Castling
Financial Planning, Ltd.

Helping You Secure Your Future ™

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Winter 2011 Newsletter:

First off, Happy New Year to All of You!

In this edition, we introduce the elements that we call “meta-assets” and how they shape your financial life. So many in the financial services industry cling to methods and strategies comprised only of those products they can sell you (“push”) or of your assets that they can “grab”under their management (aka Assets Under Management/”AUM”, or “pull”). This push and pull method of financial advising comprises about 99% of the industry. It's no wonder that this makes them ignore meta-assets.

Just as “dark matter” may represent a large part of the universe, meta assets comprise a large portion of your personal financial picture, that you may not immediately recognize. To neglect them would be damaging to your own financial well being. Please read our second article for more information, as we introduce this concept.

The Great Recession and financial crisis have taken a huge toll on the US economy and on other developed and developing countries. There have been various causes. Both political parties have been at fault. We think that two of the best books on this subject are ***This Time is Different*** by Professors Carmen M. Reinhart and Kenneth S. Rogoff[1] and ***Senseless Panic*** by William M. Isaac, former chairman of the FDIC[2]. The former focuses on the central role that debt levels have played in causing financial crises, including the most recent. The latter highlights how government incompetence in dealing with this financial crisis, was responsible for the public losing confidence. This led to a panic which prompted massive government intervention. The result was a huge increase in deficit spending, sparking further concerns about the level of our national debt.

But what was behind the increasing debt levels in the first place? Individuals, publicly traded corporations, state and local government entities, charitable organizations and the Federal Government all took on massive amounts of new debt over the past 10 - 15 years. Why? We don't pretend to have all the answers. But one of our own stock market valuation tools will uncover a cause that we believe, has been largely overlooked by the news media and other advisers. This is our lead-off article.

Finally, we give a 2010 year-end update to our model portfolio for very conservative investors: ***The Castling Defensive Portfolio***. This asset allocation of actual, low cost, no-load mutual funds has now been tested over an 11 year period from 2000-2010.   In a departure from conventional investment advisers, we developed this portfolio based on the concept of ***target return***. We searched for the lowest risk portfolio, with the highest probability of achieving a 7.2% net pretax annualized return, across many rolling periods.

Using 1970 to the present as our date range and multiple asset classes, we put together our own proprietary database, resulting from over 17 billion portfolio calculations. This helped to provide us with the blueprint.

We then recommended using only high quality, low cost, no-load investment products from firms that demonstrate a commitment to good stewardship. These are firms that we nonetheless maintain a strict policy of not creating affiliations with. In other words, ***we avoid conflicts of interest, not rationalize them away, as conflicted advisers do***.

Information about this asset allocation and fund recommendations is offered completely free of charge, as a way of demonstrating the analytical approach we perform for our clients, in constructing their investment portfolios.

Have a question, comment, suggestion, criticism or just plain feedback? We would like to hear from you. Please contact us by email, post or telephone as shown below.

Castling Financial Planning, Ltd. was created as a unique, fee-only hourly non-product selling and non-AUM based investment adviser and financial planning firm, that is still very affordable for Middle America. We do not engage in conflicts of interest (and prove it), never set asset minimums and welcome all clients. Less than 1% of all financial advisers are both hourly and affordable for Middle America.

Do you currently have an adviser who says he offers you "free" advice? We are so confident that we can save you money over your current adviser (based on your total costs), that if we can not demonstrate how during our initial meeting with you, we will offer to perform your financial planning services in 2011 without charge, completely pro-bono.

"Free" advice is worth exactly what you paid for it. How do you separate where the sales presentation ends and the analysis begins? Castling Financial Planning, Ltd. advises everyone to stop paying for the privilege of buying a financial product, through commissions and sales loads. We also disagree with the concept of paying asset management fees to a AUM based adviser. Does he actually spend a great deal of time working on your finances? By definition, he has an obligation to provide "Continuous and Regular Supervisory or Management Services" for your securities portfolio[3]. Good luck finding a definition for "continuous", other than having this apply to the continuous fees YOU pay.

We believe financial planning services should be paid for in the same manner as your accountant, dentist or lawyer. You pay each based on their time expended and for their professional expertise, not as a percentage of some amount. This is partly why each is considered a true profession, while the Financial Advisory Industry struggles along with endless conflicts of interest, scandals, questionable motives and some truly awful advice.

