EPISODE 551

[ASK FARNOOSH]

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FT: Welcome to So Money everyone. March 24th, 2017. It is Ask Farnoosh time, got your money questions with me and as always, Sophia, welcome to the show.

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SY: Hey Farnoosh.

[0:00:44.5]

FT: Hey. All right, we are mid-March here and to all my Persian friends out there, happy Nowruz, New Year. New Year, new you. It's a very fun tradition where — what do we do? We don't even do anything.

We had a lot of traditions around New Year's when I was growing up in my household. Lots of family friends would come over, we would exchange gifts, kind of like our little Christmas when you're Iranian, New Year's is like Christmas. So I hope everybody who celebrates this is celebrating it with friends and family and is looking forward to a prosperous new year.

All right, so today on Ask Farnoosh, we've got a number of questions regarding retirement versus student loans, one person's got some questions about their car, whether they should keep it or maybe just deal with the issues that the car has. Because cars are depreciating assets, what are you going to do? Then also, how to save up for a home.

Sophia, kick us off here with Allison, what's her question?

[0:01:43.0]

SY: Allison's in her mid-20's and she just got a $20,000 raise and she has a good size emergency fund so now she's trying to tackle retirement and student loans. She's leaning towards increasing her Roth 401(k) contribution so that she can contribute the max and then put the remainder towards her student loans, but she wants to what your thoughts are?

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FT: I like that you know, that she's trying to balance both retirement and student loans. It sounds like she can comfortably do this. She just got a nice raise, she has her emergency fund so that's taken care of, so she sounds like she has a lot of her foundation figured out and now she's just trying to maximize retirement while also being very mindful of the student loans.

There's some extra information she provided us right? She is already doing above and beyond with those student loans, right?

[0:02:35.3]

SY: Yeah, she is. She actually has $20,000 in student loans with this 6.55% interest but she already pays an extra 30% above the minimum monthly and she's on track to pay them off three years early. But she says, if she maxes out her 401(k) and puts the remainder of the raise towards her loan, she'll have them paid off a year earlier and she already contributes 12% to her 401(k) with the 3% match and maxes out her IRA. So it sounds like she's doing pretty well.

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FT: I think she's doing everything right. I think I have no additional advice for you, Allison. I think that is awesome, you're being super responsible, you are covering all your bases, you're doing wonderfully with your 401(k) at work, you also have an IRA, you're getting an A plus, I think, for retirement savings, you're getting an A plus for managing that student loan and congrats on the raise.

I mean, win all around. Allison, great job. Virtual high five. All right, I'm done with you Allison, tell me something negative next time. Tell me something I can actually fix next time! But this is great, this is just a reminder to all of us that when windfalls fall on our laps in life, there are many great things you can do with them. I think that's why I usually advocate for people to adjust their withholdings so they do get a little bit of a refund in the spring time. I know that's giving the IRS basically an interest free loan, but we can really move the needle when we get a lump sum of cash.

It's a lot more difficult, I think, when you get drips of money. But when you get thousands suddenly it's like, "Whoa, I can pay off my credit card debt. I can get a real head start on my student loans, I can maybe put a money towards a down payment on a home." So that it just really gets your financial life in motion.

Okay, Leigha, she's got a question on behalf of her boyfriend, she's a good girlfriend.

[0:04:26.5]

SY: Her boyfriend bought a car four years ago and even though it was brand new, it's come with a lot of problems and right now he's months away from finishing paying off the loan and they're wondering, should he cut his losses and consider trading it in for another car or should they keep the car and take the risk of more problems down the road?

[0:04:45.8]

FT: Yeah, I mean I'm sorry to hear that they have trouble with the car and I wish I had known this earlier, I would have said, take it back. There are lemon laws in some states. If your car keeps breaking down, you are entitled to a new car from the manufacturer.

I don't know, it sounds like they probably didn't have a warranty, at least not a sufficient one where they wouldn't have to be paying out of pocket so often for this breakdowns. That's a bummer, I think if this is the kind of car they have, it sounds like a damaged car and at this point, maybe trading it in for a preowned vehicle might be the best way to go about saving.

Don't buy a new car again, you know, maybe that's a lesson learned. Or if you're going to buy a new car, make sure that you buy it with a warranty, you've done the research and you are very clear, if the car breaks down and it's not your fault that the manufacturer or the dealership will help you out and not expect to have you on the hook every time.

Because I had a bit of a lemon once and a lemon car and it wasn't fun. You know, I couldn't wait to get rid of it because it just — some cars are just not built well. If you believe that this is the car that you have that it's kind of a pain in the you know what and you've been paying already a lot to maintain it, it's time for a change. If you're planning a wedding, I understand, they're also trying to get married and move in together, which you didn't mention Sophia, but I sneaked a peek at the question.

