BARENAKED MONEY PODCAST: EPISODE 23

Financial Literacy…With Clowns (Pt. 1)

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Announcer:
You're about to get lucky with the Barenaked Money podcast. The show that gives you the naked truth about personal finance with your hosts, Josh Sheluk and Colin White, portfolio managers with WLWP Wealth Planners, IA Private Wealth.

Colin White:
Well, welcome everybody to the next edition of Barenaked Money. This week's episode is going to be talking about the value of financial literacy with clowns. Now the clowns is not a reference to Josh and myself, it was just an effort to be more circus-like to get more attention for people to listen to us. I guess time will tell if that's paid off, hey Josh?

Josh Sheluk:
Yeah, I'm not sure if a clown makes it more likely or less likely they listen to us, but we're both open to experimentation, so let's let it fly.

Colin White:
Some AB testing, if you will. Listen, one of the pet peeves I have in the back of my mind that grates there a lot is, knowing the increase in the percentage of everything that we produce has turned financial. If you go back into the '40s, maybe 10% of GDP or 10% of what we produced, was financial in nature. Well, that's climbed to be over 20%, approaching 25% in certain parts of the world. Now, I know this may sound a little hypocritical for somebody in the financial world to be complaining about this, but we really don't do anything. At the end of the day we didn't make a car, we didn't grow a cob of corn. We didn't really do anything except move money around. It shouldn't be that profitable, I guess, would be my take on things. Josh, do you want to disagree? Do you think we're worth it?

Josh Sheluk:
Well, I hope we're worth it. Maybe others in our business are not, yeah.

Colin White:
I don't think it's the business per se, as much as the system. So in today's episode, we're going to start diving into giving you some tools with financial literacy to maybe help you make some better decisions so that you're getting the most out of the financial world and not being taken advantage of as much as the overall system maybe set up to allow to happen. Now, Josh, I created an outline for this and you have it in front of you. Do you want to lead off where we're starting?

Josh Sheluk:
Well, I know that you replaced a car recently and I replaced one last year. So both of us have a bit of perspective on going through the car loan or lease process.

Colin White:
This probably could be a podcast all on its own. Listen, the car industry makes way more money off of financing vehicles then it does off of actually selling you a vehicle. Case in point, there's vehicles out there that get into the used market that people have actually done work to research how many times it's been resold. You've got a $3,000 or $4,000 or $5,000 car where they've originated $80,000 to $90,000 worth of loans against it. Doesn't take a lot to figure out they made more on financing that car than they did on actually selling you the car. Which is why a lot of the car dealerships will have, hey, no credit check, no problem. Are you currently bankrupt? No problem. They get really, really aggressive with these things and there's a big reason for it.

Colin White:
They're not going to make money on selling you the car, they're going to make money on financing it. So much so that I attended a conference one time with an unnamed institution who indicated that they had increased the maximum lease amount on a vehicle to 225% of its value. Just let that sink in for a second. They're willing to lend you over double the value of the car on a lease because well, they could. Nice, comfortable monthly payment for the rest of your natural life and long beyond the life of the car. But that amount they're lending you, isn't just for the car, it's for whatever. Josh, I'm not sure how much money they offered you in addition to your car when you purchased it.

Josh Sheluk:
No, that wasn't a thing. I don't know if I went to the wrong car dealership or what it was. But they are, to your point, fairly liberal with the amounts that they're lending out. Now, one of the reasons is that they're securing their loan against the vehicle that you've purchased. But as we both know, I think the number out there is that as soon as you drive the car off the lot, it depreciates by X percent. I don't know if that's 15% or 20% or whatever it is, but it's in that ballpark. They're willing to lend you this money because they know that they're going to make pretty good money on it by you paying the interest on it, as well as having some security with the value of the vehicle, should you decide not to pay those monthly amounts.