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Our Approach to Stock Market Valuation: Reversion to the Mean and Let's Blame it on Y2K!

We believe that a few basic principles go a long way to explain markets, the economy and much more. However, none of these tools allows us to predict accurately at the "event" level.

One of these concepts is called "reversion to the mean". Simply put, asset returns are not expected to stay overvalued or undervalued indefinitely. At some point, their valuations must revert to their long run mean. How often, when and by how much, can not be answered with accuracy.

To show this graphically, we created our own estimate of the valuation of large cap US equity. It is commonly recognized that the "average" annual total return of the S&P 500 index of large US stocks is "about" 10%[4]. The fact that this statistic varies slightly, with the exact time frame under analysis, does not invalidate the concept. If we take the difference by which the actual total return differs from 10%, we can see stocks getting overvalued some of the time, undervalued at other times and staying (roughly) fairly valued the rest of the time.

For our analysis, we needed to start at some point which we could call "fair value". For various reasons, we chose January 1, 1970. Some of our readers may disagree with this conclusion. Others may even be nodding off at this point...sorry.

Suffice it to say that we did not have a pure bull or bear market at that time. NASDAQ was just getting started. Earlier data for some of our asset classes was either not readily available or was not of high quality. So we chose 01/01/1970 as the starting point, just as we did for our proprietary asset allocation database.

What may not be well known is that the annual standard deviation (a statistical measurement of variation from the mean or average value) of those annual returns is "about" 20%[4].

By using our starting point and then taking the difference between actual return and this long term average, we plotted the degree to which the stock market was over or undervalued. This is depicted in Figure 1. We added the red dashed lines as "upper/lower control limits" at approximately one standard deviation distance from the wonderful 0% line. In a perfect world, we would see the stock market deliver a 10% per annum return, without fail. Year after year. The values displayed on the chart would then be a flat line on 0%.

But in our real world and not some Bernie Madoff, made-up world, this never happens.

As a result, the connected points represent the year by year level of over or undervaluation.

Above the upper limit dashed red line, we consider the market to be overvalued. Below the lower limit dashed line, we consider the market to be undervalued. Within the upper and lower dashed lines, we conclude neither is true and that the market is within a broad range of "fair value".

The concept of reversion to the mean implies that stock market valuation will always correct from an over or undervaluation condition. From a visual standpoint, this means that if the graphed line lies above the upper limit, it will definitely move lower, <u>at some point</u>. If the graphed line lies below the lower limit, it will definitely move higher, <u>at some point</u>. It is extremely uncertain when this reversion from the trend will take place. As a result, we do not recommend this as a market timing tool. Then again, we do not recommend market timing in any investment portfolio! Look where we placed the arrow. The rest of the graph depicts some trends or drifts and appears to be centered around our plus or minus one standard deviation limits. But something started happening by 1995. Stock market valuations started going up, almost in a straight line. By the end of 1999, according to our estimates, valuations on large cap US stocks were almost +175% above fair value.

This had the effect of increasing the risk investors faced, while also changing long term perceptions. We recall hearing often the phrase “It's different this time”, to describe why the stock market should not be considered overvalued.

Castling Financial Planning, Ltd. believes that for the market to have gotten this richly valued in such a short period of time, some extraneous forces must have been at work.

During this time, work on fixing the Year 2000 problem on worldwide computer systems was undertaken. Corporate upgrade cycles were dramatically shortened, since Y2K was a deadline that could not be missed. The rise of the Internet occurred during this time and should not be minimized. But we believe that Y2K was the essential catalyst. Businesses simply did not wish to spend millions of dollars just putting two extra year digits into aging computer code. Instead, they largely chose to upgrade. This was also an attempt to leapfrog the competition. It meant not only implementing Y2K compliant applications, but also systems that could do other things, such as electronic commerce over the Internet.

The Internet existed long before Y2K was recognized as an issue. While the invention of the World Wide Web by Tim Berners Lee in the early 1990s was an essential innovation, it was the integration with back office systems and online transaction security that made e-commerce a reality.

