SOUND
Financial Bites
with Paul Adams

Sound Financial Bites 034 - Paul Adams

Episode Transcription

> *"Spend money on building a portfolio, spend money on building the capital required to one day replace your income."*

Hello! Paul Adams here. 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.

Welcome to Sound Financial Bites. My name is Paul Adams, your host today and president and CEO of Sound Financial Group. We're going to talk now about part two of the last week's episode where we talked about the idea of Stop Acting Rich, or the reverse of that building balance sheet wealth, and this idea that what we need to do is we need to be in a position where we can A.) Observe others. All the ways that people are spending money. All of these -- just way people accept that spending occurs the way people accept is wealth. We need to insulate ourselves from that. One way we can do that is educate ourselves about how much people's current way of living is not sustainable, and I'm just saying most people. I'm not singling out anyone who's an individual. Please don't be offended if you're listening to this. But most people's way of leaving off of their money is non-sustainable. As a result of being non-sustainable, we get drawn into a non-sustainable situation as well, because we pull up next to them in the car at the stoplight. So we're going to continue that today. This is going to be on the analytical side of our podcast because I'm going to be digging into numbers a little bit, but I'm also going to teach you some great financial truths that I think will help you.

Well, today's episode is going to be that analytical podcast. Know that we've got the others that are going to be personal, financial philosophy. We've got the business and career advice podcast, and lastly, we always have the design and build a good life podcast that are going to be the bio-hacker, fitness person, marriage coach or parenting. We're going to have those kinds of experts being as well. So today's going to be a bit more analytical in nature.

Last episode, we talked about why the person that has $20 million worth of paid off stuff to be balance sheet wealthy, likely needs $60 million of net worth. We just kind of look at that to help insulate ourselves from all the ways we see this consumption, and we can feel less than those people simply because we don't have what they have. Well, what does that mean for us? So let's say you find yourself right now making half a million dollars a year, and that's K-1 distributions from your business or stock options, regardless if you work for a publicly traded company. But we're going to just talk half a million dollars a year, you can divide that by 2 of your 250 or multiply it by 2 if you make a million years, you listen here. Here's what I want you to consider. If you save -- and what I mean by save, let me just take a step back. Hopefully, everybody has listened to episode one on the wealth coordination account there. When I'm using the word save, translate that to how much money you're putting into assets every single year. The amount of money that you're putting into assets every single year, if you're putting $100,000 worth of assets, a $100,000 of money into assets every year then let's sit back and think about that. That means in one way or another between taxes and everything else, it's taking $400,000 a year to pay for your lifestyle, and most people are not educating themselves when we first meet them in the financial mechanics.

Here's an easy one. People say, well what's going to happen is when I retire, my home will be paid off, and the kids will be moved out, and then I won't need as much money. But what they haven't done is I'm making half a million dollars a year, my mortgage is $4,000 a month, like $4,000 a month of mortgage gone does not equal, you no longer need $4,000 a year. It means you now maybe don't need $400, maybe now you only need $352,000 a year, or they'll say my kids will move out and then it'll be less expensive, or I'm not paying for their school anymore so it will be less expensive. What I'd offer you in return is maybe, because while kids may move out, *"If you had an $8 million dollar debt sitting on your balance sheet right now, would that change your next spending decision?"*

we're no longer paying for private school or private college or state college, whatever you're paying for, you might not be paying for those anymore but you're going to have increases in expenses. I cannot tell you how many people I have met or that my colleagues have worked with, that literally are now paying more in property taxes every year than what they paid in mortgage as they paid off their house over time. So consider that. Other things are going up in value that we need to be straight with ourselves, when you not fool yourselves, because there's so many things that we're doing that we tell ourselves that I would offer you our stories that act like some sort of tranquilizer dripping into our veins that are having us not be in action. I would get this constant drip going in like one day it's all going to work out, because I put 10% of my 401K, and because their expenses are going to go down because the mortgage will be paid off, and the kids will be moved out and they'll just be okay. We just won't need as much.

I encourage you to take the time, dig in and realize that you need to also be crystal clear on how much money that's going to be. For now, I'm not going to get into, gosh you need to take into account inflation, all that, that's financial planning stuff, that's not what we're looking to do here. I want a mindset change for all of you as to how much capital it's going to take given where you are right now. So a very simple math, if you're putting $100,000 a year into assets, and then $400,000 a year is leaving your hands somehow. It's going to taxes, it's going to kid's college, etcetera. It's going to take $400,000 a year for you to live. Now quick pause, let's go back for a super analytical people. Yes, if you're saving $100,000 after tax every year, then that means you don't need the taxed money on that amount of money. So Paul, it's only $365,000 a year that I really need. I grant you that we're going to keep using round numbers because most of our listeners right now are not thinking about that degree of detail, and what I want you to be is thinking ECR, Equivalent Capital Required. Very simply, what is that person worth every year to the family, or what they're worth in that consumption is going to be $10 million, because we're going to need $10 million of capital at work somewhere. Outside of our home, outside of a vacation property, outside of any consumables or personal belongings, $10 million capital at work to be able to consistently and dependably throw off 4% a year to put that person in the position to continue that level of consumption in lifestyle at age 65.

