

*Episode Transcription*

*“You don’t need to predict where the wind is blowing, just the zip code it’s blowing to.”*

Paul Adams: Hello and welcome to Your Business Your Wealth. I am your host, Paul Adams and CEO of Sound Financial Group, joined by my partner and President of Sound Financial Group, Cory Shepherd. Cory, here we are, rain or shine, like the mailman or rough coughing throats. So, we're gonna try to edit out all the coughing for you guys, but we're a little under the weather, and what's going to carry us through today is our passion about the topic and our agitation about what some people say out in the media, and we'll cover that in this week at planning.

Paul Adams: But today, what we're gonna talk about is maximizing the use of your 401 [k]. You have one either as a business owner, or you have one as a highly compensated executive. Either way, maximizing this tool is critical for you being able to make the best decisions possible and accumulate the kind of money that you need to have the capital at work to replace your income one day. So, with that, we're gonna jump right into this week at planning a topic that has had Cory and I, just prior to this call, I'll just call it sufficiently agitated. [chuckle]

Cory Shepherd: It's got my chest warmer than the Vicks VapoRub that I should have used this morning. That's right.

Paul Adams: [chuckle] Well, this comes out of the Wall Street Journal. It's an opinion article that deals specifically with investing in small little startups. Now, it's not obvious why the article is called An Investment Tip From Mr. Zip, but it all comes down to the very bottom, and I think we'll talk about this first, the future is always fuzzy, like horseshoes and hand grenades you only have to be close. Get in the zip code where the wind is blowing and watch things fly.

Cory Shepherd: The paragraph before a couple more, he says, "The simple lesson, you don't need to know the address if you're in the right zip code," which sounds like this magical nugget of gold from someone on the inside. It really does.

Paul Adams: Of course, yes.

Cory Shepherd: It's beautiful.

Paul Adams: And it is a really great saying, "You don't need to predict where the wind is blowing, just the zip code it's blowing to." Now, here's the trouble. Here, we are reading this investment tip, this is published October 6th, 2019, and it's about this stock trader choosing the right particular stock, a small cap stock, and he ended up accumulating over a million dollars worth of this stock when it was trading below \$4 a share, such that they actually had to complete SEC filings to be able to continue to own that many shares of the total outstanding shares of a public and traded company. I think they cleared 10% of all

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*“Once you put the money in [to your 401(k)], you’re making an irrevocable decision to pay the taxes on that account at future tax rates, whatever they are.”*

shares. Now, they say it started in 1995 at \$7 a share. So, what we're gonna have to assume is that some time later it fell to \$3 and it had \$10 million shares, and they had invested enough to end up with over a million shares. So that's over \$3 million invested somewhere. Now, he scrolls down in the article...

Cory Shepherd: Or we scrolled down.

Paul Adams: Yeah, we scrolled down.

Cory Shepherd: He just kept writing.

Paul Adams: He just kept writing about the different prices he acquired it at. And they kept buying shares until something happened in the marketplace that made what this company manufactured super valuable and inexpensive enough. Now, here's what's key. As we get down here, let's notice this. Number one, 1999 is when he had his exit from the stock. Now, I hate to be somebody who's skeptical, but if stock picking worked, well, sorry, I'm about to go off the handle.

Cory Shepherd: You love being someone who's skeptical. Let's just call a spade a spade. And it's gonna get good, so hang in there folks.

Paul Adams: Only when it's total BS do I enjoy being skeptical. Otherwise, I love listening to other ideas and testing them. But if this worked, don't you suppose maybe this author would have something more recent than two decades ago having an exit? Two decades old this is. And it's easy to read the article and get inside of his narrative. And here's the other thing that we all do. We will make up new actions we might have been in in the last two decades, because we should have seen the Amazon coming. We should have seen the Apple coming. We should have seen... It goes back to our episode about shoulding all over yourself, but the deal is, you didn't.

Paul Adams: And right here he says, "Believe me, I've had plenty of awful investments, including more than a few zeros." I wanna pause on that. When he says a few zeros, this doesn't mean investments he took on that had 0% rate of return. The worst you could do is negative 100%. Maybe worse than that if he leveraged his company to be able to invest in these stocks. So, this is not a, "Aw, darn, I didn't get great use of capital." This is like, [05:14] \_\_\_\_ Capital gone.

