

POPULAR IBC TOPICS

Notes on Lecture 1: Car Financing

Robert P. Murphy

July, 2015

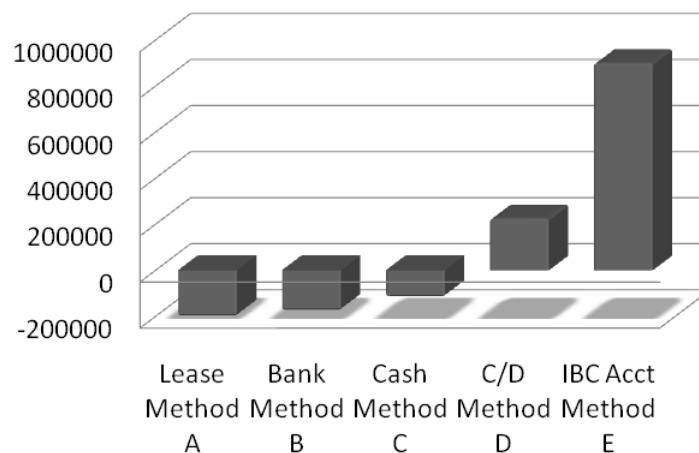
THE SERIES: The purpose of this 4-part series is to be a “refresher” from the Course material, focused on topics that are of particular relevance to the IBC Practitioner as he/she interacts with the public. In addition to reviewing the theory from the Course Manual, we will also discuss different ways of expressing these points succinctly to the public, and go over some possible pitfalls to avoid.

REVIEW FROM MANUAL:

(Taken from SOL-II in the Course Manual.)

Figure 1

Five methods of having use of an automobile over a forty-four year period of time



The choice of a 44-year interval reflects Nash's assumption that a car is replaced every 4 years; the above results are therefore showing the cumulative outcome after 11 vehicle purchases.

First let's look at Method B—financing the vehicle the conventional way. Nash walks through his assumptions—a net purchase price (accounting for the value of the trade-in) of \$10,550 financed over 48 months (i.e. 4 years) at 8.5% interest—to conclude that it will cost the person \$260 per month to obtain a perpetual “use of car services” through this method. Over an 44-year period, that works out to a cumulative outflow of $\$260/\text{month} \times 528 \text{ months} = \$137,280$.

Circling back to Method A (leasing), Nash argues that it *must* be more expensive (measured in simple dollar expenditures) than Method B. After all, in order for it to be possible to lease a car, there must be an owner, and the lessee doesn't have a trade-in after his time expires. So Nash somewhat arbitrarily sets a higher number—\$175,000—as the 44-year cumulative cost of perpetually leasing an automobile.

The third approach, Method C, is to pay cash, where someone literally stores up the sticker price of a car in cash over a 4-year period (perhaps storing it under his mattress, or in a savings account with negligible interest). This method only results in a cumulative outflow of $\$10,550/\text{car} \times 11 \text{ cars} = \$116,050$ over the 44-year period. Note, however, that this method, while “cheaper” than the first two, involves *discipline* and *abstinence*. Specifically, in order for this method to work, the person must contribute to his **sinking fund** first, before he can begin enjoying the use of a car. If his contribution rate is the same *before* he gets his first car, as it will be during the period of car usage, then it will take him 4 years to grow a large enough fund to afford the first purchase. (It will actually take longer, because he won't have a trade-in when making the first purchase.) In other words, the reason Method C is “cheaper,” is that the individual had to wait 4 years before he could begin driving.

Method D, rolling over bank **certificates of deposit (CDs)**, takes the idea of **capitalization** seriously. Rather than simply saving up enough to *just* afford the first car—and thus reduce the accumulated funds to \$0 to start again—in this scenario, Nash assumes the individual waits 7 (not 4) years before buying the first vehicle, *and* that the contribution rate is higher, at \$5,000 per year. Rather than storing the cash under his mattress, the individual lends it out to others by buying CDs yielding 5.5%. Taking account of income taxes, Nash assumes the person only nets a 4% yield. After the 7-year capitalization period, the person practicing Method D has accumulated \$41,071.13 to begin his car purchase operation.