So again, you find yourself at 45, you got half a million dollars a year of earnings. You need to be thinking $10 million is what I need. Now there are things that we can do in our planning that will be able to throw off that amount of income, not requiring the full $10 million. It may take much less but it takes efficiency and work for years. So if you're listening to this and you're not working with one of our advisers right now, you need to hold $10 million of money as you journey towards age 65. If you're working with one of our advisers, the number maybe slightly different but you need to know what it is. What's the number you need to arrive at for that equivalent capital required, ECR of your current income.

For instance, when you wake up in the morning and somebody says, "How do you feel?" Instead of saying I feel like a million bucks, if you're in this position of somebody making $500,000 a year, saving a hundred, consuming in one way or another $400,000 a year, well then you -- what you ought to be sitting back is saying, "I feel like $10 million." I want to talk to those of you that maybe listening who are at, say $200,000 a year, and you may see the result. If I was making half a million dollars a year, I would easily save a $100,000 a year. I want to challenge you, if you're at $200,000 now and you're not saving $50,000 a year or at least $40,000, then there's not a very high chance that you would be saving $100,000 at $500,000, because we're not talking about an income problem. What we have is a cashflow control and spending problem. What we need to do is get really good at spending our money the way that wealthy people spend their money, spend money on acquiring assets, spend money on building portfolios, spend money on building the capital required to one day replace your income.

Now, let's take a look at your current net worth. So one mechanic we've learned so far is the 4%. We need to make sure that whatever a current level of consumption is, I need to have somewhere in the area of 25 times that, so that I can take a 4% distribution and have enough money. Now, Ben Stein's spoke about this brilliantly in an interview years ago back in like 2010. For those of you who don't know, Ben Stein, while he's famous from Ferris Bueller's Day Off, he's also a brilliant and worldwide known economist with one of the largest IQs of the people living today. So what I want you to think about is what did he say, he said, "The biggest problem we have is debt," and when the interviewer said, "Oh you mean credit card that and debt on cars," He said, "No. No." The debt is the amount of unfunded future liability people carry on their balance sheet.

So let's say you currently have $2 million of invested capital in your list, $500,000 person. That means your unfunded liability for the future is $8 million. Now if you had an $8 million debt sitting on your balance sheet right now, will that change your next spending decision? If you have a spouse who spends more money than you'd like them to spend, which could be a stay-at-home husband or stay-at-home wife, or could be the breadwinning husband or the breadwinning wife that's the spender. Whatever it is, would it change all the spending habits if you're walking around with this idea of you owe an extra $8 million to your future you? I think it would, and you can even do the net present value of the $8 million and realize what it's going to take to get there, but without getting into too much math, given we only have an audio conversation today, here's what I want to teach you, it’s the next financial mechanic which is the rule of 72.

“People forget about this. You are in 100% control of your spending.”

The rule of 72 gives you a quick formula you can use for the amount of money you currently have. So if you had today a million dollars on your balance sheet, which should be great. You have a million dollars on your balance sheet that's invested capital, that's not in anything else, and you just say, "I want to look at the rate of return on that money," and let's say you're hoping for 7% rate of return and you've got some strategies in place you think that's going to happen with. If it's a 7% rate of return, now what we need to do is the math on what that's going to grow to. So if you're 45 now, if you take 72 and divide it by 7, then you end up with about 10. So in about every 10 years, your money will double. So for the 45 year old, a million dollars they have on their balance sheet today will double to $2 million by 55 at that rate of return, or double to $20 million. It doubles one more time by the time they're 65. I'm sorry. It doubles 1 to 2, 2 not to 20, 2 doubles to $4 million by age 65. So I have $4 million, which means we stab a $4 million savings gap that we got to fill. We need to be spending on assets, and so then we just have to do some simple math on how much money we're able to create on the $100,000.

Now I'm going to give you a huge huge huge piece of insight, and I know this is going to sound silly. We've had some past financial cast on contentment and what it means to cultivate contentment. Here's a big big big deal. If you control your spending, if you spend less money than the amount of capital needed, isn't this much and I mean, but you can't mentally do that like I will one day be spending less money and then I won't need as much. That's not accurate thinking. That's not the way our bodies work. Any physician that's tried to sit with somebody and look at them dead in the eye and say, "You are going to die if you keep eating -- the way you're eating, and you keep not moving. The way you're not moving right now, you're going to die soon." A huge huge huge amount of people can't change their habits in their old age. You can't change your financial habits in your old age despite what your high thinking ideas are about it. So what we need to do is count as the amount of money that we need, being the current amount of money that we're spending. That's going to be the most accurate way you can do this, and your

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spending may drop when you're older but all the inflationary pressures and the gravitational pull that those are, which are not just inflationary pressures like consumer price index, but just the fact that I didn't even have -- an iPhone wasn't invented, or the amount of technology we have wasn't invented back when I might have been doing my retirement planning 15 years ago, but that stuff is all there today and all stuff I want to continue in my life.