We feel that a lot of the economic activity that took place was merely borrowed from future years, thereby cannibalizing this later demand. Economic activity slowed in 2000 and quite significantly, by the end of that year. A capital investment led recession was on its way.

The terrorist acts of September 11, 2001 made a slow economy grind ever more slowly.

Government reaction and intervention to the recession resulted in significantly lower short term interest rates and ever more lax lending standards.

A bubble, having been burst in stocks, started to appear again in real estate. By 2007, the real estate boom was over and the financial crisis was taking shape.

We do not think that the stock market was severely overvalued at the market peak in October, 2007. But it was definitely overvalued, having not reverted back to the mean, from the stratospheric heights of 1999-early 2000.

Many market forecasters, investment advisers, publicly traded companies, individual investors, charitable institutions, state and local governments and even the US Federal Government, failed to head the warning of reversion to the mean. Members of both political parties patted themselves on the back, while budget surpluses rolled in. Government spending went up enormously during the decade of the 2000s.

We strongly believe that Federal Government surpluses should have been a warning sign, not a reason for bipartisan rejoicing. Sound strange? This train was running out of steam.

Pensions are a particularly good case in point, both in the private and especially in the public sector. Overly optimistic forecasts about investment returns ("it's different this time, right?") caused policy makers to promise more and fund less, since the assumption was that the market was going to give great returns.

Reversion to the mean meant that markets would turn eventually. Unwary investors and policy makers were caught blind sighted, as if led to the edge of a steep cliff.

Who is to blame? Everyone who assumed that they understood investing , but were unprepared for the consequences.

Not only did so many fail to heed warnings that the 2000s decade would see a reversion to the mean, but they actually increased their risky bets. This had a compounded effect in the opposite direction. Many market participants, including many professional investors, expected their portfolios to return 10-15% per year, indefinitely.

Why bother funding pensions to the extent that was done earlier? Why not increase government spending several times the rate of consumer price inflation? There's no danger, right? It's different this time, right?

Ouch!

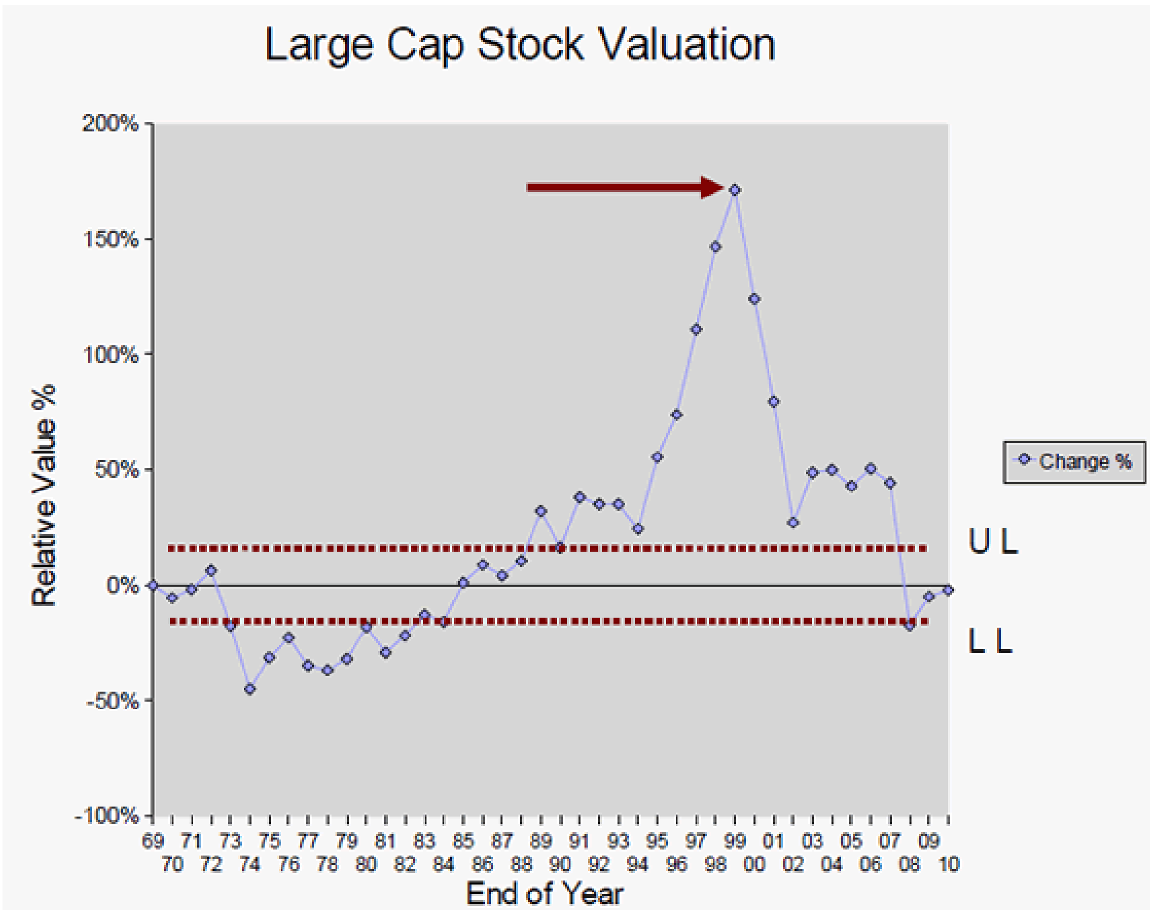
A focus on reversion to the mean should have resulted in caution, as market values increased in the later 1990's. Spending should have been restrained. Promises should have been tempered with reality. Pensions should have been funded while maintaining less rosy forecasts.

