Sound Financial Bites 057 - Paul Adams
Episode Transcription

“Hope is not a strategy by itself.”

Hello, Paul Adams here. Welcome to Sound Financial Bites, where we help you with bite-sized pieces of financial and life knowledge to help you design and build a good life.

Hello, and welcome to Sound Financial Bites. My name is Paul Adams, President and CEO of Sound Financial Group, and I just got to start by saying I am so glad that you logged into the podcast today, that you're taking the time to invest in yourself to start thinking a little bit differently about money.

Now, today's topic is a financial philosophy topic and what we're going to talk about is how important it is to realize what life we're planning for when we're planning, and we all have different levels of lifestyle that we want to build for the future. And if you've ever had a chance to work with our firm or one of our advisors, you probably heard some of these before. They will sound familiar and yet you should listen to this entire podcast.

For anybody that's never on our podcast before, here's what I'd like you to reflect on. I'm going to introduce you to three key new distinctions, and what I would have you do is just make sure you remember what each of them are and what they mean because it will start to change the way you view the world.

You see, there's even been studies on people that we actually view the world differently based upon what's on our mind. If somebody sees something new, when they have them in an MRI and they show them something new, you would think the part of their brain that would light up would be the visual cortex, and it doesn't. 90% of the activity happens, when something new is seen, is pulled from the memory banks. People are trying to make sense of it.

What I promise you is your future financial decisions will start to look and feel different, and the promise is you're going to be able to actually use these terms beyond this podcast today. So, I want you to think about that if you're new to our podcast because these are so, so critical. So, let's talk about what happens normally when it comes to finance, when it comes to planning when people are looking at their futures.

When it comes to finance, when it comes to planning and people are looking at, "How much money do I need one day, how much money do I want one day?" let me tell you, they only look at one number. Now, some of you may remember the ING commercial from years ago, and those ING commercials were really cute. It was somebody had a number tucked under their arm, and they were going through the airport, and they had to put the number through the baggage scanner, and "What's your number?" was the theme of that, and you needed to find out what your number is.

Oftentimes, what people do is they set that number based upon, probably, their experience of their lifestyle right now. The problem is they're only considering one number. And for those of you that have had a chance to be with us and go through our philosophy conversation, we talk about the problem with aiming for that number is, too often people miss it, and the bigger problem is in how they miss it is because, at some point, they sat down with a financial advisor, or maybe they just went to the internet and did the math themselves, and when they went to the

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internet and did the math themselves, what happened was they said, "Oh, I'm not going to make it. Oh my gosh, that is way out there. I'm not going to have enough money. I don't have any more assets. I can't save anymore," and they get the idea that what they need to do to get there is take more risk, and when they take more risk, they might even get some good rates of return. I think we saw a lot of people do that, taking a lot more risk with leveraging real estate. Or, back in the '90s, taking a lot more risk buying a lot of tech stocks, maybe even on leverage.

"Hope is what you do after you've done everything else you can do."

What happens is we nearly, as often as the downs come, people do get the ups, and people had some upswings in their assets and in their portfolios because they took more risk, but that volatility that comes along with that additional risk also came along, and those people got hurt really badly. They got hurt badly enough that you hear time and time again, you've heard it from your friends, "I'm never going to do X," whatever X was, "I'm never going to do that again," and it even bleeds over into not making good financial decisions again.

Because of that, people end up missing their number. The very pursuit of that single number is what has them miss it, because their "number", they didn't see a way to get to it. They thought the only way to get to it was to take more risk, and way more often than we would like to remember, it doesn't work out for people to simply take more risk as a strategy. In fact, that's hope as a strategy. "I hope, if I take more risk, I am going to get a higher rate of return," and hope is not a strategy by itself. Hope is what we should do. For those of you that are people of faith, hope is what you do after you've done everything else you can do.

You know, my wife and I are part of a church plant right now out of the main campus where I'm on the board there, and when we went out and did everything we could to invite people, and it was a Sunday where the weather wasn't good and the flu was going around, but we've done everything we could to invite people, we had set up the church, we did everything we knew we could strategically do. Now, after that, it's time for hope.

But, too often, people take an action that's not well-grounded and then layer hope on top like icing on a cake that, maybe, is not a very good tasting cake, if you get my drift, and it still tastes terrible. It doesn't turn out well. So, we can't hope as the primary strategy. Hope has to be what we do after we've executed everything we know how to do and we've been diligent around that.