Because this person hasn't completely wiped out his fund with the initial purchase (as happened in Method C), his wealth rises over time, as shown in Table 1 on page 45 of *BYOB*. Even after making his fourth car purchase (in year 20), the person still has \$64,390.78 in his CD account. This is why Figure SOL-I-1 above shows a positive figure for the 44-year period as a whole; not only does this person get the use of a car (after his 7-year capitalization period), but he ends up with more total dollars than he put into the system.

Finally, Method E involves the same capitalization period and funding levels as Method D, but this time directed as premium payments into a dividend-paying whole life policy. As both the Figure and Table 1 in *BYOB* illustrate, the individual (eventually) emerges wealthier from this approach, even compared to Method D. Nash argues that this superiority reflects the fact that when using someone else's bank—with the CD method—you are letting others tap into your "pool" of money, whereas the policyholder of a dividend-paying whole life contract (from a mutual company) *is* the "shareholder," receiving both guaranteed interest (in the form of guaranteed increases in cash value) and his share of the "profits" of the company (in the form of dividends). Moreover, withdrawals from the policy are not taxable until the cost basis has been recovered, whereas the IRS will begin taxing the interest on the CD approach immediately.

Safe and Accurate Ways to Explain to the Public:

“Most Americans finance their vehicle purchases very inefficiently.”

“The way Americans finance their cars makes outside bankers very rich.”

“Let me show you a way to finance your car purchases with the same out-of-pocket cashflows, that will leave you much wealthier down the road.”

Possible pitfall: Although related to the discussion above, some fans of IBC try to grab the attention of a prospect by asking some variant of, “Do you want me to show you how to get wealthy by buying cars?”

The Problem: The allure of this pitch is that it takes an apparent financial negative—spending money on buying a car—and (apparently) turns it into a positive. The problem is, that’s wrong. It is *not true* that you are becoming wealthier *by buying a car* (or taking a cruise, etc.). So to the extent that this approach “works” by making the newcomer see the “magic” of IBC, it is wrong.

To see that it’s not the “buying cars” per se making the person wealthier, consider the following three people:

| Person | Strategy | Wealth After 44 Years |
|--------------------|--|------------------------------|
| Typical American | Finance \$20,000 new car every 4 years using outside finance company. | Middle Class |
| Typical IBC Client | Finance \$20,000 new car every 4 years using IBC. | Rich |
| Miserly IBC Client | Spend \$1,000 every 4 years taking the bus, and invest other \$19,000 in farmland and CDs using IBC. | Very rich |

As the table above illustrates, it is not the *buying of cars* (or other goodies) that allows a client to grow wealthy while using IBC. The buying of cars per se reduces a person's wealth. Other things equal, when you buy a \$20,000 car from the dealer, your financial wealth goes down by \$20,000. Whatever method a financial coach wants to use, to show a person how to "leverage that purchase" into more wealth down the road, would work *even better* if the person bought a financial asset with that \$20,000, rather than a new car. It is *not* the case that a person can "use his policy more" by borrowing against it to buy a car. He could do even better by borrowing against the policy and buying some other productive asset.

Now to be sure, most clients *do* need to own a car in good working condition. In that sense, buying a car may be a perfectly sensible thing to do, which helps the client generate income (by driving to work, the grocery store, etc.) which makes everything else possible in the financial plan. And of course, Nelson's whole point is that *given* that you are going to buy a car *anyway*, you should finance it using IBC.

However, I think it is important to stress to IBC Practitioners that it is wrong both in letter and in spirit to describe this situation as "growing wealthy by buying cars." It is more accurate, and less sensational, to use the type of descriptions given earlier.