In studying and using our valuation tool for the past couple years, we have drawn a number of conclusions and we thought it would be useful to share these with you:

1. Markets can stay over or undervalued for significant lengths of time. Don't bother predicting at the event level.
2. You can still lose money even when the market remains overvalued.
3. You can still make money, even when the market remains undervalued.
4. An overvaluation condition does not call for getting out of the market or engaging in timing. it just requires exercising ever more caution, as markets go up in relative value.
5. So called exogenous events can exert a huge influence over a number of consecutive years. We believe that Y2K was one of the most significant negative factors of the past several decades. However, most people think Y2K was just a big nonevent.
6. Over the last forty years, the market was overvalued (judging by the area under the curve but above the upper limit) much more than it was undervalued. However, the moaning and groaning heard during bad times tends to be remembered more than the euphoria.
7. Fewer people seem to remember all the major positive years while they cope with the major negative ones. Why? One answer is that while chasing performance, these folks missed a lot of the market's move upward. By the time they invested, the market had already run up. So they got in just in time to get "hammered".
8. "It's different this time" philosophies seek to rationalize high market valuations as being justified and are not worth the hot air of those who belch them out.

9. Since reversion to the mean is not something that will always show itself over a short time period, many will succumb to the temptation and throw caution to winds, just as they should be doing the opposite.

Figure 1



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What is "Castling"?
Why do We Call it Our Philosophy and Not Just a Chess Move?

Long before starting **Castling Financial Planning, Ltd.**, my wife Lucja and I developed some loan amortization software called ***L'Amort***, in the early 1990's. One of its primary features was the ability to generate dynamic amortization schedules, that took into account the effects of single or recurring loan pre-payments.

In discussing this with many people, I was a bit troubled by some of the responses I kept hearing. When compared with "other investments", the "rate of return" earned from paying down one's mortgage was considered too low.

This did not sound right to me. One of the more visual retorts I came up with, was the following. A ***Porsche 911*** is a great car, but compared to "other station wagons", it doesn't have much cargo space. This elicited some blank stares or nagging replies, "Well everyone knows that a 911 is not a station wagon" True. This was my point.

Mortgage pre-payment is really a form of forced savings. It is not an investment. As a result, it can not be compared to other investments. My point was about making a distinction between savings and investing.

The central idea behind savings lies in the safety and certainty of principal (though this is really nominal principal, which is not protected from inflation) and certainty of a known rate of return. The central idea behind investing is uncertainty. How much return will I earn? When will I see this return? Will I be able to convert my investment back to cash? Will I get my principal back? When? If uncertainty were removed from investing, it would cease to be investing. Some "investments" are touted as being "guaranteed". This betrays the very notion of investing. Such guarantees are not free and may have limitations. All of this affects your rate of return.

