

Financial Strategies & Solutions

Financial Planning, Investments, Insurance, Asset Management

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"A penny saved is a penny earned."...Benjamin Franklin

Whose Money Is It Anyway?

We all borrow money. We take out a mortgage to buy a house. We borrow money to buy a car, or to finish school. The interest paid each month on the credit card seems like a relatively small amount, or the only way we could afford the house is to take out a mortgage.

If you want to scare yourself sometime, add up all the interest you pay to all sources in a month. Multiply that times 12. Do that year in and year out and you are talking real money. That interest is what makes banks and other lenders profitable. *How would you like to be on the receiving end of all that interest?*

If you are willing to set a little more money aside today in order to have a lot more tomorrow, I have an idea you may find valuable.

Basic Assumptions

Let's start with a few of concepts.

Whether you save interest you would have otherwise paid, or you earn interest, the net result to you is the same thing. The classic example is your home mortgage. Let's assume,

1. You are paying 6% on your mortgage
2. You are in a 25% tax bracket and
3. You are eligible for a tax deduction of your mortgage interest.

The effective after-tax cost of your mortgage is 4.5%. Many people make extra mortgage payments because they realize how much interest they are paying over the course of the loan. What they don't realize is how mortgage payments work. *Each month you pay only one months interest on your outstanding balance.* The remainder of your payment goes to principle. That is why in the early years of a mortgage most of your payment goes to interest. That is when the outstanding balance is highest. Therefore that is when the amount of the payment that is allocated to interest is highest. You typically repeat this process every month for 30 years, and that adds up. *But if you invest money for 30 years, the result is just as impressive.*

So in the above example, your after-tax cost of interest for any given month is 0.375%. Over the course of a year, the effective after-tax cost of your mortgage is 4.5%. What happens if you invest the money you have been using to pre-pay your mortgage? *If you earn 4.5% after tax on that money, you will have enough to pay off your mortgage balance at just about the same time that the mortgage would have been paid off if you kept pre-paying it. If you earn more than 4.5% after taxes, you will have enough to pay the mortgage off even faster.* There are other things to consider, such as the fact that pre-paying the mortgage represents saving the

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interest risk free and the same cannot be said about money that is invested. But the example illustrates how interest earned or interest saved amount to the same thing.

All money is borrowed. When you spend money it is no longer available to be invested. Money is not free. It costs more than the money spent. *It also costs what that the spent money would have earned if it were invested. You either borrow from a lender, or from your investments.*

Assume that the cost of all borrowed money is 12% per year. That sounds high. Here is why I say that. From 1951 to the end of 2007 the S&P 500 Composite Total Return Index has been up 43 years and down 13. Its worst year was 1974 when it lost 26.49%. Its best year was 1954 when it gained 52.62%. *The average rate of return during that period was 11.54%.* If you take money out of the market to buy something, you lose whatever gains (or losses) the market will experience until that money is replaced. *So, in order to replace that potential gain, you have to repay the money used plus its potential earnings.* You want the interest you pay to yourself to be high enough that after money has been withdrawn from your banking system to make a purchase and replaced over time, you will have as much or more on deposit than you would have had if you had not made the withdrawal at all.

We don't know what the stock market will earn in the future, and we can't predict or even assume it will earn what it has earned in the past. But 12% gives you a high enough number to be relatively confident that when you replace money borrowed from an investment portfolio, *you will have replaced the money borrowed plus what it may have earned. You will be repaying this 12% interest rate to yourself, so you don't mind overpaying.* The account you use to fund your banking system, may not even be invested in the stock market. It could be in an interest bearing account earning much less. *But this whole system is a tool to create a systematic method for you to save and invest money while saving interest paid to commercial lenders.* Since you will be the recipient, your concern is not to avoid overpaying interest, but to avoid underpaying it.

BYOB (Be Your Own Bank)

Here is how it works. *Add up all of your debts, large & small, from your mortgage to the \$150 credit card balance that you didn't pay off last month. If you pay off your credit cards each month, don't count them, & good for you. That number goes in the "Debts" column. The "Interest" is 1% of the amount in the "Debts" column (12% per year). Any thing that you borrow for the month, including what you charge on credit cards that are not paid off monthly goes in the "Debt Increase" column. Your "Payment" will be the interest due for the month, plus something to reduce the principle. You can do that by paying more then the minimum amount on your higher interest debts or by making a deposit into an account you will be using for your own bank (explained below). For our purposes, after the first calculation of your debt balance, ignore what your monthly statements tell you about your ongoing loan balances. Add the "Debts", "Interest" and "Debt Increase" then subtract the "Payment" to come up with the "Debt Balance". And the "Debt" for the following month is the same as*

Date	Debts	Interest	Debt Increase	Payment	Debt Balance
January	\$100,000.00	\$ 1,000.00		\$ 1,200.00	\$ 99,800.00
February	\$ 99,800.00	\$ 998.00		\$ 1,200.00	\$ 99,598.00
March	\$ 99,598.00	\$ 995.98		\$ 1,200.00	\$ 99,393.98
April	\$ 99,393.98	\$ 993.94		\$ 1,200.00	\$ 99,187.92
May	\$ 99,187.92	\$ 991.88		\$ 1,200.00	\$ 98,979.80
June	\$ 98,979.80	\$ 989.80		\$ 1,200.00	\$ 98,769.60
July	\$ 98,769.60	\$ 987.70		\$ 1,200.00	\$ 98,557.29
August	\$ 98,557.29	\$ 985.57		\$ 1,200.00	\$ 98,342.87
September	\$ 98,342.87	\$ 983.43		\$ 1,200.00	\$ 98,126.29
October	\$ 98,126.29	\$ 981.26		\$ 1,200.00	\$ 97,907.56
November	\$ 97,907.56	\$ 979.08		\$ 1,200.00	\$ 97,686.63
December	\$ 97,686.63	\$ 976.87		\$ 1,200.00	\$ 97,463.50

the "Debt Balance" for the previous month.