So what this same person could do is let's say they figure out how to build a lifestyle off of $15,000 a month of spending, $180 a year, and then they still got to pay their taxes on 500. Let's assume that they're paying about $140 in total taxes, which leaves them the total amount of capital to do something with this 360. Then if they're leaving off of $180 a year, well let's think about that. That leaves them 180 that they can save.

Now two things are going to happen. It's going to ramp the amount the assets they have. More importantly, it's pulling back the amount of money that their capital needs to produce for them every single year. So literally, something -- people forget about this, you are in 100% control of your spending. Beyond some absolute basic necessities, you control it 100%, you have massive amounts of control, authority and power around the way you choose to depart with your dollars now.

By the way, you may be dealing with some problems from your past self. Past self may have committed to buying your car you still have a loan on. Past self may have bought a home that was bigger than what you should have bought, and your current self has to deal with those poor decisions. By the way, in your old age, you don't want to be dealing with your past self's bad decisions. So what I want you to think about is what can you do differently to have future self have a better opportunity. So if we're leaving off of $180 a year, to net $180, I don't know, make about $250,000 a year. If what we need is $250,000 a year of income, well, that's about $6.2 million of capital required , way less than 10 million. We just increased our likelihood of financial success geometrically simply because now we only have to accumulate $6.2 million by age 65 for our 45 year old person. What that person did is they cultivated the contentment that they needed during those years that they're working. Because what we're seeing is it's the decisions that are coming at us constantly. All of the consumption decisions -- buy the new car, take a vacation, you deserve it, that we see creating the greatest amount of difficulty for people when we meet them. At some point we meet them because they're in their early 40s and they're making top 1% income and they're kind of saying, "Man, I don't why I'm not further ahead," because most of the investment industry has really been saying that rate of return is what's going to save all, and over the last 20 years, that has not been people's experience, that rate of return hasn't made up for everything else going on. So we need to do is take the greatest amount of control that we can which is our spending.

What I want to encourage everybody to do who's listening today is read books like Simplify by Joshua Becker, especially if you're a person of faith, that author is really going to resonate with you around what I would call, unstuffing yourselves. Getting rid of some of the stuff cultivating contentment, and the book Stop Acting Rich which I think is going to recast for you what it means to build wealth especially based upon how everybody else is spending around you. So I want to encourage you guys to do that, and really have you reflect on, just look at your current income as you get off the podcast today. Take a sheet of paper and just jot down. In fact, you shoot us a note on Facebook and let us know what you did and how much it's going to take for you on your current level of spending and what your gap is, what do you owe your future you? Not in a bad way, but just declare it, say it, be aware of it, tell your spouse, tell your friends. Send this podcast to your friends and start some conversations around money that otherwise not happening.

Because of what you've got is you owe your future you, whether it's $4 million or $2 million or $1 million, you can control where your money goes and put yourself in the position to do that. I can't tell you how much I've watch people say something like, "Well, I'm a car guy." Cars, I really like cars. I'm just a car guy so I need to buy a really nice car. It's like man, you got to realize, you got no option to be a car guy or a car woman come age 65. You just got no shot, because you're not going to have the ability to own a car the way your balance sheet might currently be shaping up. That's not a cool thing to say to people. Like, heck if I said that to one of my friends right now, they might fairly quickly not be one of my friends, so I'd like -- those are conversations I think months and months to lean into. But what I would offer to you is, whatever that thing is that you're surrendering your will to, that's what we're doing. The person says, "I'm a car guy, I just need to drive nice cars," that's spending $1,500 a month on car payments instead of building their balance sheet. Think about that. They're literally surrendering, "I'm a car guy," and surrendering their entire financial future or good chunk of it. Because of some way that they feel life is. Oh I need to be in this kind of home, or I need to have this, or I need to have that.

For example, this is where I leave off, I know a couple that are real estate agents. Most real estate agents are notorious for buying big awesome homes and having big fancy cars. I don't know everything about them. I just don't know their spending, all that, but they live in the same house for a very very very long period of time, and I'm talking like 15 plus years as they continue to be successful as real estate agents. What that's done for them is it's put them in the position to cultivate contentment around their home, so that they haven't been constantly trading up like many people in the real estate business do, to not just keep with the Joneses but maybe be the Joneses themselves. That gives them control. That gives them freedom. I want you to give yourself that control and freedom by figuring out what's really important to you, spending money on only those things are important to you, and driving the rest to assets on your balance sheets so that you have equivalent capital in the future required to produce the level of spending you have today. If you walk around with that as a mindset of "I need to get to $10 million," if that's your number, or "I need to get to $5 million," it will change nearly every spending decision you make.

If you want us to help you, if you want to have a conversation with me, I'm happy to do it. Just reach out and we'll do whatever we can to support you in that mission. Have a great rest of your day and I hope you enjoyed this episode, and the last episode which is part one of Stop Acting Rich.

Hi! Paul Adams here. I want to acknowledge you for taking your 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'd be more than honored to take that time with you. Now you can also go to our website www.sfgwa.com, download the first three chapters in 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 podcasts. You might hear one of your comments or questions on that future podcasts. For our full disclosure, you can check the description on this podcast, or on the podcast series or go to our website. Have a great day!

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