So, this extra risk is not the solution. Shooting for one number is not the solution, and that number most people are shooting for is what we call your surplus number. I'm going to come back and explain the surplus number in a moment, but let's talk about what comes before surplus so we can cover these in order. What comes before surplus is a number we call your sufficiency.

Now, we're going to relate to these in three different ways. As I roll out each of these distinctions to you - and you're going to hear them over and over again, so be ready - is sufficiency, surplus, and superfluence. Sufficiency, surplus, and superfluence. We're going to go through these three different times. One, giving you a definition, and then two, giving you different exercises you can go through to really look for what is sufficiency for me and my family, what is surplus for me and my family, and what would superfluence be? Now, superfluence doesn't apply to everybody. When I get to it, I'll explain more.

So, sufficiency is the life that most people are already somewhere north of sufficiency, at least

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> *"[Business owners and executives] We can't predict what technology will take us out."*

the people that we've worked with. What that means is they have enough right now where as they look around, they've got in excess of what a good life would be for them. Having financial sufficiency means we basically got $1 more than any untenable compromise we could not see ourselves making.

Now, this is different for everybody. If somebody's been making $2 million a year for the last 10 years, their sufficiency's probably going to be higher than the household that's making $500,000 a year, and that's okay. It's different for everybody, but sufficiency is the lowest of the three numbers. So, sufficiency is what does it take, what does life look like to have you outside of everything you would call unacceptable?

So, think of it this way. What is the house that is one feature or one square foot above what you would call, "I could have a good life in that house with my family."? It's a safe enough neighborhood. Not the safest, not the nicest neighborhood, safe enough. It is constructed well enough, it is warm enough, it is clean enough, the furnishings are good enough that I can look around and I realize I could have a good life in that. This is that practice of resetting ourselves periodically and saying, "I need to cultivate contentment here a little bit." So, that's sufficiency. One more thing on sufficiency, no luxuries. No luxuries.

So, now let's go to surplus. Surplus is where we have that and we have our sufficiency handled, and now we're living a life where we're starting to have things that are better than the minimum required to have a good life. We have a better car, we have a better house, we probably take a little bit better vacations than we would otherwise, and we have a little better in a lot of different areas, and that little bit better in a lot of different areas puts us in the position where we can take and enjoy some luxuries.

As an example, instead of driving to Disneyland with your family, you say, "Okay, we're just go ahead and splurge on the plane tickets and do it that way." So, a little surplus. Maybe, periodically, driving first class, going out to nice dinners, etcetera. That's a surplus lifestyle. Most of you listening to this podcast live in a surplus lifestyle today, and the problem, when it comes to planning, is we're oftentimes making our "retirement plan" that picks our number. That is being chosen based upon our current experience of our lifestyle with no reflection on sufficiency, which is how most people endanger their sufficiency.

Now, for our high-level tech executives, corporate executives that get significant amounts of stock, and for our entrepreneurs and business owners, there's another number called "superfluence". Now, superfluence is where you're trying to hit the ball out of the park. That is you own a business right now, you took over a family business, and you're saying, "We currently have a $20 million valuation, but I think I can grow this thing. We'll get a $200 million valuation, I'm going to sell it. Or, not sell it. I'm going to keep running it, but I want the 100-foot yacht, I want the vacations that just stun people. I'm going to be one of those people that travels overseas with my family and close friends and we have a photographer that just travels along with us too because we want to document." Whatever it is that we're after, that's the superfluence. That's the way, way out there.

Now, here's the thing about superfluence is that it's not just superfluous, although that is something they use to define superfluent. But, another part of the definition is super-abundant,

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or flowing, or floating above from, or on the top of. When you look at superfluous as a definition: exceeding what is sufficient or necessary, extra, or not needed. I am a huge fan of people shooting for superfluency. It is not needed. You don't need to have a 50-foot yacht. You don't need to have a $15 million home, and I personally would love for you to have those things if you're listening to this podcast. That is great.

Here's the problem. Too often, what people do is they risk their sufficiency, and they risk their surplus in pursuit of superfluence. We're going to talk about how to build each one of these and how to make sure that your life can be okay by simply being aware of each of the three stages, and I cannot tell you how many entrepreneurs I know who are, after producing this huge life, never having distinguished sufficiency or surplus.