Cory Shepherd: Capital gone. And he was right for the wrong reason. His idea was TVs needed a DVD drive to hook up to them, which actually did happen, it's called TiVo. We just didn't print out, burn CDs from it. So, he invested in the wrong thing to get where he wanted to go, and what he says is that he was just in the right neighborhoods that worked out for him. I would call that lucky.

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*“With the Roth 401(k), you put the money in after tax and now the money is 100% yours as the investor and retiree.”*

Paul Adams: That's exactly right. He just speculated, it worked out. And this is where he says it right here, "And I was wrong about what would make this stock work." No, you were lucky that it worked out, and as evidenced by the many you've had not work out, by your own admission of this article, and the fact that the one example you side of your genius is two decades old. I'm going to imagine if he had some others that were similarly spectacular, he would have at least hinted at them in this article, if for no other reason than to get Wall Street Journal to allow him to publish more opinion articles about what he did.

Paul Adams: And last but not the least, I think it's telling, where is this article? The Opinion section of the Wall Street Journal because this is an opinion. And we have all kinds of opinions that lead us astray. When we're dealing with our money that can have us manufacture opportunities or missed chances, almost like creating a false memory about the past as if we could have done that. So, with that, I think I'm done ranting. Cory.

Cory Shepherd: [chuckle] For now.

Paul Adams: Anything else you wanna mention?

Cory Shepherd: No I think that it's... This guy had, has a great story and he and I do love that line. I wish I had thought of it. You don't have to know the address if you're in the right zip code and it probably applies somewhere like a horseshoes and hand grenades which he mentioned. But it is in the entertainment section of the Wall Street Journal, AKA opinion.

Paul Adams: Amen. Alright, so let's get back to our topic about 401 [k]. Now, here's the thing, we all have this incredible or access to this incredible tool. If you're a business owner, you don't currently have one, you can listen for where one might make sense for you. If you are a business owner or a high income executive, how do you maximize this tool? Well, one of the things that you can do when you're maximizing it and trying to use it fully, is to think about the match.

Cory Shepherd: And I think that it's, I was thinking about this because I always think about what is common knowledge? Or what's the thing that most people know so well that they don't even think about it anymore. And that's where danger lies. The first one is maximize your match. Everybody, like even if no one's heard it before, they hear it for the first time, it's like, "Oh, yeah, of course, it's free money." and almost everyone who's over 20 has heard this, maximize your match, but consider the timing would be my first response. If you're 21 with no cash reserve, and you wanna lock away money for 30 years, just to get that little extra from your employer, I don't think it's gonna work out well for you because life happens, emergencies happen, it's almost guaranteed that you will be pulling money out of that 401 [k] early to and have to pay early taxes, early penalties, all of those things and the match will get eroded. And so you gotta think about, is this capital I can afford

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*“For most people, it’s not until their early forties that they really start going to town (on retirement).”*

not to access for a long time? And there are lots of situations even if you have your liquid reserves ready and you earn the right to go into a 401 [k] and meet that match, there could be a place that you wanna put capital that will earn you more than that match. It's possible. So just don't think about it as a given that like a reaction like the doctor hitting your knee and making your leg go out that you should just do that. Just think about it first.

Paul Adams: Yeah, don't allow it to be reflex and what you can do because it may be open season right now, open enrollment, you can just add 1%.

Cory Shepherd: Open season. [laughter]

Paul Adams: Open Season. Open Season. That's what the 401 [k] companies is calling when they open season on all these employees, but just add 1% because usually with most plans, if you add 1% then you don't have to wait for the next open enrollment period. So if you build that emergency fund, then you can go let's say they match 50 cents on the dollar to 10%. It's a very simple mathematical formula. That means they're going to put in 50% for every dollar you put in up to 10% or whatever your employers matches. Now, usually you have to be there for a vesting period. Like you need to have worked for your employer for five years, so that you actually own your match, which are all...

Cory Shepherd: So, if you're in tech, especially, but and almost any career where people change jobs a lot. If you move after three years, you may actually get zero of that match. So it's the opposite of free money. It's no money.

Paul Adams: Yeah, exactly right.

Cory Shepherd: That's why it's worth thinking about. But if you can be there for a while, if you're already past your vesting period, like if you've already been there for five years, and it's a five year vest, and you've never used your 401 [k] for some reason, you can turn it on now and it's all your money instantly. So you're in a good spot. You're in well, but it's not all your money, feasible. I almost slipped.