The interest rate you pay your lenders depends on the kind of loan and your credit rating, among other things. Credit cards are commonly more than 12%. Home mortgages, student loans and car loans are usually less. But this accounting system is for your own bank, not that of your lenders. *You will fund your personal banking system by paying off higher interest loans & pocketing the difference on lower interest loans.*

If you have a credit card balance of \$10,000 at 18% that is the first place you will apply your payment amounts. Pay the minimum on all your other loans and enough extra on your credit card to make your payment greater than the 1% interest paid for the month. Do this for all of your high interest loans in descending order of their interest rates.

When you get down to your low interest loans, like the car loan you got for 0% interest, instead of paying them off early, start funding your own account. *As the value in that account builds, you will be in a position to lend yourself the money you need for future purchases.* This account becomes your bank. The 12% interest you are paying is being split. Your lenders are getting what they are charging you, and the balance is going into your own banking system. *The money going into your banking system is now earning you more money because it is either earning interest or it is invested, and it is available for future use.* When you need to make a purchase in the future, you can choose to borrow from a commercial lender, if they offer you a low enough rate, *or borrow from your own banking system.* In either case, you will be paying that loan back at 12% interest. Over time, this account can grow to become a substantial asset.

An important thing to keep in mind, is that *when you prepay a loan to a commercial lender, you are guaranteed to save the interest that loan would have cost. No such guarantee exists when you are investing money.* For that reason, you will likely want to pre-pay some loans that are costing you less than 12%. A loan that is not costing you any interest is a no-brainer. Stretch that one out for as long as you can keep the money interest-free & pay yourself 12%. The 18% credit card is a no-brainer on the other end. Get that one paid off as fast as you can. There is no magic number between 0% and 12% to use for a cut off point. But *because pre-paying a loan is a risk-free venture, and investing is not, you will want to pre-pay some loans that are costing you less than 12%.*

Where do you put the money that you are using to fund your own bank? Initially, any liquid account will do. The important things are that you can add money to the account easily and take money out without penalty. If you have a permanent cash value life insurance policy that is an excellent start. If it permits flexible premium payments, make extra payments with the “loan” payments you are making to yourself. When you need money for a purchase, you can borrow money from the policy and add that loan to your “Debts” column. Now start paying off that policy loan with your “loan” payments until the policy loan is paid off, then go back to over paying premiums. Because most permanent life insurance policies build cash value slowly in the early years, an existing policy will usually work better than a new one. *Eventually, your account will become so large that you will not likely ever use all of it for future loans.* When that happens, you can start adding your payments to your Roth IRA or your company’s 401k, or any other investment account.

Some Q&A.

Q This sounds great. Should I stop funding my 401k &/or IRA in order to fund the personal banking system?

A *Use this system to replace money you borrow, not money you are investing for retirement.* Use the money in your personal banking system to supplement your retirement, not to replace other retirement plans.

Q When I add my mortgage to the formula, I can't afford to pay 1% on the entire balance plus something to reduce the loan amount. Does that mean I can't make the system work?

A This system is your tool, not your master. If you have to begin by excluding your mortgage, then leave the mortgage out of the calculation. If this results in only using loans that are costing you an average of something close to or in excess of 12%, you will have to make sure you pay enough in your "Payments" column to re-pay those loans plus something to fund your personal banking system.

Q What do I do when I have paid off my loans to my lenders, but my personal banking system still shows an outstanding balance?

A *This is when the system really starts to work.* You still owe your personal banking system the balance shown on your spreadsheet. Now, instead of having to send part of your monthly payment to a commercial lender, you deposit all of it into the account, or accounts you are using to fund your bank. You keep doing this until your "Debt" column reaches \$0.

Q Will this really make that much difference?

A If you buy a car for \$25,000 and finance it commercially for 6 years at 6% you will pay \$4,831 in interest. If you borrow the money from your own banking system and pay it back over 6 years at 12% you will replace the \$25,000 you borrowed from your account plus an additional \$10,190 of interest you will be paying yourself. *So you save the \$4,831 you would have paid the commercial lender and add \$10,190 into your account that would not have otherwise been there.* In addition to that, *all money that is waiting to be borrowed and any money that has been paid back on a loan is either earning interest (if it is an interest bearing account) or is invested in the market (if it is an investment account).* The longer you do this, the faster you can expect the account to grow, keeping in mind that you can expect an investment account to sometimes lose money over periods of time as well as earn money.

Q 12% is pretty steep. I can't afford some of the things I want if I have to pay that much interest to buy them.

A One difference between the financially successful and those who are eking out an existence is the willingness and ability to postpone spending money, even on some things that seem important, in the short

term in order to acquire greater financial independence in the long term. If you can't afford the payment, you can't afford the purchase. Wait until you can.

Q I don't have any debts to make payments on. How do I get started?

A Since this is your tool and not your master, you just start funding your account at whatever pace you can afford.

All that money you are now paying to lenders, you can be paying to yourself. As a bonus, as you do so it is earning interest, dividends &/or capital gains. You can call our office if you would like to discuss this further or if you want help in setting up your own personal banking system.

The seeds for this idea came from R. Nelson Nash's "Infinite Banking System". I have taken his concept and made some modifications. Interest rates and rates of return used are for illustration purposes only and are not a prediction of future results.