calculator that you can use and read through and understand better, and another part of these resources is going to be a couple of videos from this 1 couple who lives extraordinarily, extraordinarily and radically within their means. Now this is something my wife and I took on a little over 3 years ago, to be really living radically within our means. We are nowhere near where this family is right now in terms of the percent of assets that they saved, but we are far, far above most people. In another episode in the future, I'm going to walk you all through the way we think about money, and the way my wife and I, in particular, save money. As we move kind of in the top 1% income space and yet, live extraordinarily conservatively as compared to most people in the top 1% from an income perspective.

So, I'm going to introduce you to this first couple, their name is Mike and Lauren. So Mike and Lauren have a YouTube channel, and their YouTube channel has -- I think they do like woodworking and do-it-yourself projects on one release per week, which I have not watch any of. Then their other videos talk about them working toward retiring by his age 31. Yes, you got that right, these people have totally normal jobs, they're not shooting the lights out in terms of income, and they're going to show you that. In the second video I'm going to introduce you too, but I think the thing that's most unique is the philosophy they have inside of this first video I'm going to introduce you to. So, I'm going to take just a moment and bring it up onscreen for you here.

So this is Mike and Lauren, and I think the first video to look at with them is this one called How to Retire Early: Our Plan for Financial Independence. Now, in the show notes below, we're going to make sure you have a link directly to this, and they're just talking about how they're going to save and what they're going to do with their money to put themselves in the best position to retire by age 31. Their philosophy is they'd much rather reach the point of financial independence, which doesn't necessarily mean they're going to stop working. It's just financial independence where they can be at the point that they have the choice of what work they want to do and when they want to do it, because in what work they want to do and when they want to do it is their definition of freedom. I think it maybe many of ours, definition of freedom, and they're going to talk a little bit about this business video, and you see it's not very long. 5 minutes, wonderful investment of your time to give you a sense of what it takes to really retire well and design and build a good life. I love the paradigm breakers, when this couple says how little they live off of, in the next video, Mike and Lauren exposed one of their YouTube watchers, literally watch YouTube, saw that this couple was -- the way they were doing their math, and got pretty darn close to the net worth, so they say we're just going to tell people about it instead of keeping it a secret anymore. But I want to show you one of the articles that they referenced that's out online, you can go look at yourself. I highly encourage you to read this article. It's called The Shockingly Simple Math Behind Retirement, and this is a gentleman named Mr. Money Mustache, first introduced to me by a good friend of mine that's in my bible study, and what he said was "This guy has gone through the absolute minimums of living on as little as possible income and saving a truck load of money."

Now, here's the thing that somebody like Mr. Money Mustache or Mike and Lauren do for you and I. It's so easy for us to first, you know, we make income, it's coming in the door, we have enough, and then what we do is we spend -- some of the money we spend a little more the money, we'd take out a loan for our car, and those decisions accumulate, and what these people can do uniquely for us is pull us away from the center. You see by pulling us away, like putting us in the position where they're over here, and we might be way over here. We're kind of -- even we don't know it, we're trapped in the consumer's cycle of most of America, why? Because everyday we're around most of Americans. When we watch TV we're getting bombarded with commercials marketing us to get us over here where every marketer would prefer, we spend 100% of our income or maybe more. Then we have people like Mike and Lauren and Mr. Money Mustache that are over here, and they're pulling us the other direction as much as they can and they're on the far extreme.

But by letting some of these people into our mind, and not saying, and this is something I really got to encourage, don't say to yourself, well, "They don't have this or they don't have that, and I need that or I have  5 kids, or I have 2 kids and they have no kids," and make that as a reason why the rest of what they say isn't valid. What I want you to do is not be a devil's advocate as you listen to these, but rather, take it on. Use it as an opportunity to break your paradigm around spending, and then give yourself the opportunity and chance to reflect. So, The Shockingly Simple Math Behind Retirement is Mr. Money Mustache's blog, and you see that here, again, we'll have it in the show notes, but further down the blog, this is the thing I think is most interesting. In the blog, I'm going to introduce you to the calculator where this can be calculated is this very simply with very easy assumptions of 4% withdrawal rate in retirement, and a 5% growth on capital, is that if you're saving 5% of your income it's going to take 66 years to have enough money to be able to retire.

Let me say that again for the people listening to just the audio, that what is going to happen, and if you've saved 5%, it's likely going to take 66 years to be able to have enough money to be able to retire. So, it's a pure percentage game, why is is a pure percentage game? Because the more money that you save, that means the less income that you're living on, and the less income that you're living on, the less your nest egg has to be. One day, less capital at work is required to then produce the income that you need for the nest egg. But if you say 50%, 50% of your income, you could close that gap in as little as 17 years.

In this blog you're going to be able to see all of his assumptions, but there's also this link to networthify. Now this is not a major financial planning calculator but here's what I think it can do for you, it can put you in a position where you can look at your current assets and income and say to yourself, "How long is it going to take me at these very simple assumptions. I would encourage you do not increase the rate of return pass 5%, do not change the distribution rate, well, you can change both of those when you click show more options. But what this is -- this is not a financial planning calculator, it's not meant for you to make all of your financial decisions around but I do wanted to create a reflection for you about how you might live in safe. So let's go to our couple, what you want is calculations, you want to use your after-tax income for current annual income at the top.