In January, 2001, I did something I am not prone to do. I called into a radio show from Boston. The resident "financial guru" was making it well known how much he disliked mortgage pre-payment as a general concept. He conditioned the audience to expect 12% returns from the stock market.

I was, first of all, mighty surprised that they took my call. When I explained that I disagreed with the guru and that he was not making a distinction between savings and investing, he rather sheepishly replied "What's the difference?". The rest of the call went downhill from there. Other than some personal remarks aimed at me, the guru and his radio host really just didn't "get it".

Academically speaking, one could think of all such vehicles as being investments. However, any valid comparison of potential returns would need to be made on a "risk adjusted basis". Savings carries no risk to nominal principal, or almost no risk. We don't think of saving for a down payment on a house and then one day opening up our bank statement, only to see the amount cut in half, from a month earlier.

Savings and investments are truly different. We can and should hold both. We can recognize the distinction between the two. <u>Because of that distinction, one can buttress the other</u>. For example, a savings cushion of two years worth of expenses in retirement, can lessen the drain that a static withdrawal rate has on an investment portfolio during a down market. When the market eventually recovers, some of that new found growth can be siphoned off to rebuild the savings portfolio. One supports, or buttresses, the other.

In 2002, this led me to search for a term to describe this. While we did not invent the concept, I think that we at least attempted a new name for it: "***castling***".

The term originates from chess. It is a simultaneous move involving two pieces on the same side: the king and one rook. Both pieces are fundamentally different and carry different weightings. Without the king, the match is lost. The purpose of castling is to protect the king and simultaneously make the rook more active[5]. The rook supports the king.

While I imagined saving and investing as the rook and the king, respectively, I started thinking about whether there were other such distinctive assets, even if we could not measure them on our personal financial statements. This led me to apply the label of "meta-asset", to what I was looking for.

After thinking about this on and off over the course of the next two years, I came up with the following seven meta-assets, in total. I tried to break this down into more elements, but these seemed to cover everything I could imagine impacting our financial lives.

1. Investments
2. Savings
3. Job/Business Skills
4. Life Skills
5. Ability to Manage Money
6. Health
7. Time

Some things, like insurance, were folded into the Ability to Manage Money. While valuable as a means of transferring risk, insurance is not considered an asset, unless there is some underlying cash value. Typically, if nothing bad happens (i.e. a covered peril), some asset does not automatically grow in value.

In future editions of this newsletter, we will explore each of these meta-assets, see how distinctive they are and explain why we firmly believe that the person who optimizes these seven meta-assets, stands the best chance to live a financially secure, independent and resilient life.

Life is about balance. Blindly maximizing any one of the seven will be to the detriment of one or more of the rest. But utilizing each one of these to assist in improving the others, will lead to an overall better result. Some would call this synergy. We like to call it ***castling***. This is the life planning philosophy we live by and evangelize to our clients. It also sets us apart from, and often at odds with, product selling and AUM based advisers.

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Castling Defensive Portfolio: 2010 Year-End Update

To review what is in the ***Castling Defensive Portfolio***, please refer to Table 1[6,7]. While we reserve the right to potentially change the selected funds and percentage allocations, these weightings are the result of comprehensive research using our proprietary asset allocation database. We review rolling period returns. Each subsequent year adds more valuable data, but on an incremental basis. We do not give more credence to the recent past, nor do we try to predict the future at an event level. (We'll leave the latter for those who claim they have crystal balls and then look on with a humorous grin as the results of their predictions come tumbling down to earth).

Table 1

	The Castling Defensive Portfolio:	**Ticker Symbol**	**% Allocation**
1	FDIC Insured Certificates of Deposit (Avg. of High Yielding)	Bank CD's	9%
2	Vanguard Short-Term Treasury Investor Shares	VFISX	9%
3	Vanguard Short-Term Investment-Grade Investor Shares	VFSTX	9%
4	Vanguard Intermediate-Term Treasury Investor Shares	VFITX	12%
5	Vanguard Inflation-Protected Securities Investor Shares	VIPSX	12%
6	Vanguard GNMA Investor Shares	VFIIX	11%
7	Vanguard Wellesley Income Investor Shares	VWINX	11%
8	Royce Special Equity Investment Class Shares	RYSEX	15%
9	Vanguard REIT Index Investor Shares	VGSIX	8%
10	Vanguard Total International Stock Index	VGTSX	4%
	Totals		**100%**

The ***Castling Defensive Portfolio*** is our model allocation for very conservative investors whose required rate of return is 7.2% pretax, net of mutual fund fees and expenses. Our measurement criteria is the rolling period of five years and multiples of five years. We must stress that no investment is certain and no assurance can ever be made (by us, or any other adviser) that any particular return can be earned over any given time period. Investments can lose value, including principal.

