MI J.D. Roth

Jaime: Welcome to Millionaire Insiders. I'm Jaime Tardy and I have J.D. Roth back on the show. I am super so excited to have him on. We're going to be talking about financial indepedence. The cool thing about J.D. is that he really changed his life, going from broke, in terms of personal finance, to being a millionaire and I think I really want to hone in on how you guys can do that too. Because it's one thing to make a lot of money in business but if you spend all the money you have, you still will not become a millionaire.

J.D.: This is exactly right.

Jaime: Beautiful. We were talking about your course and I want to pull out a little piece that I think will help people, so tell us about your philosophy for financial independence.

J.D.: I think you hit it on the head just now – it doesn't matter how much you make if you're going to spend everything that you make. This is something that a lot of people struggle with. When I read comments on my story or on Mr. Money Mustache's story or on the story of anyone who has managed to become financially independent, people always say 'That's great for them because they had this particular advantage but I don't have that.' As I mentioned in our earlier interview, I don't like excuses like that because everyone has things that hold them back and if we allowed our excuses to hold us back we would never get anything accomplished. One of the other things that people say is 'It's fine that so-and-so is a millionaire but they had an income of a quarter of a million dollars a year.' Well, the quarter of a million dollars a year isn't what allows you to be a millionaire – it's the gap between your earning and your spending that does it. If you earn a quarter of a million dollars a year and you spend $300,000 a year, you're screwed – you're deep in debt and you're struggling just like the average person. On the other hand, there's an older fellow I know, I think he's 74 now, and I call him the real millionaire next door. He was a high school shop teacher during the 1950s, '60s and '70s. He never had a huge income, yet he's a millionaire, and that's because he created a gap between his earning and his spending, he lived very frugally and invested wisely. So what I'd like to share with your listeners is what I consider the formula for achieving financial independence.

Jaime: Beautiful – how do we do that? We want to know. Because, looking at where they are right now, like 'I'm not making the money I want and I'm probably spending too much. Now what? Please help me, J.D.'

J.D.: The first thing I would say, and I've hinted at this, is that you've got to create as much profit as possible. Remember – profit is the difference between how much you're earning and how much you're spending. There are two ways to go about creating profit – one is to reduce your expenses and one is to increase the amount you're earning. Different people will emphasize different parts of this formula. For example, Ramit Sethi at 'I Will Teach You to be Rich' often emphasizes the earning more aspect, at the expense of cutting expenses, whereas if you read Trent Hamm from 'The Simple Dollar', he emphasizes cutting costs as opposed to earning more. I think they're both important; they're both vital, because what you're trying to do is create this gap. If you can lower expenses you're creating a greater gap between your expenses and your earnings. If you can increase your earnings, you're doing the same thing. If you can do both at the same time it's awesome. I feel that people ought to develop good frugal, thrifty habits – cutting coupons, borrowing books from the library, other things that allow you to save money in small doses – but those aren't the best ways to achieve financial success. I think people need to go for big wins and there are a handful of big wins. One is to reduce your housing expenses – that might mean that you would need to sell your house. Most people spend about 33% of their income on housing, or 33% of their budget on housing. That's a hell of a lot of money. I think it's more reasonable to spend 15-20% on housing, so maybe you need to move to a new place, and that might mean moving to a new city where there's a lower cost of living, certainly moving to some place that's smaller and costs less. So you should spend as little as possible on housing. Also reduce your expenses on transportation. Transportation is the second largest expenses in most American's budgets, accounting for about 17% of the budget. I'm a huge advocate of using public transportation, walking, using bikes, whatever it takes to get your transportation budget cut quickly – and this is something that people could do today if they had the mental fortitude. If they could go out and say 'Alright, I'm selling my car and I'm going to rely on other means to get around,' that's something that could be done instantaneously to reduce costs. Also I think it's very important to save for the unexpected – both good things and bad things – so have an emergency fund but also have what I call an opportunity fund, something that allows you to seize unexpected opportunities that come along.

Jaime: I've heard so many things about emergency funds and how much we should have in that – six months of expenses – but what's an opportunity fund? How much should we have in that?

J.D.: It's going to depend on your situation. If you're deep in debt you're not going to have much in an opportunity fund because it's better to get out of debt. Not everything that's unexpected that happens to you is bad, right? Some of the unexpected things are good – somebody comes along and says 'Hey, I'm going on a trip to South America. Do you want to come along?' If you don't have the money, you're not able to seize that opportunity. Or someone comes along and says 'You know what? I'm starting this business. I know it's just a small stake but if you have $5,000 I'll give you a 5% stake in it.' Maybe you think it's a great business and you want to take the opportunity – if you don't have money set aside to do that, you can't do it. I feel that this is a great way to be prepared for good things that come along. So big wins – a cheap home, lowering your housing costs, lowering your transportation costs and I think it's also important to maximize your income. Most people have a job, so you've got to figure out ways to maximize the income from your job. There are a few ways to do that. One great way is to negotiate your salary. Studies show that people who negotiate their salaries make far more than the people who don't but most people are afraid to do it. This is especially true of women – men are something like 5-8 times more likely to negotiate their salary than women are and yet this is a great thing to do if you have the mental strength to do it. It's tough – I don't like negotiating, but when I do it, I get good results.

Jaime: I want to tell a quick story about that – I asked for a raise. I was 22 years old and I had $40 an hour which was ridiculously good for a 22 year old. Three months after I started that job I asked for a $5 an hour raise and I got it. I talked to my boss and he said 'You might as well ask,' and I was like 'I'm going to ask!' and it totally worked. Years of working at that job made me a lot more money, which was totally great, so it doesn't matter where you're at.

