[Guest Post] Unconventional Finance – Part 2

Today's post is from a returning guest writer. Sean found GYFG and left his first comment back in October of 2015 and has been a loyal reader ever since. After several months of back and forth in the comments of various posts on this blog, we realized that we had a lot in common with respect to age, upbringing, financial aspirations, etc. We also found that we do things differently in terms of our approach to wealth building. After several private email exchanges back and forth I convinced Sean to write his first guest post [to share his unconventional path](#).

We also entered into a friendly wager to see who will make it to a $1M net worth first. To date, he has held the lead and is currently at $915K vs. [my $850K](#).

Since it's been a few years since that first guest post I was curious to see how things have been working out and asked Sean to write a follow-up guest post to give us all an update. Below you will see the questions I posed to Sean to guide his update based on he had shared in his original post.

I hope you get a chance to go back and read his original guest post, too.

Take it away Sean…

I've been following Gen Y Finance Guy for almost three years now and have even had a chance to meet its creator for lunch – what an inspirational guy! I wanted to follow up on some of the topics I discussed in a guest post two and a half years ago.

[GYFG – You mentioned that you would not only never pay off your mortgage but at the time you were planning to refinance the mortgage in order to pull the equity out to invest. How did that go?]

I was discussing how we were in the process of doing an interest-only cash-out refinance. Unfortunately, I learned that banks are extremely conservative in their valuations for cash-out refinances and they said my condo was only worth $707K at the time when it easily could have sold for $800K or so. Nevertheless, I was still able to pull $40K out in the refinance process, and reduced our combined mortgage payments from roughly $3,400/mo to the current $2,600/mo (these figures include escrowed taxes). Our interest rate is currently 3.25% and locked in for another 7 years.

This move has worked remarkably well for me and my wife on two accounts: (1) we are paying less interest as a whole and (2) we were able to invest the difference into a bull market. I want to stress that I think interest-only loans only make sense for people with a rock solid budget who will not let lifestyle inflation creep in. I am also well aware that interest rates are increasing at a rather fast rate and once the loan becomes adjustable in ten years **WITH** an accelerated payment attached to it, it won't be pretty. Our ideas to address this are:

(1) sell the condo before seven years;

(2) absorb the increased payment, if our income has increased enough to do that;

(3) or just write a check to the bank to pay the loan off.

[GYFG – Living in the Bay Area, I would suspect that your condo value has only continued to increase at a ridiculous pace, as that market has been on fire. Questions: I wonder if you hadn't done it already, would you still pull your equity out today? And if so, what is stopping you from pulling out the additional equity you have built up since your last refinance a few years ago? If you guys pulled the trigger on option one and sold the place, would you consider moving to a lower cost of living location?]

[GYFG – How has the "free leverage" strategy performed over the last couple of years? Especially in light of a very low volatility environment?]

I have also discussed how I am using free leverage. At the time of my first post, I was in my infancy of exploring this as a real option. Two and a half years later I'm fully invested in the strategy and using it to its fullest potential. I'm currently leveraging 50% of my account value into selling puts. I currently have short puts on the following names: CPB, CVS, GSK, HBI, KHC, KMB, KMI, MMM, O, PCG, SBUX, SO, T. Important to note, these are all companies I would be ok holding long term if put the stock.

In fact, earlier this year, for the first time ever, I decided to sell a slightly ITM ("in the money") put on JNJ. With JNJ stock $140 I sold the $150 strike put. I did this because I believed JNJ was going to end higher than $150 within a year and wanted to receive more premium (almost all my puts are a one or two year time horizon and I intend to hold to expiration always). Lo and behold the February sell-off was just around the corner and the market dropped 10% practically overnight.

For whatever reason, JNJ was one of the worst hit during this time and actually dropped, I believe, 11% on February 2 with absolutely no warning. Whoever exercised the put I sold decided to exercise early and I ended up buying 100 shares of JNJ at $150 when the stock was currently around $125 – ouch! The only saving grace was I got to keep my premium of $13 which brought my actual cost down to $137.

The net premiums (including the ones I lost money on) I have collected on an annual basis are as follows:

2018: $2,750
2017: $5,760
2016: $2,053

The greatest thing is that this was all free money, meaning I earned this by using free leverage. Granted I took the risk that the market wouldn't be strong, but all the puts I sold were on companies that I wouldn't mind owning long term. I'm not upset when I get put the shares, like in the JNJ case. And in this case, I just used my future contributions to pay the shares off.

[GYFG – A little clarification for readers that are less than familiar with selling options and how a margin account works. Sean is able to sell naked options because he has a margin account that meets the minimum requirements ($2,000 is the legal minimum but many brokers require a larger balance; I believe Sean's broker requires a $25,000 account value). With a margin account, he really ends up having 2X his account value in terms of buying/investing power. So, if he has $100,000 fully invested in stocks, he also has $100,000 worth of margin capacity (money he could borrow from the broker at x% interest). By selling naked puts he uses up margin capacity but doesn't actually trigger borrowing or any interest expense by selling the put itself. However, in his JNJ example above, when he was put the stock, this would have triggered him to go on margin and incur interest until he deposited enough cash to pay back the margin loan that resulted when he was put the stock.]

