MONEY

Nearly Every Swedish Economist Says This Is the Financial Concept You Most Need to Understand

And more important, you need to use it on a daily basis.

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Photo: Getty Images

A guy at the gym said he was getting a great deal on a new car. "My payment will only be $500 a month!" he said. Then he asked for my opinion.

"What are you paying for the car?" I said.

"Doesn't matter," he said. "$500 works for my budget!"

I tried to (gently) explain that a low monthly payment in no way indicates a good deal. He should negotiate the price first, then negotiate loan terms.

I've had similar conversations a number of times in the past; if asked what's the most common financial mistake made by consumers -- as well as by entrepreneurs who need financing to start a business, buy equipment, etc. -- I would have said "payment shopping."

Turns out, I was wrong.

A team of researchers asked nearly every Swedish economist which financial concept would be the most beneficial for the average person to understand.

The clear "winner," according to the 2020 paper published in *Studies in Higher Education,* wasn't interest. (Although interest was number two, so I wasn't far off.) Nor was it inflation, nor supply and demand.

The most important concept? **Opportunity cost**.

In simple terms, opportunity cost is the loss of potential gains from other alternatives when one alternative is chosen. At its purest level, opportunity cost is mutually exclusive, where choosing one thing removes the opportunity to choose another.

If you have $1,000 and invest it in Amazon stock, you miss out on the potential return from investing in Apple stock. If you decide to go out to dinner tonight instead of attending a networking event, you might miss out on meeting a new supplier. If you decide to watch TV instead of working out, you exchange leisure for potential health benefits.

Opportunity cost is what you give up when you make a choice. Investing in *this* means not investing in *that*. Spending time with one person means not spending time with another.

The premise extends to that guy at the gym. Spending $45,000 on a car when he could have spent $40,000 for the same car means he doesn't have $5,000 (plus interest) to spend on something else. Or save. Or invest.

"The real cost of any purchase," Warren Buffett says, "isn't the actual dollar cost. Rather, it's the opportunity cost -- the value of the investment you didn't make because you used your funds to buy something else."

That's why Charlie Munger, Buffett's longtime Berkshire Hathaway partner, says, "In the final analysis, everything we do comes down to opportunity cost. Intelligent people make their decisions based on opportunity cost."

Keep in mind that can apply to nearly every decision, not just investing.

Why don't we consider opportunity cost?

For one thing, blame budgeting.

Say you've allocated $500 a month for your car payment. Opportunity cost considerations then focus on the car you think you want to buy against the car or cars you won't.

Or say you've decided you can spend $15 a day on lunch. Once that decision is made, opportunity cost considerations tend to focus on particular restaurants. Going to Subway means missing out McDonald's.

But the better question is, "Is this the best possible way to spend my $15?"

That's a trap many entrepreneurs fall into. Imagine you've allocated $4,000 a month for Facebook ads, and your ROI on that spending is nearly 200 percent. At face value, that sounds great.

But what if you instead hired a salesperson? Or used a portion of those funds to improve operations? Or allocated a portion to other marketing strategies?

Your opportunity cost is what else you could have done with that $4,000; the only way to know if that spending makes sense is to evaluate it against other uses of that money. (Including saving some of it for the inevitable "small-business rainy day.")

The same principle applies broadly. Choosing to chat with co-workers instead of making a sales call means missing out on potential revenue. Choosing to watch TV instead of working out means missing out on improved health and fitness. Making one choice always means giving up another.

That doesn't mean you have to be a slave to opportunity cost. (Sometimes the best use of your time is to do nothing productive with it; at times a short-term approach really is better.)

But it does mean you should use opportunity cost to frame most of your decisions.

The easiest way? Ask yourself one question: "Will choosing *this* instead of *that* help me reach my long-term goals?"

That's the basis from which opportunity cost should be evaluated. First decide what you want to accomplish or become. Then frame your decision making through that lens.

For example, your question might be, "Will *this* help me build a $10 million business," (if that's your goal), "or should I do *that* instead?" Or your question might be, "Will *this* help me better serve the people I lead, or will *that*)?"

Frame your choices that way, and you'll be much more likely to achieve the professional and personal goals you set.

Because your actions will more consistently reflect what really matters to you.

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