So if you have somebody who's making, let's say 200,000 since that's the number we've been using here for a little bit, if they're making $200,000 a year and they're saving 5%, they put 10,000 a year inside their 401k, because they get a little bit of a match from their employer, their current savings rate is only 6% -- up, let me go back and change this number, current annual income they make 200, or I'm going to sit back and reflect that maybe after all their taxes they're only really keeping 160 maybe, something in that range. So the after-tax income, their savings of 10,000, the total of 6%, 6% savings rate, and it's going to take them 62 years to have a shot at retiring. That certainly doesn't sound like a lot of fun. But if that same couple could put themselves on a path where they could live off of, about $100,000 e year. Meaning that they save 60, now that is going to take some diligence and some work, but it's also going to take diligence and work to stay in the workplace competing as you age for 61 years. I think that's the thing that's all too often forgotten, is that people say "What? It's just too much work to save that much money," versus competing the marketplace and trying to put in another 30, 40 years, we now have the opportunity to control our destiny by controlling our spending. We control our spending. We don't control rates of return in the market, we don't control all these other things but there's a great deal about what leaves your wallet and leaves your bank account every month that you have a ton of control over.

So, now this person has a 38% savings rate. Would they have to work hard at that? Yes. Would they have to tell a lot of people in their life I can't go on a vacation with you because it's going to break strategy? Yes. Would they have to make some degree of sacrifices? Yes, but keep in mind, this person just recaptured 39 years of their life back out of the workforce that they chose to do that, or, they stayed in the workforce, they continue to build their career but maybe they allowed their consumption to creep up a little bit because they now have enough in assets, or, they now work in their career but they now no longer worry about ever losing their job. If they're a business owner they don't concern about the fact that they one day, need to sell this business, or that whether a particular vendor contract is going to go the right way or not. So I'd really have all of you consider as you watch both of Mike and Lauren's video, read Mr. Money Mustache's blog, that what you're going to do is reflect and just say to yourself "Where is I'm spending money? Is it really bringing me and my family value or is it distracting from the very things I think I'm going to enjoy?" So, with that I encourage all of you, scroll down to the show notes here, grab these links, watch these other videos, it's only going to be about another 8 minutes investment of your time. But here's what it is going to do, it's going to allow somebody to pull you off of the regular marketed way of thinking about money, and pull you off of perhaps the way you were taught about money, in spending money.

A very good friend of mine, just last night as I was sharing some of these concepts with them, she said "You know, my husband and I were perfectly fine living on basically hardly any money. We were happy, we both had incomes, we saved a ton and then it was --" in their case their family that was saying to them, "You know what? You need to get a house. You need to buy a condo. You need to --" and asking them to step things up from a consumption perspective because in their case, their parents were looking at the outside look of success for our friends as their success. Now they're fortunate, they're still in their early 30s and they're reflecting and saying "We're now going to shift back to making and putting money on our balance sheet more important than buying things that other people can see."

Another great resource for all of you watching the video today, you hear me talk about it before, I will continue to talk about this, it's a book called Stop Acting Rich. Highly offensive title but a wonderful book when it comes to the way people really build wealth. You can read it, it's by the same author that wrote the Millionaire Next Door. You can take that book into your house and have a different way of looking at statistically and what the probability is that making certain consumption decisions stack the likelihood against or for you having the degree of financial success that you want.

I'm glad all of you could join us today. Remember, you can subscribe here to our YouTube Channel. You should definitely open up your Apple device and subscribe to our podcast and all of our upcoming events. You can go to our website, see our upcoming live events, you can subscribe to our newsletter, we're going to let you know about any of those live events that are upcoming in your area. You know what? Also, don't hesitate -- the Seattle area is beautiful. Fly up here, come to one of our events live, take a weekend with your family afterwards. We look forward to spend more time with you, know that we work with clients all over the country, we do it by go-to meeting all the time. What we wanted to do is work with you to help you design and build a good life. That all starts with a 30-minute phone call, and on that 30-minute phone call all we want to do is, to whether or not philosophically worth it for one another, and if we are, and I think we maybe able to help you design and build a good life for you, your family, and your future. Have a great rest of your day.

Hey, this is Cory again. I just wanted to say it's been great to have you here listening to this episode. You can find out more information about us on our website, www.sfgwa.com, or you can find us on Facebook under Sound Financial Group. We'd love to hear any questions or comments from you there. Who knows? You may hear one on a future episode. For our full disclosure, you can go to description of our podcast series, this episode's description, or our website.

---

***Paul Adams is a Registered Representative and Financial Advisor of Park Avenue Securities LLC (PAS). Securities products and advisory services offered through PAS, member FINRA, SIPC. PAS is an indirect, wholly owned subsidiary of Guardian. Sound Financial Group is not an affiliate or subsidiary of PAS or Guardian.***

***This podcast is meant for general informational purposes and is not to be construed as tax, legal, or investment advice. You should consult a financial professional regarding your individual situation.***

***Guest speakers are not affiliated with Guardian or PAS unless otherwise stated, and their opinions are their own. Opinions, estimates, forecasts, and statements of financial market trends are based on current market conditions and are subject to change without notice. Past performance is not a guarantee of future results.***

***This Material is Intended For General Public Use. By providing this material, we are not undertaking to provide investment advice for any specific individual or situation, or to otherwise act in a fiduciary capacity. Please contact one of our financial professionals for guidance and information specific to your individual situation.***

***2016-25645 Exp. 7/18***

---

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