Colin White:
For the vast majority of people, having a car is crucial for getting to work, crucial for all kinds of things. People are really motivated to make that car payment because again, it's essential in their life. There have been times in the not distant past, like last year, where I've seen dealerships advertising $5,000 cash back, $10,000 cash back, $15,000 dollars. That's buying a new vehicle and borrowing $5,000, $10,000 or $15,000 more dollars than you needed to buy the car and they're presenting it like it's a gift. And for some people, when they walk in they go, "Hey, for $550 bucks a month, you're going to give me $15,000 grand? That sounds great."

Josh Sheluk:
I think one of the things that we'll come back to here repeatedly throughout this conversation, is try to look at it from the point of view of whatever institution is handing out this money, or this gift, or whatever it is. They're not just going to give you $5,000 free dollars. There's a catch somewhere and it's

not necessarily to say, "Don't buy this car," or, "Don't take out this loan," or, "Don't finance the vehicle this way," because as Colin said, you probably need the car to get around. It's just being aware that some of these, can we call them gimmicks, Colin, these sales gimmicks that are positioned in a certain way are more so to incentivize you to do one thing and maybe not saving you a whole bunch of money at the end of the day.

Colin White:
Well, there's lots of restricted covenants that are built into these leases that can end up costing you more so you have to be careful with that. You have to be careful about the interest rates. The interest rates can be higher than they need to be. The other one that I've run into in the last few years was the whole, hey, zero interest. It's like, "Really?" I was on the lot with a friend who was buying a vehicle and they were talking about the zero interest lease. I said, "Okay, what's my lease price?" And they gave me the lease price, whatever it was. I said, "Okay, if I want to pay you cash right now, how much cash do I have to give you?" The guy looked at me and said, "Yeah, there's a cash discount." Oh, okay. Let's just call it what it is. There's interest built into the lease upfront. He goes, "Yeah, the implied interest rate's 2.9%." Now see, we can be friends. You finally gave me the interest rate that you were actually going to charge and it's not a bad one. I don't know why you hid it.

Colin White:
People have been convinced that having a car payment's a normal thing. It doesn't have to be, but because we're convinced it's a normal thing and most of us have our lives revolving around a car payment, the car industry has turned into the finance industry. And it's the finance industry where the real money is made in the automotive industry. That and the service departments, but that's beyond the scope of this conversation.

Josh Sheluk:
Yeah, the 0% one's good because it's a bait and switch type of thing. Again, to your point, I don't understand why they do that. Here's a question for you because I don't know the answer to it. Do you know why they often have different rates for a lease versus a finance of a vehicle?

Colin White:
Well, to quote one of my favorite comedians, "I don't know, but I'm sure it's not in my favor."

Josh Sheluk:
That's right.

Colin White:
This is actually going to recur throughout this. Whenever there seems to be an incentive to do something, they're winning. They're not trying to incent you to do something that's in your best interest. That's not how business works. Now sometimes on a car loan, they'll give you a better interest rate on a five year amortization rather than a seven and there's probably some honesty in that, in that the vehicle probably is re-sellable for them at five years and it's not re-sellable for them after seven. But again, it's in their best interest, so just be aware.

Colin White:
That question I asked about what's my cash price, like, "If I'm going to pay you cash today, how much do

I have to pay to get this vehicle," and they say, "Oh, that attracts the cash discount." Now you're getting down to the real price they're willing to part with the vehicle over. If you get down to that price and they say, "Yeah, and we'll finance that at 0% interest over five years for you," okay, that's a real offer. But you have to ask some questions to get to that. I guess it's buyer beware and seriously pick up the phone and have a chat.

Colin White:
My information on the auto lending industry is not comprehensive. It's fairly deep and I do understand motivations. So if you wanted to chat with one of us, or tell us your stories... Hey, let's start this, Josh. You can write in, you can send us your favorite car buying stories because I'm sure there's a few out there.

