Creative
wealth maximization strategies*

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Gradually, Then Suddenly – in Cars.

Every now and then life gets sideways. There's an unexpected event, a change of plans. All of sudden, you're wondering "How did I get in this mess? And how am I going to get out of it?"

If you get sideways with your personal finances, a frequent fix is to borrow money. You might ask for help from family or friends, take a cash advance on a credit card, get an unsecured note from the bank, open a home equity line of credit, or tap your 401(k).

This stabilizes your situation. You figure out how to pay the loan. Life goes on. Except…

Even if your budget can afford it, the amount you pay a lender each month decreases what could be saved. Which means if you have another sideways moment – a medical bill, a car repair, a leaking roof – you will borrow again. Monthly payments will increase, and saving will once more decline.

You know this is not ideal. But eventually, you adjust. The extra debt is your "new normal."

"How did you go bankrupt?"

"Two ways. Gradually, then suddenly."

This two-sentence exchange from Ernest Hemingway's 1926 novel, *The Sun Also Rises,* might be the most concise explanation for the trajectory of events that lead to financial ruin: "Manageable" debt gradually accumulates until, quite suddenly, it is overwhelming.

Going broke in this manner isn't caused by a character flaw, like overspending or a gambling addiction. It's just the inevitable result of reflexively using debt to resolve life's sideways financial moments. Here's what John Mauldin, in a November 2019 *Thoughts from the Frontline* commentary, had to say about the normalization of this behavior:

"One of Western civilization's biggest problems is we've convinced ourselves that debt can be permanent. We don't use that specific word, of course, but it's what we do and why government debt keeps rising. We borrow faster than we repay previous borrowing."

In sober moments, everyone understands that borrowing faster than you repay previous borrowing is a recipe for trouble. Yet this is how a lot of American households buy automobiles.

The Normalization of Negative Equity Loans

It starts with a sideways event: an urgent need to buy a new car, but still owing money on an existing vehicle. For a dealer to accept the old car in trade, the loan against it must be paid in full. The easiest solution: Roll the old debt into the new car loan; a portion of the new loan pays off the old debt. But since many dealers will offer no-money-down financing on the new purchase, the loan often exceeds the value of the new vehicle. This is referred to as a negative equity position.

Edmunds.com, an online resource for automotive info, reports that "33% of people

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who traded in cars to buy new ones in the first nine months of 2019 had negative equity," with an average rollover amount of $5,000.

Do this once, and you might eventually get right-side-up again. But according to Edmunds, consumers with negative equity not only owe more, but they tend to get longer loan terms, with higher interest rates and higher monthly payments. This tends to create a cycle in which each trade-in leaves them deeper in debt.

A November 2019 *Wall Street Journal* article highlighted an extreme case: Over two years, a 40-year-old electrician took out four car loans, each time rolling unpaid balances from the previous car into the next. His last transaction: a $45,000 loan to buy a $27,000 vehicle. That's "gradually, then suddenly" in a very short period.

Why does this happen?

From a consumer perspective, rising car prices have made automobile ownership more expensive. Because personal transportation is often a financial necessity, many households have no choice but to take on debt to meet the need. (The electrician's story included a divorce, an accident, and an aging vehicle that had become unreliable.)

It seems counterintuitive that lenders would allow borrowers to get into a negative equity position, because the risk of default is higher. But the *Wall Street Journal* article notes that "The transactions are often encouraged by dealerships, which now make more money on arranging financing than on selling cars."

Compared to a year ago, are you borrowing faster than you're repaying? If the answer is "yes," there may be good reasons to see this as a temporary condition. But remember: gradually, then suddenly.