

[Guest Post] Unconventional Finance

Today we have a guest post from a fellow reader from the Bay Area explaining his Unconventional approach to his personal finances. Our guest Sean and I happen to have a lot in common and since a few email interactions back and forth have agreed to a little friendly competition to see who hits \$1M in net worth first. As I publish this we are pretty close to parity with our net worth.

Take it away Sean...

First of all, I wanted to say I respect everything being done at GYFG. I have been a long time finance blog lurker over the last 4-5 years and I just recently stumbled across GYFG and it is the first one to really resonate with me. I live in Silicon Valley just south of San Francisco and the whole “live like a college student” movement that all these blogs portray just doesn’t sit well with me. It is very expensive to live where I live, and I love living where I live.

I think it’s important to give a quick background on myself. I am a 29 year old working in finance. I had a very similar upbringing, it sounds like, as GYFG. Neither of my parents graduated high school and I have been on my own more or less since 13, and 100% on my own since I was 18. Growing up in the suburbs of Chicago, it made for a tough childhood. No one taught me much of anything, let alone finance, but I knew there had to be a better way.

Anyways, I won’t get too much into it, but a quick 30,000 foot look at my finances. I am worth about \$320,000-\$420,000 (the reason for the large range is because zillow says my condo is worth \$760,000, yet exact same units in my complex have recently sold for north of \$900,000. Zillow also says those units are worth \$760,000. The \$320,000 figure is putting my condo valued at \$760,000), half of that tied up in equity investments and the other half tied up in my condo. I paid my own way through college and have been actively saving since I was 18.

As I previously mentioned, I work in finance and would never recommend any of my clients, friends, or family to participate in the strategies I am about to outline below. The only reason these strategies work for me is because I think of my finances as a business. I view myself as the CFO of a corporation, and every decision I make is for the shareholders, as I hold 100% of the shares of my

company, myself. None of these strategies will work for someone that doesn't have sound principles, which would be 99% of the population. Although people reading this blog are most likely that 1%, which is why I have decided to share.

3 Unconventional Steps I am Taking With My Own Finances

1 - Why I will never pay off my condo - Don't get me wrong, at some point far down the road, it will likely be paid off. I bought my condo for \$660,000 and put \$60,000 down. I currently have a 30 year fixed rate at 4.125%. My mortgage, HOA, taxes and insurance come out to \$4050 a month. For anyone wondering, this is an entry level condo where I live. It is a very modest 2 bedroom 1000 square foot place built in the 70s. Remember how I said living in Silicon Valley is expensive? I wasn't lying.

I am currently in the process of refinancing to an interest only loan for the same reason that I will never pay off my condo. Of the \$4050 monthly payment, about \$700 of it is currently going in to principle. Net of tax deductions, the actual rate on my mortgage is roughly 3% (and will be lower once I refinance). With that in mind, my \$700 principle payment is essentially going to a guaranteed 3% investment return. I am a 29 year old swinging for the fences aiming for 8 figure net worth, let's face it, 3% isn't going to get me there.

Once I refinance my loan to interest only, it will be around 3% interest, and net of tax deductions I will be paying about 2%. My new payment, including mortgage, HOA, taxes and insurance will be around \$2500. The reason most people get into trouble with interest only loans is because they take the difference, in my case \$1500 a month, and inflate their lifestyle. Then when the ballooned amortized payment comes up 10 years later, they're screwed. I will be investing 100% of the extra \$1500 at what I can promise you will return me more than 2% a year.

I will be taking this "Why I will never pay off my condo" one step further, I will periodically take out the appreciation as it makes economic sense, and invest it in the market. Every dollar sitting in my condo is costing me significant opportunity costs, since I only pay 2% for the leverage. The most important takeaway here is I am using the equity and the \$1500 a month difference in payments for investments. I will be purchasing dividend paying blue chip stocks.

I understand the merits of people wanting to be debt free, and I would never scold anyone for paying their mortgage off. I just believe in my scenario the opportunity cost of paying down 2% leverage is far too great.

Inevitable I can see people ask why not just rent? That's a great question and one that I have put quite a bit of thought into. First, once I refinance to my interest only loan my monthly cost with everything included will be roughly \$2500, the cost to rent the same condo? About \$3500. The second reason is that identical units, on the exact same level, with nearly identical views are going for over \$900,000 recently (I paid \$660,000)? Yeah, if I was renting I wouldn't have that ~\$240,000 in equity. Although Zillow says it's worth \$760,000. Still, minimally \$100,000 in net worth has been realized so far from owning instead of renting.