Paul Adams: Not at all. You slip because that is what most people think. I want you to think about this for a moment. We just completed that episode on tools called equity indexed or fixed indexed annuities, and one of the major drawbacks of those tools is they have a high surrender charge. You put your money in, you may only be able to get 90% of the money back unless you leave it there for a lot of years. Well, the 401 [k] is similar, although they don't call it a surrender charge. They call it the money you delayed the tax of on the IR... When you put the money in instead of paying the IRS. Now, if you're in the highest tax rates in this country right now, that's 37%. So if you get your 401 [k] statement now, and you're looking at it, you're like, "Oh my gosh, I cleared six figures in my 401 [k]."

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*“We have to be setting aside money above and beyond the 401(k) because you, as a listener of this podcast, are likely in that top one percent income realm. And, as a result, the 401(k) just doesn’t do enough heavy lifting to replace the income that you’re earning prior.”*

Cory Shepherd: Nope.

Paul Adams: Not so fast because 37% of it still belongs to the IRS. You have about 63,000. The IRS has \$37,000 invested as your partner and that's a current tax rates. Now, if you watch this is not meant to be political. But if you watch many of the debates right now of people running for president nearly everybody has a plan to give more people more things and tax those people who have been responsible with planning for their money. That's it. Now, let's say nothing changes, we just got to continue to fulfill on the existing obligations of our federal government, Social Security, Medicare, Medicaid.

Cory Shepherd: It's a lot.

Paul Adams: It's a lot.

Cory Shepherd: Big bill.

Paul Adams: And who's gonna be responsible for that? The people that are old and have nothing? Or the people that are old and have built something? I'm not seeing it is highly likely that we're gonna end up magically in a much lower tax rate one day, even if your consumption stays exactly the same. It gets worse the second your money goes in. It's not 37%. You owe the IRS, it's 47% if you wanted to take it out early, 'cause there's a 10% penalty. Now, if you were investing in a business partnership, the first thing you would assess is this, you would just simply say, "Hey, Cory, we're gonna invest in this business together. Yes. Well, what do we do if we exit?" and Cory says, "I can't believe you're this kind of business partner, Cory it's terrible." He says, "I'll let you know." I'll let you know how much I'm gonna take it a partnership when we cash out. What kind of things can we invest in only things inside the 401 [k]? Like you kinda see how that goes. Your partner in this is the IRS. And once you put the money in, you're making an irrevocable decision to pay the taxes on that account at future tax rates, whatever they are.

Paul Adams: And it's just good to be aware because if you put that money in and you're also in a state that has a state income tax that might be 47% of your account today, 57% of your account if you decided to take it out early and it's never disclosed on your statement, it's one of the biggest travesties I think of the financial services industry is that there's nothing on the statement that with your before tax 401 [k] that they do not disclose to you, they do not disclose to me or disclose to Cory, they don't disclose to any of us.

Cory Shepherd: Right. Anybody.

Paul Adams: Yeah, there's a big chunk of your retirement plan that is not owned by you it's owned by the IRS, they are your partner, they will get paid when you take money out

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okay.

Cory Shepherd: This is why we say... We suggest using a Roth every chance you get because of these very numbers. Now, it's easy to say that you'll be in a lower tax bracket in retirement which is why folks would wanna defer the tax but let's talk about that because think about you've successfully exited your business and you've saved all that money into a 401 [k] and some other accounts and you're gonna wanna live on the same amount of income if all of your money is in a 401 [k] well then you're pushing yourself back up to the same tax bracket anyway.

Paul Adams: And now your kids have moved out, you've sold your business through which you had many of the deductions of the economic benefit of being a business owner.

Cory Shepherd: Yes, your budget actually just went up at home, more non-deductible expenditures.

