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Late Spring 2013 Newsletter:

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Stock Market High: Real, Inflation Adjusted, Nominal, "Numb-inal" or What?

You probably have heard how the US stock markets hit new record closing highs this past May, on both the Dow Jones Industrial Average (DJIA), as well as the Standard and Poor's 500 Stock Index (S&P 500®). Since then, market prognosticators, pundits, soothsayers and tea leave readers of both bull and bear extremes have made their unique cases on why the market is going to continue going up or is a bubble ready to burst. Others talk about a long overdue correction and that the most recent developments point in that direction.

So who should you listen to? This is kind of a trick question, since we would naturally like it if you simply listened to us! ***Castling Financial Planning, Ltd.*** has, from its inception, rejected what we call "Event Level Prediction". While someone who guesses correctly the next move in the market will profit handsomely in the short term, we simply respond with the following question: "OK, then what?"

The Event Level Predictor (ELPer) is a bit of an elf. He or she is all over the business news media on days when the market responds in the direction that he has previously staked out and is conspicuously absent on days when the market turns in the opposite direction. At the very least, the ELPer suffers from the disease of "recency". This means that he overemphasizes what recently happened, as being more important to the future, than it actually is. What's worse, the ELPer is contagious. He can infect you with his emphasis on recency, clouding your long term judgment.

The ELPer claims to be accurate. But we have long maintained that for the ELP to be of any lasting value, he or she needs to be: accurate, consistently accurate and consistently accurate for an indefinite period of time. Timing is essential. Please keep in mind that a broken clock is correct twice per day. Put another way, would you hire someone simply based on the fact that he correctly predicted the 1987 stock market crash? Of course, we're still waiting for that next prediction of his to come through.

As an example, we'll cite author and market commentator, Harry Dent. We are not trying to pick on Harry alone and he has made some very worthwhile points that should be discussed. But he wraps it all up in a tight bundle that will leave the unaware thinking that he is the ELPer who has got it all together.

In his 1999 book, **The Roaring 2000's**, Dent claimed that an economic boom would be upon us in the last decade, due to demographic factors. In reality, by the time it ended, this was more often called the "lost decade", not the "boom decade"[1].

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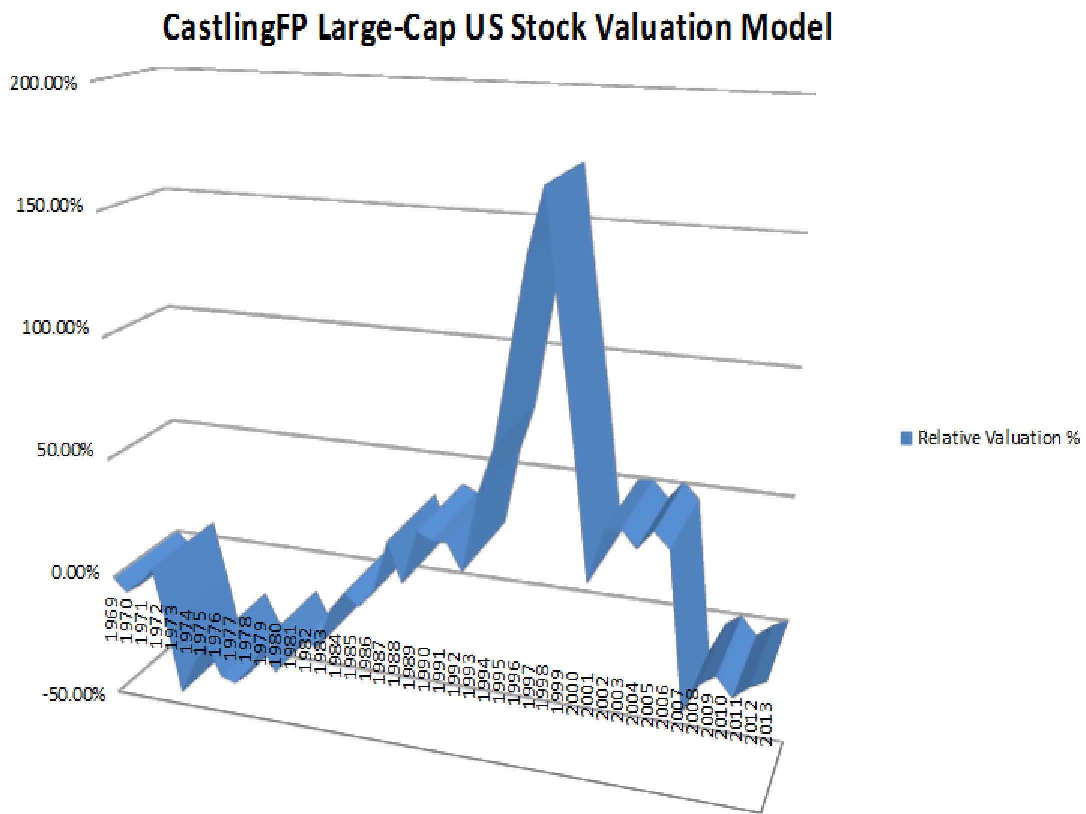
Some years later, Harry was at it again, warning us of a coming apocalypse in: **The Great Depression Ahead**[2]. Although the stock market was low and going lower in January, 2009 when this book was published, the market low was established in early March of that year. Had you hurriedly sold off your beaten up stock portfolio in early 2009, fearing depression, you would probably have realized huge losses. By contrast, the following years did not materialize a depression, least of all in the stock market. Instead, large cap US stocks have more than doubled in just the last four years. So much for the "new normal".