J.D.: That's $10,000 a year right there and over, say, 10 years it adds up to $100,000 because you had the guts to ask for a raise. Plus then all future raises are based on that and future jobs that you go to, so absolutely. Other ways to make more money – become better educated, go back to school.

Jaime: You like going back to school? Keep talking. Because I'm not sure, I go back and forth on this one.

J.D.: A lot of people poo-poo the idea, they're down on it, but the statistics do not lie – the better educated you are, the higher your income is likely to be.

Jaime: For a job, though. The caveat is that it's for a job. Because in all the millionaire interviews that I've done, most of the millionaires do not use their college education at all. Not that we shouldn't be more educated, because we should be more educated.

J.D.: That's an interesting point, because if you look at me, I have a psychology degree with an English minor, and on the surface it might look as though I'm not using that degree in any way. When I was working I was a box salesman and now I write about personal finance – and yet I use this degree all day every day because I write about the psychological side of personal finance. I think it's important to understand that we are made up of everything that has happened to us before and that includes seemingly irrelevant past educational experience. Plus you never know what's going to happen in the future and when that education is going to come in handy. So I'm a fan of becoming better educated. Starting a side gig, starting your own business, obviously, and I'm also a fan of selling the stuff that you have. I made a lot of money selling the stuff that I had accumulated when I went into debt. I sold my comic book collection for $25,000.

Jaime: What? A $25,000 comic book collection!

J.D.: It was a loss – there's no question it was a loss.

Jaime: That's crazy. No wonder you didn't have any money!

J.D.: I have to make a note to myself – for tax purposes I need to remind my accountant that I had that as income because that's going to count as income for me and I'd better report that or I'm in trouble. Anyway, you're doing these things to minimize your spending and to maximize your income and what you're really trying to do is create that gap and that gap, in business, is called profit. In personal finance we call it a savings rate. If you talk to most financial advisors they will tell you that you should have a savings rate of 10-20%. I think that's a great start and I preached that for years and years that, yes, you want to save 10-20% of your income. I'm not going to argue that doing that is a bad thing, but if you follow that advice you're going to be working at your job for between 30 and 45 years, or running your business for 30-45 years, because that's how long it takes to accumulate enough money to become financially independent. Now, financial independence is the state where you have enough money saved to live off of the proceeds of the interest or the investment returns or even just from drawing it down. To get to financial independence more quickly, to achieve early retirement, basically, you want to save more than 10-20%. I'm a fan of saving 50% or 70%.

Jaime: Mr. Money Mustache convinced you. Wow, that's impressive! That's tough!

J.D.: You just cannot argue against the math. If you save 50% of your income you can achieve financial independence in about 15 years. If you save 70% it's something like 10 years. This may sound extreme but, when you look at the numbers, by adopting a lower cost lifestyle and earning more and learning to live off of only 30-50% of your income, not only are you learning to life off of less but you're setting it up so that when you do retire you need less to support yourself so you need to accumulate less. I have a rule of thumb for finding out whether you're ready to retire or whether you've achieved financial independence and this rule of thumb is based on making standard assumptions about inflation, investment returns, safe withdrawal rates, just some standard assumptions about these figures. So what I say is if you can multiply your current annual expenses by 25 – say you're spending $40,000 a year, if you multiply that by 25 you end up with $1 million, so the average person needs $1 million to become financially independent. If you're conservative or you're not risk tolerant and you make some conservative assumptions about the stock market or about inflation you might need to go to 30 times your annual expenses. On the other hand, if you're risk tolerant or you think you're going to make more money in retirement or you just make some liberal assumptions you can do it when your savings are at 20 times your annual expenses. So somewhere between 20 and 30 times your annual expenses is where you become financially independent, based on standard assumptions.

Jaime: That's interesting. So everyone should do this calculation right now so that way we know what our number is. Because a lot of people think we need to be millionaires but some people don't need to be millionaires and some people need to be way more than millionaires, depending on what they want.

J.D.: Right – this is where lifestyle comes into play. You can keep your lifestyle, so if you have a $20,000 a year lifestyle and you make some aggressive assumptions you can be financially independent at $400,000.

Jaime: Of course that's a choice, though. There's always that back and forth. I didn't have to buy a $20,000 car with cash if I didn't want to, but I really, really wanted it. There are so many parts to figuring that out.

J.D.: Absolutely. In the Get Rich Slowly course, in the Be Your Own CFO guide, I talk about opportunity costs, and that's essentially what you're talking about – it's a tradeoff. You can have the car now but what are you giving up in the future?

Jaime: That is a huge question. Todd Tresidder, who has been on the show, talks to me about this all the time – when you're saying yes to something you're saying no to something else, right?

J.D.: Absolutely.

Jaime: That's a really, really important question to ask yourself that we do not ask our own selves enough so having key friends to call you out on that is always annoying but a fun thing.

J.D.: So I said that if your lifestyle costs $20,000 a year and you're making some aggressive assumptions then you could be financially independent at $400,000 a year but if your lifestyle costs you $100,000 a year and you make conservative assumptions or you have low risk tolerance you're going to need $3 million. So there's a huge gape there between the $400,000 and the $3 million for financial independence and that's influenced by how much you spend.

Jaime: And that's a choice, so you can decide how much you want to spend, no matter how much everything else is all excuses. Thank you so much for coming on today, J.D. I really appreciate it. We're going to have everything in an action guide so you can go ahead and do your numbers so you know exactly how much you need and what you can do to try to make that profit gap even bigger in your personal life. Where can we find out more about you and your course and all of that fun stuff?

J.D.: You can read my personal finance stuff at GetRichSlowly.org. The Get Rich Slowly course lives at MoneyToolbox.com and if you want to read about overcoming fear and pursuing happiness and financial independence go to JDRoth.com

Jaime: Beautiful. Thank you so much for coming on the show, J.D. I really appreciate it.

J.D.: Thank you.