

## >: 3 Key Steps to Building Your Wealth...

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Many people don't realize it, but perpetually living with rampant debt is a sure fire way to prevent yourself from ever achieving real wealth in life. Debt forces us to waste money on paying unnecessary interest, as opposed to building wealth from earned interest!

A recent article in Bloomberg.com states that U.S. consumer borrowing rose in January, as Americans spent twice as much on their credit cards as they did a month earlier. Think about this for a moment. Consumers spent twice as much on credit cards the month AFTER Christmas, as they did the month BEFORE Christmas! What is wrong with that picture?

Furthermore, with the Home Equity financing market drying up, consumers are now using their higher interest credit cards more and more for large purchases. Total borrowing on credit cards has now increased for several months in a row, and shows no sign of letting up soon.

Some may see this as good for the economy. But there is a down side to all of this spending. Moody's Investors Service is predicting that late payments and charge-off rates on credit cards will probably increase over the next year. Consumers are clearly struggling more and more to pay off their personal debts. Late payments and charge offs will dramatically lower their FICO scores, which makes future borrowing even more costly.

Meanwhile, the Federal Reserve continues to lower interest rates to stimulate an economy which is already stimulated to the point of drowning in debt. Certainly the consumer benefits from paying lower interest rates on their current debt, but this raises some paradoxical questions:

~~Do the savings from lower rates offset the increase in the amount of debt they credit?~~

I believe the answer to all three questions is **YES!**

Basically there are two kinds of debt. Although sometimes referred to as "good debt" versus "bad debt", the more accurate terms are debt on appreciating assets versus debt on depreciating assets. Examples of debt on appreciating assets would be long term mortgages on residential or commercial real estate. Examples of debt on depreciating assets would be an automobile or furniture loan.

Wealth is typically built by using debt only for appreciating assets, while eliminating or minimizing debt on depreciating assets. Unless you were born into a wealthy family, buying a new car every four or five years will usually keep you from becoming rich. If you finance a new car over time, your car payments will make it very difficult for you to save and invest money for your economic future. This is most true for people in the 25-40 age range, who often seem to struggle the most financially. After paying off student loans, car loans, rent, insurance, utilities, and other obligations, there isn't much left. The combination of smaller incomes from newly established careers and unnecessary debt is lethal to long term wealth building.

In David Bach's book, "The Automatic Millionaire", the author points out that people need to pay themselves first, before anyone or anything else, in order to build wealth over time. People usually do the opposite- they pay their bills or buy things they want first, and then save whatever crumbs are left over. Money wasted on financing a new car would be much better invested into a 401k plan or Roth IRA.

Let's take the hypothetical example of Joe and Lisa, two 25 year olds, both on tight budgets, and both of whom decide to buy a car this month. Joe

buys a new car for \$25,000 and finances it with no money down over five years at 8%. For the joy of having a new car, Joe will pay \$506.90 a month. In 2013, Joe's \$25,000 car will only be worth about 35% of what he paid, or about \$8750, but the total financing has cost Joe about \$30,000. Joe now has a five year old car; no money saved, and is hardly any better off than he was five years ago. In fact, he has lost five crucial years of investing power.

On the other hand, Lisa buys a decent two or three year old car with low to moderate mileage, and pays only \$13,000. She too finances it at 8% a year, but decides to pay it over just three years, so her payment is only \$407.37 per month. The total paid in three years will be \$14,665.

Lisa takes the \$100 that she saved each month by buying a late model car, and instead invests in a ROTH IRA mutual fund or ETF over the same three years. Let us assume the same 8% interest rate that was paid on the car loan will now be earned on her investments. After the third year, Lisa's account has \$4080, and her car loan is fully paid. With no car payment anymore, Lisa decides to now put \$400 into her Roth Ira each month. Two years later, as Joe is finishing with his car payments, Lisa's Roth Ira is now worth \$15,227. Let us assume her seven year old car is now worth \$5000. Her total assets of Roth Ira plus the car are \$20,227, while Joe's total asset of his car alone is only \$8750.

If Lisa continues to buy late model used cars, finance as little as possible, and prudently drive them as long as possible, she will always do better financially than someone like Joe. A 25 year old such as Lisa, who will sacrifice and pay herself first to save \$400 a month into a 401k or Roth Ira, (at 8% average annual interest) will have \$1,405,700 in their account at age 65.

By contrast, if Joe continues to finance new cars (or spend money in other frivolous ways), instead of attending to his retirement from an early age, at age 65 he may either still have to work, be dependent upon a very shaky social security system to meet his needs, or have very few assets for his retirement. Getting rich is not always about how much you earn, but how much you keep!

Sad to say, there will be a large number of Baby boomers who may soon find themselves standing in Joe's old shoes. They didn't save and invest enough at an early age, and are now going to have to scramble to make up for lost time. Furthermore, many of them didn't teach their 25 to 40 year old children how to pay yourself first and invest either.

So what do we need to do to be like Lisa? There are three steps to building a wealth plan:

Step one: Resolve to pay off all debt, except for your mortgage. That means student loans, car loans, credit cards, and even that personal loan you took from your parents. It doesn't matter how big or small your interest rate is, just pay it off. Some people prefer to pay the smallest debts first and then snowball the money into the larger debts. Others like to pay off the highest interest rate debt first. Either way, paying off debt will involve sacrifice. That may mean an extra part time job, not eating dinner out for awhile, or just tightening up one's budget. Learn to say no to extraneous spending!

Step two: Once the debt is paid off, put together three to six months of your expenses in a separate bank account or money market. Do not put these reserves in your checking account. This is the money you must have to avoid going into debt again should you ever suffer a job loss, a medical problem that substantially reduces your income, or other type of financial emergency.

Step three: Begin to pay yourself first, either through a 401k or 403B plan at work, or a Roth, Traditional, or SEP Ira, if self employed. Do not begin step three before you have completed step one. Always pay off debt on depreciating assets before investing. Remember that in a 401k plan, the money that is deducted from your pay is taken out BEFORE taxes are paid, so if you have \$100 going into your 401k plan each pay period, your net reduction may only be \$75 or \$80 less than before. The other great thing about a 401k or 403B plan is that your employer may even choose to match a percentage of the money you are investing. That is like getting a 100% return on those funds!

The number one bonus derived from getting out of debt is the psychological sense of relief that it brings, especially when economic times become difficult, as they are now. Dave Ramsey, the Radio and Television financial talk show host, calls this having "Financial Peace". When people all around you are lamenting their high payments and lack of money, you may still be sympathetic, but you will no longer be in their shoes. You will

have paved a better road toward achieving wealth for yourself and your heirs.

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