This is not a time to be taking on additional expenses. Especially with a car that breaks down, that's a surprise expense, everything is going well and then suddenly, you're a thousand dollars in the whole because for whatever reason. So you can't afford that right now. I think you just want to make sure that you have a reliable car, a certified preowned vehicle might be a good way to go about it.

These are cars that obviously have been used but they have gone and sent back to the manufacturer or the dealership to basically make sure that they are highway ready, road ready, that they've been tuned up and their parts are all in place and it usually comes with a warranty as well.

Look for that kind of a deal, hopefully you won't have this agony and you can just relax and without stress, plan a wedding and enjoy living together. Ugh, cars. I'm so glad I live in New York. I mean, I have a car but for many years, I didn't and I feel lucky that I haven't had to go down that path too often in my own personal life because I know it can be very frustrating and stressful.

Jonathan, he and his wife are trying to save up for a house, tell us more about them?

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SY: Yeah, they want to do this within the next five years and right now they're using Betterment and they have about $20,000 saved. Their goal is to have $100,000 and they want to know, do you think this is a good strategy and is there a preferred method for saving for a home?

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FT: Well, I love Betterment but if you need this money within the next five years, I wouldn't be investing it. Not aggressively in the stock market, which is what Betterment does. I know they do index funds and they're great, for long term investing. For short term goals, I would be cautious of putting my money in the market because as we know, the market fluctuates, short periods of time, you may not have time to recover if we go down south in the market.

Which we've had a very strong last decade but we could get a major correction in the next five years and then you lose value in that account and then you want to go buy the house and you're left with less than what maybe you started with and so, I just learned from Jim Kramer, many years ago who is the host of Mad Money and he wrote the investing chapter of my very first book, *So Money*.

Then he went on to write his own personal finance book and his advice is that if you need money, if you're saving for a goal and you need this money within the next five years, keep it liquid, keep it only invested in "safe investments" like maybe it's a bond, maybe it's some CD's but you're not putting it in stocks.

You're not putting it at the risk of market fluctuations because within five years, you may not have enough time to recover, right? If this was like 30 years we're talking about, 25 years, of course, you can be more aggressive, you can take on more risk. But, not really when we're talking about just a five years window. Jonathan, maybe you want to reconsider where you're parking that money, just saying.

All right, Kayla, also another question about home ownership, this is like spring time, right? The cold is over, you're looking towards like the summer, very popular time to be doing your research and maybe even putting out some bids.

[0:09:27.7]

SY: Yes, so she actually has a couple of questions about home ownership. Right now she's currently living at home but she says it's time to find her own place, her dad says she should buy a home or a condo to build up equity instead of wasting money on rent and she's already been approved but she's uncomfortable with the debt and the unknowns of the housing market.

So she wants to know if you agree with her dad and if she can afford it, should she buy over renting and she'd also like to know how high is too high for a mortgage payment and interest rate and what exactly does equity mean?

[0:09:59.9]

FT: All right, do I agree with her dad, is the first question. I don't know, I don't want to be in disagreement with any dads out there. Dads always know best, right? Not always. I mean, listen, I think that when you are talking about two different generations here, her father and then we have Kayla who is probably our generation.

There's going to be a difference in opinions especially when it comes to things like real estate and there's a lot of conversations right now and I think a lot of backup for these opinions where people are like, "You know what? If you're not ready to be a homeowner and you don't have the stomach to be a home owner, you shouldn't be a home owner. Maybe not now."

As we've talked about on the show many times, becoming a homeowner is not just a matter of math, the numbers do need to add up but also your emotions need to line up. You need to be ready psychologically, emotionally prepared to take on what is going to be probably the biggest purchase of your life.

With home ownership comes a lot of potential stress, you are in charge of this property, if it breaks down, you need to go fix it, you need to keep up with the debris and the weather and there's going to be a lot of things you'll have to do to invest back in the home, get a new roof at some point, change the plumbing at some point. There's maintenance expenses and then of course getting the mortgage is a whole to do.

I've done it a few times, I'm not saying that it can't be done and obviously people all over the world own homes and they do it well. But you have to know yourself, "Am I ready to do this?" It sounds like you're on the edge, you're not sure. So I think that, not to say that your dad is wrong, but there is something to be said about where your head's at and your head just isn't really in it. Your heart's not really in it yet.

So I would say, for that reason alone, don't jump into it and continue having a conversation with your dad. Maybe it's just that you have to get more educated on the market, you have to go to some more open houses, talk to some real estate agents, talk to some friends, maybe some contemporaries who have become homeowners. They may be able to give you more of a current perspective on housing.

Your dad may have bought his last house decades ago. That's going to be different than a perspective from someone who bought a house three years ago or six months ago. Talking to people who have recently become homeowners I think could be really important as you do this research.