So, let's go back to sufficiency. As you look at each one of these, you have to first say, "What does that life look like?" So, for each one, you could, if you wanted to be in an exercise with your spouse to really do a great job with this, what I would do is write it out. If they're not listening to this podcast regularly, before you sit down and try to write out what it would look like, have them listen to this podcast first.

So, they listen to the podcast, you sit down and you write out maybe half a page. Half a page just written narrative about, "Here's what that would look like just for us. As a household, we would live in a house smaller. We could live five more miles away from the city center." Depending on who's listening to this across the country, "We don't need this much cattle, or we don't need that much in tractors. I don't have to have a Mercedes," whatever those things are. It's very freeing. You just realize how you could live a good life and what it would look like. We're not talking how much it costs yet, just what would it look like differently than the way you're living now.

Next is surplus. Now, the interesting thing about doing the surplus part of this exercise and what does life look like, you'd be amazed how often you put things in your life right now that aren't part of your surplus. It might be a great example would be that maybe you have a camper trailer, but your kids are grown and it's just sitting next to your house and you haven't used it in three years, or an RV. It might be time to just kind of stop and realize that's not part of your surplus life anymore, and it needs to go and just declutter yourself.

Greg McKeown, I'm not sure how to pronounce it. It's M-C-K-E-O-W-N. Wrote a book called Essentialism and talking about boiling life down to those key parts. Joshua Becker wrote a book called Simplify, and the idea of releasing the cognitive load of getting rid of the stuff that's no longer part of your surplus life can really, really be an amazing thing to help you design and build a good life.

So, in surplus, you're reflecting on what you have now. Are there things missing? There could be. Maybe, there's a surplus thing, you've been in the habit of driving an older car, and you're like, "You know, I'm going to get a used car, but I'd like to get one a little newer." That's something to come out what does the surplus life look like to you.

Then, for those of you that are those business owners or people that have the chance to have the huge idea that could just take you over the top and get you to some level of superfluence, and for the sake of this conversation, let's just call superfluence $20 million and up in net worth, then

sketch out what that life looks like. As you sketch that out, you kind of start to see the three different stages.

Now we have to go back to the beginning to sufficiency. What does the sufficiency life cost you? I heard a woman on the podcast the other day, and she was great, and one of the things she said was, "I realized what allowed me to have and take the risk of building my business was I realized that it's not the end of the world. I don't need to be afraid because I'm pretty consummately employable, and if I had to work as a manger of a restaurant, or if I had to be a staff accountant somewhere, it'd be fine. My family and I would just adjust our lifestyles, but we would be taken care of. I didn't have to fear it."

So, you could see how, while she didn't have the language of sufficiency, she was clear on what sufficiency looked like and that she could pay for it, even if she wasn't successful in her business, which gave her the additional courage it took to go out, launch out, and build a business, given that she was, particularly, an introvert.

So, sufficiency, how much does it cost? Is your sufficiency lifestyle $6,000 a month is what you need, which might mean you got to make $8,000 or so before tax to be able to have $6,000 after tax and live that life is your sufficiency for? But, it really is freeing to know how much that's going to cost. Then, we move onto surplus, same exercise. How much income has to be earned to supply the surplus, and then how much income has to be earned before tax to put you in the spot that you can have that after tax?

So, you've got to make sure, "Okay, I've got to make, for my surplus lifestyle, that's $300,000 that I want to spend, $25,000 a month. So, I've got to 450, 425 to pull that off." That's where you've taken the time, "Oh, we would be in this kind of house with this kind of mortgage. We would want to have a second home, a cabin, an RV, this much in vacations, this much time off, whatever it is." Surplus lifestyle.

Then, for those of you that are really thinking over the top, you're going to blow out your company in a good way, like you're just going to blow the doors off and it's going to grow enormously, you got to get clear on what this is. Now, if that's a million dollars a year, you can do the math. You might have to make a 1.35 million, 1.4 million to have a million of spendable money every year, and what does it take for you to have that?

Because now, instead of just kind of imagining one day you'd have a yacht, you'd realize, to have that level of superfluence, you really got to have $1 million of income after tax every year, and suddenly, you have a flag that you can chase in that business for your superfluence. But, here's a caution. As you go after your surplus and you go after your superfluence, whichever of those stages that you're at, the sufficiency must be there.