2 - Why I only contribute up to the match in my 401k - My Company has a pretty fantastic match, they match the first 5% of contributions, dollar for dollar, and on top of that there is profit sharing every year that typically runs 2-3% of my pay. Essentially I need to contribute 5% to get 7-8% from my company. I will do that as long as they allow me. What I am going to be discussing is merits of **NOT** contributing that 6th percent and beyond. Again, for most people, please..please..please for the love of God, max out your 401k. But here is why I won't contribute a single penny beyond the 5%.

Let's start with some numbers. This gets a little more artistic than scientific, so bear with me as everyone's situation will be different. \$5000 invested in a 401k over 35 years earning 9% a year will compound to \$1,078,554. Nice, just over a million bucks. But wait a second that still needs to be taxed at your current income tax bracket. My fiancé and I are at about 50% with state and federal (thanks, California).

Woah, all the sudden that cool million bucks becomes about \$500,000 (I fully intend to stay in the 50% tax bracket the rest of my life, even when retired. If I am not, then I've done something wrong. For people seeking the college lifestyle in retirement and will be in the 0% tax bracket. Good for you, this isn't intended for you).

Okay, let's take that same \$5000 and say go ahead government, take your fair share, I am left with about \$3500 (yes, I said I am in the 50% tax bracket, but that's for every nominal extra dollar I earn. With all the deductions and whatnot, my true tax rate is closer to 30%). \$3500 compounding at 10% a year for 35 years will be

worth \$948,585. Rats, I came up just short of what I would have had in the 401k, or did I? That money has already been taxed. So that \$948,585 remains mine indefinitely as long as I don't trigger any long term capital gains.

[GYFG here. To clarify, the 10% is probably more like 10.45%, when you consider you will likely be collecting dividend distributions in an after tax account (you mention investing in dividend paying blue chips below). If we assume a 3% average yield at a 15% long term capital gains rate, then you're looking at an additional 0.45%]

Essentially all you need to do is earn a measly 1.45% a year more investing outside a 401k for it to make sense not to contribute extra dollars to the 401k. Okay, so there's tons of financial professionals and money managers out there that consistently underperform the market, so how do I expect to consistently beat the market by 1% every year?

The answer is through careful security selection, but most importantly, free leverage. Warren Buffett will likely go down as the greatest investor of all times. However, his actual investment returns aren't really all that exciting. He's never bought an IPO, and most of his investments consists of DOW companies, not earth shattering revelations here. The reason he is able to compound at 20% a year is through extremely cheap leverage.

So cheap, in fact, that he actually makes money on this leverage. Imagine taking out a 30 year loan and the bank says "we will pay you 4% a year to buy that house," with our money. Sure!! Sign me up. That's essentially the relationship Warren Buffett has accomplished through his profitable insurance underwriting, while simultaneously investing the float. Ok, so we can't all own multi-billion dollar insurance operations with which to invest the float as we please.

My third unconventional finance strategy explains how I've created an insurance enterprise with only \$25,000 starting capital needed. Don't worry, there are no articles of incorporation or insurance actuarial knowledge needed.

[GYFG here again. Just want to clarify that Sean is actually talking about the minimum account value his broker requires in order to sell options in his account, which he is about to get into below. But before he does, I wanted to state that the absolute minimum amount required by FINRA for a margin account is \$2,000, which is all you need to be able to sell options. Brokers have the option to raise limits to

their clients as they see fit]

3 - Why I've decided to take advantage of free leverage - We all know what margin is, you pay about 6% interest and can invest with the houses money. We also all know what a margin call is which will likely keep us from ever using margin. Not only do we have to beat 6% a year just to break even, but the risk of permanent loss of capital is real. I've discovered a way to use margin, for free, with extremely limited risk of a margin call.

Hypothetical - If I told you I know of an investment that can return 3% a year, every year, guaranteed, and you had access to unlimited free leverage, you would ignore all other investments and just leverage to the hilt on this 3% investment.

Enough with it, let's get into the meat and potatoes.

My portfolio is constructed of individual blue chip stocks that have a history of paying and raising dividends, these companies are often referred to as dividend growth stocks. For round numbers, let's say I have \$100,000 invested in such companies. These companies typically have less beta than the overall market, which means less volatility. If the market drops 30%, I expect my portfolio to drop about 20-25% (by the way, these are the same type of stocks that Warren Buffett invests in).