She also had a question about how much to put towards a home. The good rule of thumb is to not spend more than 30% of your take home pay on housing expenses. That includes the mortgage, that includes the utilities, the insurance, the taxes. The more you can jam pack into that 30% budget, I think you'll be in a good place because remember, you have other things to pay for.

How you work out that math, you kind of figure out what is that 30% of your take home pay, squeeze in the insurance, squeeze in the taxes and then from there, you know, work your way into what would that look like as far as a mortgage, and do I have the down payment potentially to then also afford a house where I'll be left with that kind of a mortgage?

You can start to look around from there and also she wanted to know what is equity? Equity is a very simple calculation, it's the value of your home today, subtracting the mortgage. It's what it's worth minus what you owe and that is your equity. If your home is worth $200,000 based on recent sales or based on a recent appraisal, you subtract from that figure your mortgage and that is the equity that you're left with and that is basically the cash in your pocket when you go to sell the home.

All right, hope that answers your questions Kayla and if your dad has any questions for me, we'd love to have one on the show. Maybe the two of you should listen to our episode with David Bach this year. I've interviewed David now twice and he wrote the book *Automatic Millionaire* and he's a big advocate of home ownership.

I'm also an advocate of home ownership but it has to be right for you. It's not for everybody and yeah, the market is very volatile. This has to be something that you look at, not so much as an investment but you have to love the home. It's like art, you know? Art yes, has an ability to appreciate and it is its own category of an investment but what's the advice, right?

Any art dealer will tell you, "Don't buy art unless you absolutely love it because then if the market goes up or down, at the end of the day, you still love it and you could still afford it." So same with a house. Don't be so tied to this concept that this has to become a return on investment for you. I think, historically, the housing market has proven that over a decades, it usually proves fruitful for homeowners, assuming that you're paying your mortgage and you have been holding on to this property for a very long time.

But if you're looking to turn this around, flip it, make it an investment in a short period of time, listen, that is not my game and that is very risky. Just be patient, get yourself educated and maybe you'll warm up to the idea and by then, you'll be more ready and then finally, Dannielle, tell me what's on her money mind Sophia?

[0:15:11.6]

SY: Yeah, she just receiving a $5,000 bonus from work and doesn't know where to allocate the funds. She has some thoughts. The first is maybe she should add it to her emergency savings, which is only a few hundred dollars strong right now. The second option is to use it to pay off a student loan and the interest rate on the student loan is 6.8% or the third option is to open a Roth IRA or some other type of investment. What do you think?

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FT: Okay, so she's got $5,000 to work with. Should she put it in savings, which is pretty paltry right now, just a few hundred bucks, which you want to get that beefed up to somewhere like three to six months of your living expenses. Should you put it towards the student loan, which has standard rate? It sounds like a federal loan of 6.8%. Or put it towards retirement? I don't know how much her student loan debt is, did she say?

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SY: No, she didn't say that. No.

[0:16:02.2]

FT: Okay and I don't know how much she has saved for retirement. What I do know is that she doesn't have very much in her rainy day account. So Dannielle I would say, maybe you could do a little bit of everything here. You could put a couple thousand dollars in savings. You could take another thousand and open up a Roth IRA or maybe take a couple thousand dollars and open up a Roth IRA and the other thousand, you could add to the principle of that student loan and then you've got all your bases covered.

But I think that if I had to really prioritize it here, I would say it would be emergency savings, then retirement, then your student loans. Again, I don't know what the balance is on those student loans, but the interest rate seems pretty average to me and it sounds like a federal loan too. So if she need help in that department, the good news is with federal loans, you can do income based repayment potentially.

There are some modifications that the government does provide that sometimes private loans don't. so I feel like in that case, there's always some other ways that she could tackle it more affordably but no one is going to come to you and say, "Hey we have a new modification plan for your Roth IRA" you have to invest in that yourself and be aggressive and be consistent and so do that.

I'd say emergency savings then the Roth then the student loan, anything you have left over and hopefully when you see your emergency savings accumulate, so you get to $2,000 plus in that account, make a commitment Dannielle. Every paycheck, I want you to be adding to this, just like you'll want to be adding to that Roth IRA, just like you're regularly making that student loan payment. Make these three things non-negotiables and just allocate automatically something from your paycheck to them.

All right that's a wrap. Thank you Dannielle, thank you Kayla and Jonathan, Leigha and Alison for all your questions and send them to us. You know it's very easy to send us your questions, go to somoneypodcast.com, click on "Ask Farnoosh" and you can either leave a voicemail or your written question or comment. We love to hear how things are going, updates, wins, let us know. We love being in the loop with you, and thank you Sophia.

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SY: Of course.

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FT: Have a great weekend everyone. I hope your weekend is So Money.

[END]