Paul Adams: Home is paid for, all that stuff is done so a lot of the deductions you had prior you may not have it all anymore and if your income just stays the same it's not highly likely you're gonna be in a lower tax rate, is certainly not as likely as is nearly rattled off by default at every 401 [k] meeting. In fact we have clients do a thought experiment of, would you like to be in a higher or lower tax rate one day in the future they'll all say, well, lower and I'll say, but do you plan on having more wealth or less wealth than you have today and they're like more, I'm like, how do those jive and you see the cognitive dissonance in people's eyes while they straighten that out and they go I guess it wouldn't be. Now, here's the thing if we get in a lower tax rate bracket because of whatever happens in the world, our entire country goes to a VAT tax system, whatever, then great you'll get that windfall but we should plan it maybe you won't and that's where the Roth 401 [k] comes in. With the Roth 401 [k] you put the money in after tax and now the money is 100% yours as the investor and retiree.

Paul Adams: Now, I'll give it a simple metaphor of sharing elbow room with somebody, so if you can while you're listening or watching here on YouTube I want you to take a moment and imagine you're sitting on an airplane and someone's walking down the aisle and this person looks like they played linebacker for the Green Bay Packers, they're a big individual and they're gonna sit down with you, unnecessarily, they're gonna eat up part of the armrest even if they don't want to that's our 401 [k], you have a limited amount of money you can put in every year 19000, in 2018, 20... 25000, Cory check me on that 25000 max if you are over the age of 50 and that is elbow room you share with the IRS because the IRS is gonna own 37% of it in return you get a tax deduction this year but we have a limited amount of money we can put into these tax-exempt vehicles where the taxes are not compounding every year as your money grows.

Paul Adams: So here's the choice, we can share that elbow room, now, in my example I'm

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just gonna use 10,000, if you put 10,000 into a traditional 401 [k] you're sharing the elbow room of between 3700 and 4700 with the IRS. If you do it all in Roth you get all the elbow room, it's a limited vehicle, we can only put so much money in you should keep it all to yourself the entire amount that you could put in that is the biggest benefit of doing Roth instead of just going down the road and doing tax deductible 401 [k] like everybody else and then making that irrevocable decision that one day you'll pay taxes on that at whatever the future tax rate is. Cory, how about those contribution limits?

Cory Shepherd: Yeah, you're good there, 25.

Paul Adams: Okay, good.

Cory Shepherd: I'm good. And the other part about this unknown future tax rate is, we do another thought experiment which is asking clients what are the different reasons why taxes might need to go up in the future, whether that we want them to and there's a list of things like, well, Social Security being underfunded, solving healthcare wars overseas, the list can go on and on from there but when we ask the reverse, okay, now some reasons why you think taxes could potentially go down in the future.

[noise]

Paul Adams: It's like then you hear crickets. Instant cricket sound here.

Cory Shepherd: Alright, that's a great time for a quick commercial break and an announcement from Sound Financial Group. So from free money not being free to how to use a 401 [k] to save you from a Green Bay Packers linebacker where are we going to go next? Stay tuned, we'll be right back.

[music]

Paul Adams: Hey, everybody, I had to interrupt our show for just a moment to share with you something new. We've designed a new white paper that we think is gonna add you value in the way that you think about money, it's, "Three Biggest Mistakes That We See People Make and The Six Things That You Can Do to Fix Them." Now, for some of you, you might not want the white paper, you might be ready to have a conversation with us and that is okay, you can email us at [info@sfgwa.com](mailto:info@sfgwa.com), that's [info@sfgwa.com](mailto:info@sfgwa.com), find us on the web at [yourbusinessyourwealth.com](http://yourbusinessyourwealth.com) and any time on any of our social media platform send us a message and we can get you this white paper but in the meanwhile if you want to just skip over the white paper have a philosophy conversation with us, we're happy to do that with you just let us know philosophy conversation the subject line and if you want this white paper just put white paper in there and we'll immediately get out to you, this white paper on the, "Three Biggest Mistakes That We See People Make and The Six Things That You Can Do to Fix Them" and now back to our show.

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Cory Shepherd: And we're back with Your business, Your wealth, going deep into the dark caves of the 401 [k]. And I think the last topic is really the key question that a lot of people don't even ask, which is, is the 401 [k] enough for a high income earner to retire? Is it gonna do the job all by itself? Paul, what do you think?

Paul Adams: Not a chance. Let me explain. We've talked in these episodes before about why you need to set aside if you're just, a 35 years old and getting going with your retirement, you need to be setting aside 20% plus of your gross income, your entire career to have any shot of replacing your pre retirement income. Now, there's faster ways to do that, like really holding back your lifestyle, so your capital work doesn't have to be as much, but let's just explore for a second, somebody at age 40 every single year without fail maxes out a 401 [k] plus they have some match now for ease of example sake, and having everybody be able to understand it quickly, just listening here to the podcast, what we did is a simple example of starting at age 45. Somebody for 20 years solid get 7% rate of return every single year, never a down year, and continues that contribution every single year for 20 years solid. Their whole goal is, "I just want to be able to retire."