Next, and most importantly, is the use of put options. Let's say I have \$100,000 in my portfolio, and all \$100,000 of it is invested. I will then use margin to sell cash secured put options on equities that are low beta and high quality. Stuff I want to actually own. This is how we build our own insurance company. All the cash secured on margin to secure the put options is not charged interest. This is the free leverage. At any given moment I will typically have about 50% in put strikes against my portfolio value. So if my portfolio is valued at \$100,000, I will have \$50,000 written in puts beyond the \$100,000 I have invested.

Let me first go over the criteria I use for selecting my puts. I want low beta boring stocks that pay dividends. I sell the longest dated options possible, as of right now that would be 2018 expirations. This goes against most people that convince people to do options. The other reason is with two and a half years it gives me time to get ready to be put the stock. I save about \$70,000 a year at the moment.

If I believe one of my options will require me to buy 100 shares, I have ample time

to set the money aside. My whole premise is that I want the option to expire worthless, resulting in me keeping 100% of the insurance premium. I believe that the longer dated the option, the higher the likelihood that the option will expire worthless.

I want to actually own these companies. My absolute favorite stock for writing puts is T (AT&T). It has a low price of stock, which normally doesn't matter but for options it does. The reason being is options go in lots of 100 shares. Writing a put on IBM requires ~\$14,000 in cash set aside on margin while T requires ~\$3,300. This doesn't make one better than the other, except for when you have \$8000 in put room left and you want to maximize the \$50,000 in total put room you have available. You simply don't have room to write an IBM put.

Here's an example of an actual put I have written at the moment. Recently I sold a "Put T 32 EXP 01-20-2017" for \$3. What this means is that I sold a put on AT&T with a \$32 strike that expires on 1-20-2017 for \$3. This means if T is under \$32 on January 20th, 2017, I will be obligated to buy 100 shares of T for \$32. Even if the stock is at \$18, I must purchase 100 shares at \$32.

For insuring the buyer on their shares of T, I am given \$3 in premium, since 1 option contracts represents 100 shares, this is \$300. Guess what? I am allowed to invest that \$300 the day I write the put. This is called the premium. With \$50,000 in put room, I could technically write 15 of these puts (although I spread my put room out for diversification).

$15 * \$300$ is \$4500.

I am given \$4500 upfront with which I can invest however I choose. By the way, this means worst case scenario in January of 2017 I have to buy T for \$29. I can sleep well at night knowing that. The chances of these options expiring worthless is high, resulting in me keeping all \$4500 in premium, or float.

Can you see how our insurance operation is taking roots? We are selling insurance, given a premium upfront, with which we can invest however we choose. I just created \$4500 in "float" and don't need to pay any interest, in fact, I will likely be paid to invest that \$4500 as the chances of T finishing above \$32 in 2017 are high.

Like any insurance company, it is imperative to manage risk. I am only selling puts on securities I want to own, and only an amount with which I

can have available should they be exercised on the expiration date. If T had a rough go at it over the next year, I would need to start setting aside some of the \$70,000 a year that I save in order to buy those T shares.

If the \$4500 that I get and invest realizes normal market returns of 10%, I just created \$450 by getting to invest someone else's money for free. Again, this isn't even considering the fact that most options expire worthless and the chances of T being worth more than \$32 in 2017 are quite high, in my opinion. Resulting in me keeping all \$4500 and the \$450 I got from investing the \$4500.

It's important to note that I don't use my normal cash for this as I believe the returns would be worse than just holding common equity. I hold common equity with the entire amount of my portfolio, and only sell these puts on margin secured by cash, for free.

I appreciate the time. Again, these are all unconventional finance ideas that I am currently using to try and achieve my dreams. Unfortunately I don't have the next Twitter stashed away somewhere in my brain, but I do understand numbers and finances remarkably well, and most of my innovation comes around finances. I may never make more than a couple hundred thousand a year, but I am confident that I will reach my 8 figure net worth well before 50 years old. None of these may make sense to you, but hopefully they will get you to think outside the box and come up with unique ways to reach your financial goals.



Gen Y Finance Guy

Hey, I'm Dom - the man behind the cartoon. You'll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I'm a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in

total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own [financial stats](#). I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! [Read More](#)