Josh Sheluk:
Yeah. One of the other things I'll just mention that will be a principle throughout this talk is, money today in your pocket is better than money a year from now, or money two years from now in your pocket. So if some financial institution has given you a break today, but collecting money from you a year from now or two years from now, tomorrow, whenever that is, there's some benefit to them of doing that. And it's going to cost you money in some way, whether it's clear or not to you. Because nobody says, "Don't pay me today. Pay me a year from now. I don't mind, pay me the same amount." Just doesn't happen.

Colin White:
There, I think we may have gone as far as we can with this particular topic at this time, Josh. Look, hey, we can move on to mortgages now.

Josh Sheluk:
Well, yeah. Just like buying a car, you got buy a home and you got the same type of dilemma that you have with mortgages and buying a home that you have with buying a car.

Colin White:
Well, one thing that I do see a bit more often in the mortgage side is that everybody says, "Hey, do you want mortgage insurance?" Well, mortgage insurance, that sounds good. I have a mortgage, I should insure it. Okay, what they're talking about most of the time, is mortgage life insurance. Meaning if you die, then they get their money back. Sometimes it can be disability coverage, there can be different kinds of coverage. But you're not insuring your mortgage, you're insuring the amount they lent you and they're going to be the beneficiary. So it's great for them that your house is paid off because well, they just lent you the money.

Colin White:
Now, does that mean you need to have it? No. Should you have it? Maybe. But at the end of the day, the institution is going to be fine because you bought a house and if you die and can't pay the mortgage or your estate doesn't pay the mortgage, then they sell the house and they get their money back. Now, it is different if you want to keep the house in the family, but that's not a I need the mortgage insurance. That's I need life insurance and that's a bigger conversation.

Colin White:

There's a few intricacies on those life insurance policies that they put on through the financial institutions. There's typically not a discount for non-smoker, so you immediately are paying a higher premium. You're insuring an amount of money that's declining over time. Again, the financial institution's the beneficiary. I'm not sure how much you love them or how important it is to you that they in their time of grief over your death, receive money to pay the mortgage off. But for most people, that institution doesn't make it high on the list.

Josh Sheluk:
Yeah, the clearest way that I would put that is you can almost certainly get a better rate on insurance going directly to a life insurance agent than you can through your mortgage lender. Almost certainly, most of the time. I mean, you've been more experienced with it than I have. Have you seen it where you get a better rate on the mortgage insurance than you can underwriting directly with a life agent?

Colin White:
I've never seen it in black and white in my time in the industry. The other thing is, the institutions where you take out your mortgage insurance typically ask limited medical questions. It's underwritten at time of claim. So you may think you have life insurance on your mortgage, but when you're dead, they're going to go back and say, "Okay, we got some health questions for you. Do you have diabetes?" If they go through the underwriting process and you don't qualify, they don't pay it. They give you your premiums back and say, "I'm sorry for your loss."

Colin White:
If you take out an individual insurance policy, they ask all those questions upfront, so you know you have something, you know you have what you're paying for and you're good to go. Again, it's one of the ways that the financial industry takes a little bit more. Again, you could argue that we're talking about small amounts because the monthly amount is not necessarily a huge, huge number, but it's a small amount that really doesn't add any benefit to you. It's just a little bit more sand in the gears of the overall financial system that maybe doesn't need to be there.

Josh Sheluk:
And they'll offer you this insurance on a credit card, as well. Line of credit, as well. It's all the same type of thing and it all has the same flaws with it. I remember my sister was 18 with a credit card, no worry in the world if something were to happen to her and she wasn't able to pay it off. They had somehow sold her... Oh, I know exactly how they sold it to her because she didn't have the financial literacy to understand exactly what she was agreeing to. It was a dollar a month, it was a dollar a month, but still you don't need it, it's completely pointless.