[GYFG – I remember you saying a few years ago that you don't really track your expenses or savings. You also mentioned that you don't put together a budget. Has any of this changed since you got married?]

Another bit of unconventional finance is that my wife and I do not track our expenses or savings very closely, or at all for that matter. We have both formed great habits regarding finances over the years and now do whatever we'd like. According to Personal Capital, we've made $101,800 so far this year net of taxes and have spent $46,500, so we are just above a 50% after-tax savings rate. These numbers do not include our 401k contributions either. Being married to someone like-minded with good earning potential has certainly helped our situation.

While we don't track our budget at all, I run a VERY tight ship on the cash-flow side. Anytime we have more than $1,000 in our checking account it's because there is an expense a couple of days away that will be auto drafted. I pretty much invest every penny we have immediately. I absolutely hate cash. We now currently earn roughly $1,500/month in dividends and save about $8,000 a month. I find it hard to envision an emergency that would require more than $9,500 x 2 = $19,000 (we could float just about two months on a credit card without paying a penny of interest).

[GYFG – Although I still track our income and expenses, like you guys we spend freely without much thought. The savings happens automatically. I always try to remind people that there are two types of budgeting: (1) control-based budgeting and (2) allocation-based budgeting. I think it's important to distinguish between control-based budgeting and allocation-based budgeting. Most people use the former method rather than the latter. With a control-based budget, you are trying to manage how much you spend on any particular category, and in any particular month. The end goal is to place a ceiling on your spending.

With an allocation-based budget, it's more about deciding where you want to spend your money, allocating funds to the areas that you believe will bring you the most joy. We don't use this budget to manage our spending on a monthly basis. Instead, we use it as a guide that is usually directionally right. It also allows us to see changes in our wants and needs as we evolve over time. The end goal here is to have a general idea of where we will be spending our money over the coming year. That's it! It doesn't control or dictate our actual spending.

I think both methods have their places in one's financial journey.

That said, we put together a budget every year just to get an idea of where we think we will spend our money and to know how much we think we will spend. I get your logic on using credit cards to float but keeping only $1,000 of cash in the bank would stress out me and Mrs. GYFG. It's just a personal preference. We look at our cash balance as an opportunity fund and don't feel the same pressure you do to be fully invested at all times. It has actually worked out very well for us over the years to have large piles of cash to deploy. These days we are starting to get more comfortable with holding less cash since we put a HELOC in place. That said, we still like to hold $30,000 to $50,000 worth of cash most of the time.]

[GYFG – What are your thoughts on the recent tax reform? As a high income earning couple, how will this impact you?]

Tax reform has obviously hurt my family and GYFG's family the most: coastal families earning upper-middle-class income for that area. In fact, our taxable income situation remained largely unchanged from 2017 to 2018 but I anticipate we will owe about $6k more this year than we did last year, 100% due to the tax reform. Not fun, but I still choose to live in the Bay Area and would have it no other way. This hit comes mostly from the elimination of the SALT deduction, which has an effect on the amount you can deduct from your mortgage as well.

[GYFG – I'm not so sure that the GYFG household will be worse off with the tax reform. I played around a bit with a tax comparison calculator and found that our tax situation is actually going to be favorable in 2018. We do lose a lot of deductions due to the elimination of SALT, however. I plugged our income into the tax reform calculator and it said based on our projected income of $440,000 that we would actually be saving ~$15,000 vs. the 2017 tax laws. We lost about $35,000 in deductions due to SALT, but the change in the progressive tax rates and the doubling of a lot of the married filing joint income tax brackets really offset this – or so it appears. Maybe something worth checking out.]

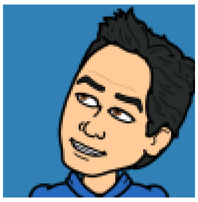
[GYFG – Where are you in terms of our race to $1M?]

I am still just as strongly as ever chasing financial freedom. We are currently worth about $915K and have a stretch goal of hitting $1M this year but would need a very strong market to do so. Our investable assets just recently crossed $500K. I believe that in order to be financially independent in the Bay Area and live a comfortable lifestyle we need a net-worth of $3M on the low end but more likely $5M to give us the additional wiggle room. We are currently 31 years old and I hope to hit these numbers by roughly age 40 or so.

[GYFG – You guys have been on an incredible run. I look forward to seeing which of us gets to $1M first but have no doubt that we will both make it within spitting distance of each other. Although our income has grown faster, your more aggressive approach to being fully invested has definitely given you the edge.]

Onwards & Upwards!

Sean



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