Our model portfolio provides the highest probability of achieving a ***7.2%*** net pretax annualized return, at the lowest risk level, of any investment portfolio we have ever researched. Please refer to our Summer, 2010 Newsletter for more details, or contact us for further information.

In 2010, our model portfolio had a total return of ***10.5%***, easily surpassing its performance target.

How do we look? The long term return of this portfolio compares favorably to some high quality funds.

We chose to compare it with the Vanguard 500 Index to simply see how this index of large cap US equity underperformed expectations, prompting some to call the time period “the lost decade”.

Wellington is a superbly managed balanced fund that follows a basic 60%/40% “classical asset allocation”. Wellesley Income is an even more conservatively managed fund that maintains roughly a 35%/65% stock to bond balance.

Please note that all three of these funds are likely to outperform our model portfolio during bull markets, because we purposefully held down our equity exposure to a super low 31%.

As a result, our model portfolio barely lost ***6%*** in 2008, the only calendar year loss during the last eleven year period. In addition, it achieved its overall objective, with a ***7.74%*** annualized total return, from 2000-2011. Cumulative returns are shown in Table 2.

We proudly stand by our ***target return*** concept as something whose time has come!

Table 2

11 Year Cumulative Total Returns (2000-2010):

Castling Defensive Portfolio:	127.03%
Vanguard 500 Index (VFINX):	3.60%
Vanguard Wellington (VWELX):	101.48%
Vanguard Wellesley Income (VWINX):	116.76%

Of course, your required rate of return (“R-cubed”) may not be ***7.2%***. Do you need help in figuring out what your R-cubed really is? Or help in determining the asset allocation with the highest probability of achieving it? With the least amount of risk? Or help in selecting high quality, very low cost, no-load and no 12b-1 fee mutual funds, in order to implement it with? Do you know what a 12b-1 fee is and whether you have been paying it for years?

For help with these and many more questions, please contact us. ***Really affordable, non-conflicted financial and investment advice is now possible with Castling Financial Planning, Ltd.***

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References

1. Reinhart, Carmen M. and Rogoff, Kenneth S. (2009). This Time is Different: Eight Centuries of Financial Folly, Princeton, New Jersey: Princeton University Press.

2. Isaac, William M. (2010). Senseless Panic: How Washington Failed America, Hoboken, New Jersey: John Wiley and Sons.

3. Securities and Exchange Commission (SEC): FORM ADV (Paper Form) Instructions: Uniform application for investment adviser registration, Instructions for Part 1A, pages 5-8, available at: http://www.sec.gov/about/forms/formadv-instructions.pdf

4. Ibbotson Stocks, Bonds, Bills and Inflation (SBBI) Classic Yearbook. (2010). Chicago: Morningstar. No chart, table, graph, picture, data series, datum or calculation have been reproduced from this work, in the creation of this report.

5. For more information about the origin and definition of the term “castling”, please refer to the Wikipedia article at: http://en.wikipedia.org/wiki/Castling

6. Information about all Vanguard funds, including their performance, was obtained through the Vanguard Financial Advisor Website. This same information is available to investors at: https://personal.vanguard.com/.

7. Information about the Royce Special Equity Fund was obtained from their Website and is available to investors at: http://www.roycefunds.com/.

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http://www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_OrgSearch.aspxh

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Click on the "Illinois" link showed on the next page.

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Lastly, we encourage you to download our Form ADV Part 2 Brochure, from the SEC Website. It is important to note that many advisers do not make this important document available until after you contact them, or just before you sign an advisory contract with them. While this behavior is technically legal, we find it to not be in the best interests of clients.

Our brochure covers our advisory services, approach to clients and also our very affordable fee schedule.

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