We've just said that, for the rest of our lives, we need to have sufficiency to be okay for the long run. You've got to have it. So, you've got to have sufficiency, then you can't be taking a truckload of risk with any of that capital. That capital needs to be the more conservative strategies, maybe even some guaranteed strategies in that to make sure that sufficiency happens. Then, you just take priority in the savings of your cash flow, and we need to make sure that nothing we're doing to pursue surplus and nothing we're doing to pursue superfluence jeopardizes sufficiency.

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That also includes, and for those of you that are clients of our firm, you've seen this. We talk about the moat around your castle. What are you doing to protect yourself so that you will always have what you built? Or, we can at least do everything possible to control the controllables so you never lose what you built. And if we can do that, make sure, much like a football team, they don't need to have an amazing offense as long as they have a great defense and nobody scores on them. So, we make sure the defense is strong on your strategy.

That's where we look at things like car insurance, homeowner's insurance, umbrella, wills and trusts, disability insurance, life insurance. All is a part of that moat that's part of your sufficiency. You got to have defense appropriate to your sufficiency, and we got to make sure it's not compromised as we pursue surplus. Then, as we build to surplus, you're going to build protection strategies that are appropriate for your surplus, and same for superfluence. Each one of those, as you move through them, creates the opportunity to have different stages of financial tools and protections.

Now, let's go all the way back to sufficiency again, and this is where we're going to, I think, sort of wrap the conversation for this podcast, and that is we need to know how much capital it's going to require to be in a spot that we can have our sufficiency, to be in a spot we can have our surplus, and to be in a spot we can have our superfluence.

So, let's do some quick math. You've heard me talk about in prior podcasts that we know that the sustainable distribution rate across many asset types is about 4% a year. So, even if you have commercial real estate and it's paying 8% a year, you don't want to go consume all 8%. If you consume all 8, then when tragedy strikes, you don't have the reserves. When major economic things occurs and you don't have the tenants, you don't have the cushion. You may have to fire sale assets. That's why a 4% distribution rate, even when assets are producing higher than 4, gives us the opportunity to build the reserves so that those assets, when they go the other way sometimes, which every asset sometimes goes the other way, what we need to be able to do is make sure we can sustain our 4% distribution.

So, let's go back to our person that for them, a little over $8,000 a month, so about $100,000 a year is their sufficiency. They need to have that in income before tax every year to be okay. Well, at our 4% distribution rate, if you've never done the math before, take your 100,000 and divide it by .04, or your shortcut is multiple it by 25. When you do that, what you see very quickly is somebody has to have about $2.5 million dollars of assets to consistently and predictably throw off income to pay that sufficiency. That does not count their home equity. It does not count any value they have in an RV or a secondary residence. These are investible assets like everything from rental real estate to a portfolio, retirement plans.

Now, you need to test it, but at least this gives you -- like, when you say, "Okay, I'm going to have $2 million of a portfolio, I'm going to have $500,000 in a 401(k), and I'm also going to have some other money in real estate," you need to test it and model it with a professional to make sure that it will actually produce the cash flow that you're thinking.

But, your rule of thumb in terms of setting the flag in the future at 4% of distribution every year: 2.5 million. Now, you know your sufficiency number. That's the first number. We go through the

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same exercise for surplus. So, we're just going to kind of follow this forward and we're going to say that somebody else's surplus number - that means some luxuries, pretty decent life, really going to enjoy some things - is going to be $300,000. Well, to have $300,000 of gross income is going to require, without us needing to work, $7.5 million. $7.5 million of assets has to be built up so that we can take our surplus number of $300,000 every year in a sustainable fashion without our portfolio running out of money.

Now, most people are trafficking around every day having no idea what either of those numbers are. But, what's worse, for some people, where their number might be $7.5 million, they are pursuing the $7.5 million not realizing they may be risking their very sufficiency.

Now, let's move back up to the person that wants to have $1.2 million a year of income. They want to have $1.2 million coming in taxable every single year. For that person, where they need to be is about $30 million of capital at work. That's a serious chunk of change that has to be set aside to sustain the lifestyle. Now, here's why this is key. For some of you, this may not apply, because you're not after a superfluent strategy. But, this is really key. We're going to be releasing a YouTube video called "When $22.5 million is not enough." When we do release it, we'll try to add it to the show notes here.

