March 2012

Zen and the Art of TCO

There are a lot of things I do poorly, but for whatever reason, I am really good at saving money. It is part of my DNA and it is one of the things that influenced me in choosing my profession. This month, I want to discuss the art of TCO or total cost of ownership. By thinking in terms of TCO with your purchases, you will be able to save a lot of money.

All too often marketers try to get us to think in terms of "monthly payments" or "upfront costs." This is wrong-headed if you are serious about accumulating wealth. Consider the free razor you were mailed on your 18th birthday or the $100 printer with enough ink in the initial cartridge to print 4.5 pages. Smart companies can afford to give away their products because they know the real money is in razor blades and ink sales over your lifetime. From a TCO perspective, it makes more sense to buy an electric razor and a laser printer. Both cost you more up front, but should be much cheaper over the life of the product.

I also try to annualize the costs of my purchases and compare that number to what I can buy right now for that amount. I recently used this technique a couple of months ago when it became apparent to me that my friends no longer wanted to talk to me. I would call their cell phones and only receive text messages in return. On my current plan, that is 20 cents just to receive a text message that says "Thx." I started to pay attention to my bill and realized that I was paying close to $5 per month just because my friends didn't want to call me back. That is $60 per year and because it is after-tax, I have to make $80 just because I am too boring to talk to on the phone!

I remembered that my cell phone carrier offered a text plan for around $5 for about 200 texts a month. I decided to explore upgrading my plan so I could stop calling people back too and send my friends cool messages like "LOFL." It turns out my carrier had dropped the baby text plan and only offered an all you can eat plan for $20 per month ($240 per year). I don't have teenage daughters and instantly realized that I would much rather spend $240 per year on almost anything else. It then occurred to me that I had to make $400 to be able to pay $240 per year for that text plan after I pay taxes. If I kept this awesome deal for ten years, that would be $4,000 of my gross income!

TCO thinking works great for communication services, shaving, and printing, but it really works well on the big things in life. One of the best things about living in Texas is that there is no state income tax. We do have high property taxes. I have found that you can really game the tax system by having a high income and a modest home. All too often people don't factor in how much the property taxes are going to be per year when deciding where to buy. It is a good idea to ask yourself how much the home will cost to live in if it was paid off. A million dollar home in Dallas will cost close to $2,000 per month just to pay for taxes and insurance!

What got me thinking about writing a letter on TCO is that I am beginning to think about purchasing my next car. I am just under the 200,000 mile mark on my 1999 Toyota Camry and hope to replace it at 250,000 miles in 4-5 years. I am beginning the thought process now because I want to be prepared to act quickly in the event a major repair or wreck forces me to replace my car sooner.

My current vehicle was purchased "previously owned" (that's what they call "used" now) with about 11,000 miles on it. I purchased it directly from Toyota's U.S. headquarters where I used to work in Southern California with the employee discount. Boy do I miss that benefit! While working at Toyota, I learned some valuable things about the car business. One of the most important lessons was to open the manual that comes in your glove box and actually follow it.

If you think about it, the people who designed and built your car are telling you precisely what to do and when to maximize the length of time your vehicle lasts. It is not a good idea to deviate from their plan. I have religiously followed my manual and taken in my car every 5,000 miles for oil changes. Every 15,000 miles there are small extra things to do. Because of this, in 12 years I have only broken down one time. There is a lot of wisdom in the Fram oil-filter commercials that say "You can pay me now or you can pay me later."

Toyota also taught me that manufacturers make very little on selling normal cars. The margins are much better on luxury vehicles and SUVs, but they make their real margins on financing and parts. If you can find a good honest mechanic (not an easy task) that doesn't work for a dealer, you will save a significant amount of money on maintaining your vehicle. I don't get free cookies, car washes, or loaner cars, but my wallet gets to stay a little fatter.

For my next vehicle, I will be purchasing a one to two year old car. If I had to choose today, it would be a Hyundai Sonata. I like the way they look, have heard good things about them, and drove one as a rental car. I also like the Hyundai Genesis and Santa Fe, but I am a believer in peak oil and part of thinking about TCO is what I will pay in fuel costs. There is a big difference in getting 35 miles per gallon on the freeway and getting 27 when you plan on putting 250,000 miles on your vehicle!