Colin White:
Absolutely. It rolls back into the car loan thing. Keep in mind that when you are borrowing money, there is no requirement for you to take any insurance. Now, the one way that I would be argued to be wrong there is, that if you're taking a high leverage mortgage, then there's CMHC insurance on your mortgage, but that's not life insurance. It has nothing to do with anything that's put on by the financial institution. But you're not required to.

Colin White:
If you're concerned about your insurability or your insurance situation, then have that conversation with

a licensed insurance professional and make sure you do it right. Make sure you understand what it is, make sure you get the best rate and the right terms, rather than just rolling something in. And some of these places will throw the meat chart on, which is the accident and sickness. If you lose one hand and one foot that's worth $15,000, you lose both hands that's worth $25,000, that kind of stuff. Well, it's only a $1.18 a month or something or whatever. They're always trying to throw these things on there.

Josh Sheluk:
What do you call that? The meat chart?

Colin White:
The meat chart, it tells you what your hands are worth, right? It's done with the different parts of a cow are worth. Your two hands, that's where $25,000, hand and a foot that's $15,000. Accident and sickness insurance is the technical term for it.

Josh Sheluk:
Right. We've been talking about mortgages and borrowing against the home. We haven't talked about mortgages at all. What we talked about was insurance. We have these other things, Colin, pre-payment, amortization, refinancing. Where do you want to start?

Colin White:
Well, I mean, again, they try to make it very easy now. Recently in Canada, the real estate value has gone up so people have been tempted to, coerced to, or made to believe that taking equity out of their home is a good thing to do. They get on a treadmill of remortgaging. Well, people get on a treadmill of remortgaging and end up borrowing an extra $20,000 or $30,000 every two years to top up lifestyle spending or pay off a credit card because they're spending beyond their means. They make it easy for you to get into a habit of spending beyond your means, which again means that the financial institutions will be able to lend you more money at less advantageous terms over time. Again, cost you disproportionately. They make it very easy to do that. It's something again, to keep aware of.

Colin White:
The other thing that people run into is that they don't look at a five year mortgage when they sign it, realizing that there's prepayment penalties and they sell their house three years in and all of a sudden, "Oh, what do you mean, there's a $52,000 interest penalty? Where did that come from? I didn't understand how that worked." Again, you can back into it and there's a whole conversation with interest rate differentials and how institutions work. But at the end of the day, that fee is larger than it needs to be to accomplish the stated of goal as set out. But again, people are signing a five year mortgage thinking that they're never going to have to break it and they get hit with these huge, in some cases gigantic, interest rate penalties.

Colin White:
When you're signing a mortgage, all of those terms matter. If you're comparing two mortgages and one of them is 10 basis points more than the other, but it doesn't have the same kind of prepayment problems, then maybe the extra 10 basis points is worth it. Maybe you don't want to take a mortgage that is more restrictive because life doesn't go in a straight line. You need to make sure that you build as much flexibility into your plan as is practical. The details to your mortgage document matter, paying it early matters. If you get into a pattern of constantly remortgaging your house every time it goes up five

grand, you have a problem. It's not a problem that you're doing it, it's a problem that you have to do it because borrowing against your house is arguably the best way to borrow money. But if it's facilitating a lifestyle that you can't maintain, then that's a problem.

Josh Sheluk:
Yeah, the other thing that's been coming up a lot for homeowners over the last year or so has been refinancing. You see interest rates go down and they say, "Ah, this rate that I got two and a half years ago, I could now get such a better rate, so I'm going to refinance it. Lock it in for another five years at a lower rate." But like you said before, when you sell your home, you break a mortgage, you're doing the same thing when you refinance. You're breaking the mortgage, they're going to charge you a penalty and generally the way that they calculate that penalty is they're looking at the differential between the interest that you paid on the initial loan and the interest that you'd be paying on a brand new loan today. And believe us when I tell you that they're calculating that difference. They're making sure they're not that much further behind or coming out further ahead by you refinancing your mortgage.