When $22.5 million is not enough because the thing is, many people can live a really robust lifestyle with a really amazing house, and a boat -- well, not boat, yacht. Amazing vacations, amazing second homes, and when they have all of that, it looks really, really cool. But, we forget the amount of capital at work it takes to replace that.

So, somebody could have a lifestyle right now that costs over $1 million a year, but if they don't have $30 million in actual investible assets, it's not likely that they can sustain a $1.2 million a year of income if whatever their primary income source is gives out. That's $30 million of investible assets outside their home, outside their second home, outside their cars. And here's the big one, y'all, outside your business.

Each one of these needs to be on your personal balance sheet, because when you own a business, that business is a single stock holding. It's one that you feel like you have a lot of control over, and you probably do, but the marketplace still surprises us. So, whether you are a single business owner that just has stock worth $40 million does not mean you've reached your superfluence number to be able to sustain that level of income. You have a $40 million company, but a competitor comes out, and in two years, wipes you out, something you didn't see coming.

An easy one is look at everybody who had huge fortunes in these medallions at cab companies, and somebody came along with a mobile app with normal people in their cars and wiped them out. We can't predict what technology would take us out, and for those of you who are high-level executives for publicly traded companies where you have stock options, you're not out of the fight either. Just because you have $30 million of stock options does not mean that you've got your sufficiency, or surplus, or superfluence handled until you convert it from that company's balance sheet to your balance sheet. As long as it's all in that single stock, what you're still doing is speculating.

Now, if you're building a business or you've got that company, more power to you. If you want to

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keep the $30 million at risk there, just know you haven't secured your superfluence. Though, as long as you've secured your sufficiency, as long as you've secured your surplus on your personal balance sheet, then you can go ahead and roll the dice and go for your superfluence. More power to you. We hope that you get there, and yet, let's not make us getting there really hold in jeopardy the stuff we really care about.

I don't think anybody listening to this who would like to have your superfluence strategy really, really, really cares deeply about owning a $3 million yacht. But, what they really, really, really care about is making sure that their pursuit of the yacht never jeopardizes their children, like jeopardizes education or their children's ability to live in a safe neighborhood. If you ask them, they would say, "Well, of course, I wouldn't want that." Yet, because they didn't distinguish sufficiency, surplus, and superfluence, they may very well jeopardize the first two in pursuit of the third, and you don't have to.

Secure sufficiency first, build for surplus, and pursue superfluency. That's a great strategy to be in and puts all of you in a spot, and if you have any disagreements in your household, if you're somebody, you're a business owner, a man or a woman that's going after superfluence, and you have a spouse that sometimes gets worried about the amount of risk you're taking to business and they get upset about the debt or they get worried about things, build a sufficiency strategy. Be able to demonstrate to them that you're taking actions that no matter what happens in the business, everything's going to be okay, and that they are more important to you than that business and you reaching superfluence. You know what you're going to get? You're going to get a spouse that will absolutely support you in pursuit of your superfluence so you guys can enjoy it together, and if you have that support, I think you're more likely to get there.

What I hope for everybody listening to me today and why I'm smiling, and you can tell I'm excited about sharing this with you. I just hope what you take away today is the ability to look at and design your life differently, that we've given you tools that would allow you to build some things differently, and we're here for you. If you want to have a conversation with me if you're investing in yourself in these podcasts, we're happy to have a conversation with you. We can walk you through our full philosophy, you can apply to become a client, and we'll make that assessment with you to see whether or not we'd be an appropriate fit. And if we're not, you can count on us to at least take time to do some financial triage with you.

So, reach out to us on Facebook, find me on LinkedIn. Reach out to us at info@sfgwa.com and we'll be here for you. We'll do whatever we can to help you better distinguish sufficiency, surplus, and superfluence to help you design and build a good life. Have a great day.

Hi, Paul Adams here. I want to acknowledge you for taking the time to invest in yourself by listening to our podcast. Not everybody does that, and out of my commitment to you, I will take just a few of our podcast listeners between each of our episodes and spend time with them one-on-one. And if you think you'd like some of that one-on-one time to learn more about our process, our philosophy, or whether or not we'd be a fit to work together, just email info@sfgwa.com - that's info@sfgwa.com - and I'll be more than honored to take that time with you. You can also go to our website, www.sfgwa.com, download the first three chapters of my book, see upcoming in-person events that we have, or listen to past episodes. You can also go to our Facebook page and engage us there, our LinkedIn, and send us questions for upcoming

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