The web has completely changed the car shopping experience. Edmonds.com and Kbb.com are two of the best sites to help you determine a good price on a new or used vehicle. In visiting them recently, I noticed that they both have added a section to help you estimate the total cost of ownership that shows depreciation, insurance, and maintenance estimates. After determining, what prices are fair, I will then scour the web to find cars to consider. I will rule out any car that doesn't have service records and I will verify the records by calling a dealer or entering the Vehicle Identification Number (VIN) into carfacts.com or autocheck.com.

In most cases it makes sense to let someone else pay the hefty depreciation of the first two years for a vehicle. I am self-employed and I cannot find a way to make a lease make sense when looking at it from a TCO perspective. I also think about insurance costs. According to Edmonds.com a 2011 Sonata costs $1,158 per year to insure and Corvette Z06 costs a whopping $3,012. That is $18,540 more in insurance premiums for ten years! I hope you are getting the hang of incorporating TCO into your thinking.

As a study in Daniel Kahneman's book *Thinking, Fast and Slow* found, the only time we feel good about our car is when we think about it and it turns out we rarely think about them. I promise you that people stuck in traffic driving your dream car are not sitting there thinking about how much joy their vehicle brings them. Buy a quality dependable car that you will be happy with and as you get sick of it and get tempted to replace it reward yourself every once in awhile with something nice for the $500 car payment that you are saving.

Markets

On February 29, the European Central Bank announced that 800 banks have borrowed 529.5 billion more Euros ($712.2 billion) in its second "cash for trash" LTRO program.[1] The last LTRO took place on December 21, 2011 and was for 489.2 billion Euro ($640 billion).[2] So far the ECB has lent out $1.35 trillion through this program and this is highly inflationary. I often harp on how absurdly risky and unstable the U.S. banking system is. Europe has taken it to a different level.

In the United States, the required reserve ratio is 10%. Without getting too technical, the reserve ratio is how much money a bank is required to keep in reserve as opposed to lending it out. In the U.S., it is legal for a bank that has $10 million in deposits to only have $1 million in cash and lend $9 million out for loans. In Europe, that same bank is only required to keep $100,000 in reserves as they only require a 1% reserve ratio! A 10% reserve ratio is playing with fire. A 1% required reserve ratio is playing with weapon's grade plutonium.

As a reminder LTRO stands for Long Term Refinancing Operation and I call it "cash for trash" to remind myself what it really is just as I try to say "money printing 3" instead of quantitative easing 3. Banks in Europe are afraid to lend to each other so the ECB is allowing them to put up dodgy collateral that other banks would not accept and borrow directly from the ECB at 1% for three years. Thus "cash for trash."

I guess speculators were hoping to see much more Euros being pumped into the economy because the event turned into a "sell the news" day. It hit gold for $100 and silver for almost 2.5%. The dollar may have found a bottom which would likely mean time for a correction. The biggest thing that has me scratching my head is how the stock market can be at multi-year highs while the yield on the 30 year treasury is close to an all time low. As you can see from the chart below, the yield on the 30 year (red line) usually goes up when the S&P 500 (blue line) goes up. Since August of 2011, there has become a large divergence between the two markets.

[1] http://www.bloomberg.com/news/2012-02-29/italian-spanish-two-year-notes-stay-higher-as-ltro-loans-exceed-estimates.html
[2] http://en.wikipedia.org/wiki/LTRO#Long_term_refinancing_operation

The S&P 500 and the yield on the 30 year Treasury, Source: Yahoo!

One of these markets has the future wrong. We are either going to see a big correction in stocks or the bears that have been hiding out in treasuries are going to sell them and chase the market higher. The chart above and many of the indicators that I follow have me erring on the side of caution over the shorter term.

Most market participants don't appreciate how much influence global money creation has on asset prices. Is oil sky-rocketing or did $1.35 trillion dollars worth of Euros buoy prices? Unfortunately asset prices are all too often priced in fiat currencies that are consistently being manipulated. Below is a chart of the S&P 500 priced in gold. On the far left, you can see the March 6, 2009 low where the S&P touched 666 priced in dollars. As you can see when priced in gold, the S&P 500 has now just barely risen above this major low. Are stocks and commodities way up or has Bernanke and Co. destroyed our measuring stick?

What the S&P 500 would look like if we were still on a gold standard. Courtesy StockCharts.com

Domestique Capital LLC
4601 Old Shepard Place
Ste. 117
Plano, TX 75093
214.556.8904 phone
www.domestiquecap.com