Paul Adams: And previously they're making \$400,000 a year. And we know from hearing from many of you, that's a very normal listener to the show. So wait a second, I need to replace like 400,000, maybe if I'm saving \$100,000 a year, you're only have to replace 300. But let's examine what happens in just the 401 [k] if flawlessly every year you maximize your contribution, and at least for our placeholder, a non-inflation adjusted \$25,000 a year of total contribution employee and employer match. And what do we get? A million bucks. \$1 million. Maxing your 401 [k] every single year for 20 years solid, and you have a million dollars at a 4% distribution rate. That's \$40,000 a year. And I am not...

Cory Shepherd: The phrase a cool million comes to mind that cliché. And it is a cool million 'cause you got to turn the heat down quite a bit to save some money.

Paul Adams: Yeah, a frigid, cold hearted not going to bail you out of the amount of expenses you have every week. Million because it's \$40,000 a year. This is all to say most people well, we hope you're the exception listening this podcast. But for most people, it's not until their early 40s that they really start going to town that retirement and what I mean by retirement, we talked about definite financial independence. But you get a sense suddenly, that one day the marketplace may not offer what you bring to bear. You've watched some people maybe hold their businesses longer than they should into their 60s and they're not getting the multiple they would have liked in selling that business. Here's the thing. If you're getting serious about setting aside enough money, the place to start first is how quickly can I get to 20% of my gross income, use the 401 [k]. That's fine. Work with someone like our firm. If what you wanna do is make sure you're also designed an exit strategy, but more than anything to be crystal clear maximum contribution limits every single year without fail, we could have backed tested this for 40 years of maximum



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401 [k] limits, and it's not gonna get there. It's just not sufficient by itself. Even when we get a really extra efficient, we do Roth instead of traditional 401 [k]. We have to be setting aside money above and beyond the 401 [k] because you as a listener to this podcast are likely not top 1% income realm.

Paul Adams: And as a result, the 401 [k] just doesn't do enough heavy lifting to replace the income that you're earning prior and you've got to put money elsewhere on your balance sheet. Now, what can you do with all this today? Very easy. One, have somebody take a look at your 401 [k] as a business owner, there's some really unique things you can do with the 401 [k], you may be able to install something like a defined benefit plan, maybe you can put aside hundreds of thousands of dollars a year before tax, and make that part of your investment strategy. It all depends on how many employees you have, the balance between them, and the effectiveness. And you may not need to do that. You might say, "Hey, I'm just gonna do the regular 401 [k] alongside my employees." And then you need to maximize where else I put money, get ahold of us or someone like us. And don't forget, subscribe, and be sure that you take the time to do a review of the podcast because doing that, if that's all you do from this show, you will make a difference for somebody else. And if you think it's impactful, think of one of your friends you could text this episode to. It'll make a difference for them. But let's talk a little bit about our featured review this week. We got this one. It's a great one. It's written Paul, Cory and Jeff. I'm laying on the beach here in Greece listening to your most recent podcast. Thanks for setting an accurate frame for viewing satisfaction with our money and success.

Paul Adams: I find your podcast and teachings are great stepping stone to living a transactionally competent fulfilling life around money. Thanks again for putting this material out there to spark curiosity in others for launching themselves into a better life. And we know this is from John ACW. John, thank you so much for sending that in. Somebody being able to read that or just seeing the five star rating can make a difference in who gets chance to trip across this podcast. And you investing two or three minutes to do that review will make a difference for somebody. We actually not too long ago, had a couple in Texas reach out to us purely from the podcast, all driven by someone like you John that took the time to do the review. And it lifted it up in their podcast ranking and they tripped over, it listened and it has changed their life financially, just getting exposed to the podcast. So with that we hope all of you have a wonderful week from Cory, myself, everyone here at Sound Financial Group. We wanna wish you an incredible week focusing on the 401 [k], making it maximize to what you want for your life. And we hope that this has been a contribution to you being able to design and build a good life.

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