Josh Sheluk:
A lot of the times what you'll find is the interest savings that you have over say the next five years, or the remaining term of your mortgage will be basically offset by the amount of penalty that you pay to break that mortgage. It's not to say that it's the worst idea, you're still refinancing at a lower rate and that if you're extending the term, it may be a good thing depending on what your interest rate outlook is. But it's just also not to say that it's a slam dunk, better for you, no matter what.

Colin White:
Just got to correct you on one thing, Josh. If the financial institution's willing to do it, I guarantee you, they're not further behind.

Josh Sheluk:
I was trying to give them the benefit of the doubt, but you're right.

Colin White:
Yeah, you really got to stop doing that. A couple more trips around the sun and you'll stop doing that. They are not going to be further behind at the end of the transaction. I'm willing to guarantee that. Hopefully that'll make it past the censors.

Josh Sheluk:
Now also, it dawns on me that a lot of people don't know what the difference between a mortgage and a line of credit is. Colin, you were talking about well, if I continually remortgage or add to my mortgage, what does that do? A lot of people I find are not necessarily adding to their mortgage, but they're taking out a line of credit or adding to their line of credit. Just to very simply explain the difference, a line of credit is more of a revolving loan so you can increase it to a certain extent, you can decrease it as much as you want. You have more flexibility there, but typically you'll pay a higher interest rate for that flexibility. This is an important point because it comes to a lot of the things that we're talking about. The more flexible your financial situation or the lending situation that you find yourself in, often the higher the interest rate is going to be. There's going to be a trade-off somewhere. Because again, they're not just giving you something for free. They're not giving you the benefit of this flexibility for free.

Colin White:
From a planning perspective, and having been at the game for quite a while, I've watched people that have, "Ooh, look, this is flexible. I don't have to make a mortgage payment every month," and maybe their income is lumpy or maybe the situation lends itself to going through periods where they can make big payments against the mortgage and then smaller payments. If you're locking in a mortgage, you're locking in a payment that's going to be comfortable regardless of anything. You're going to pick probably the lowest payment you can get that's comfortable within your situation. Which in theory means you're going to owe more money longer, right? But that is the reasonable way to do that if you're going to set up a mortgage payment for five years. If you take that, you make it a line of credit and "Ooh, look, when I get my bonus every year I can dump it against my mortgage. I can do these other things." Well, you can actually end up much further ahead.

Colin White:
Now here's the key, here's the kicker. It depends on who you are because if you're the person who can deal with all that power and not end up with two swimming pools rather than one, because you need one for the kids, one for the adults. If you can be the person who doesn't end up like that, that's probably your kind of deal. Because I've had clients who've gotten a line of credit and five years in owe more than what they started. Be absolutely apoplectic with themselves and go, "Holy crap, you got to take this away from me. I need to lock this into a five year mortgage and start getting this paid down." Because again, with great power comes great responsibility.

Colin White:
But to our overall theme here, that's what the financial industry wants. They want you to have the freedom to be you. You earned that, you deserve that. You have all of this money to work with to have the life you deserve. If you listen to it, then you can end up in a situation where you're paying way more of your paycheck into the financial industry then maybe you should.

Josh Sheluk:
Yeah. Unfortunately your average human being does not have a ton of discipline and that's how you end up with two pools. Colin, I'm not sure is that an indoor, outdoor pool, two pools outdoors?

Colin White:
I was seeing two outdoor pools that were both heated. But again, when my imagination begins to fly like that, it goes to odd places. Ooh, ooh, ooh, ooh, credit cards is next, Josh.

Josh Sheluk:
I've never seen you so excited.

Colin White:
But they make it sound so fun.

Josh Sheluk:
It's free money, right?

Colin White:
I had the experience, my son worked at a call center for a major financial institution that remain

nameless. Here's a kid who is third year in a commerce program, studying economics and he's on the phone answering questions for people. He said once a shift there'd be somebody calling in to complain about their credit card because they were making their payment every month, but the balance wasn't going down. And once a shift, he would have to try to explain to somebody who was quite upset, upset enough they made a phone call, how credit card payments work.

Josh Sheluk:
Let me guess, they were making the minimum required payments.

Colin White:
No, no, no. They were making their payment. Not minimum required, they were making their payment, that's what they figured. When I make a payment on my loan, eventually it gets paid down. Josh, do you have any idea what the latest math is if you make the minimum credit card payment, how long it would take to pay off a credit card balance?

Josh Sheluk:
Is it hundreds of years or thousands of years?

Colin White:
It's beyond your lifetime. They set it up and this is perfect. Josh knows to ask, was it the minimum payment? Because again, he's financially literate. If the vast majority of the population aren't quite as literate they go, "Well, I make my payment." Well, when they make a car payment, they will tell you their loan goes down. When they make their mortgage payment, their mortgage goes down. You make a 3% payment on a credit card, if you're paying 19% interest or 29% interest on a card and you're paying 2% or 3% a month, you might be paying a little bit more than the interest. I think they set it up so you're paying a bit more than the interest, but not a lot because they're really happy to have you holding money at those interest rates.

Josh Sheluk:
Yeah. Well, again, cost benefit analysis would look at it from the perspective of who's giving you this money? They're giving you money and by the way, you're usually getting all these points and rewards that sound all sexy and everything, as well. Where do you think that they get the money to cover all these points and rewards from? They get it from the interest payments that a lot of the people out there must make when they're missing, or short on their regular payments against their credit cards. The reason that those benefits can be so lucrative for you, is because for the lending institution, the interest payments are so lucrative for them.

Colin White:
And the money they charge the vendors for the honor of actually receiving the card. I mean, again, the gamification of spending is the part that really catches everybody's interest. I was going to save this for later, but I guess this is a good place to put it in. I want to disavow everybody listening here right now that you are remotely rational. About 5% of your brain is rational. 95% of the time you're not paying attention. You weren't awake for your whole drive home. You weren't awake when you got home and had supper. You just go on automatic pilot, you make decisions based on emotion.

Colin White:

One example I can put forward is New Coke. Who remembers New Coke? Show of hands. Yeah, whatever. Coke and Pepsi got into the taste wars and all of a sudden Coke started getting their butt handed to them in the taste wars. They said, "This is bad. We're selling pop. It needs to taste better than the other guy's pop. We need better results from these taste tests." So they came up with New Coke and they launched it. Demonstrably better, it won the taste testing. They were so proud of themselves and they threw it out to the public. The worst marketing decision ever in the history of evers and they went back to Classic Coke and they got their market share back and it's still the dominant Coke that's in the marketplace, even though it tastes worse.

Colin White:
In a rational world where everybody behaved rationally, New Coke would have been a hit. The world isn't rational. People behave instinctively. They make decisions on things other than the facts in front of themselves. And that's what everybody counts on. That's what the system is set up to do. So when they turn your credit card into a game, you can lose yourself a little bit in the game and end up changing your buying patterns to spend money on more expensive things, things with higher margin. There's all kinds of ways they can win when you enter into any of these games.

Colin White:
Again, to quote Bill Burr, it's like, "Hey, do you have an air miles card? No. Would you like one? It's free. No, thank you. Why not? I don't know how you're winning, but I know you're winning," and that's pretty true. Whenever you accept one of these cards, they're going to find a way to win, just you may not notice.

Josh Sheluk:
We still have a ton to talk about on this topic, but you're probably sick of hearing from us for now. So we're going to wrap this into a part two. Tune in next week, because we have a whole lot of fun stuff to talk about. I think we end somewhere around loan sharks.

Colin White:
Yeah, I know you're all excited for what comes next, but you're going to have to wait. We're going to do the whole cliffhanger. And the next episode is going to cover way more interesting stuff than this and the word loan shark is going to come up.

Announcer:
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Announcer:
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