To be fair, we do not think the sky right now is pure blue and the pot of stock market gold is just over the rainbow, ready to cash in at the end of this year. Instead, <u>US large cap stocks based on the ***CastlingFP*** Valuation Model, are simply in a range of fair value (between +/- 20%, as shown below), but are definitely no bargain</u>.



We would not be surprised if the major indices pulled back by 5-10% sometime this year or early next. Are we predicting it? No way. We don't generate ELPs (and no, we don't resemble that remark).

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So how do we make sense of this? Please take our advice:

1. You need to be ready for a Bear market every single day.
2. You need to be ready for a Bull market every single day.

How can this be possible, you may ask? For starters, do away with an emphasis on event level prediction (and by extension, ELPers).

CastlingFP's focus is on what we call consistency based investing whose foundation is rolling period analysis. This allows us to focus on two of our favorite concepts:

1. Reversion to the mean.
2. The Central Limit Theorem from statistics.

By creating a proprietary Asset Allocation Database, we have been able to perform our own research, which does not follow the Wall Street group think or other ELPers who are just "sure" of what the next twist or turn will be.

This reminds us of the deer who constantly gallops back and forth across a tiny road separating two halves of a forest. Each time he crosses without being struck by a vehicle, he breathes a sigh of relief, but then also builds up confidence based upon "Hey, there's no risk!" Of course, the last sprint doesn't turn out that well...

Seriously, the issue of making investment decisions is very similar. The more you focus at the event level, the more decisions you will need to make. Every decision carries the risk of being "wrong". In fact, these event level decisions are really two headaches for the price of one. Selling can be felt as the easy thing to do. But we can always ask next: "OK, then what?"

Every buy or sell decision made outside of a predefined asset allocation really requires two decisions. When to sell sets up the invariable decision of when to buy next and vice-versa. More decisions means more things can go wrong.

So our advice is to always invest via a predetermined asset allocation that has the highest probability of achieving your required rate of return (net of fees and expenses), but with the lowest level of risk. Any remaining risk is still very real and needs to be evaluated, based upon your: willingness to take risk; ability to take risk and above all, your need to take risk.

We emphasized the word "risk" in the previous statement, since ***CastlingFP*** has found that most people have a vague understanding of risk, which results in one of the biggest

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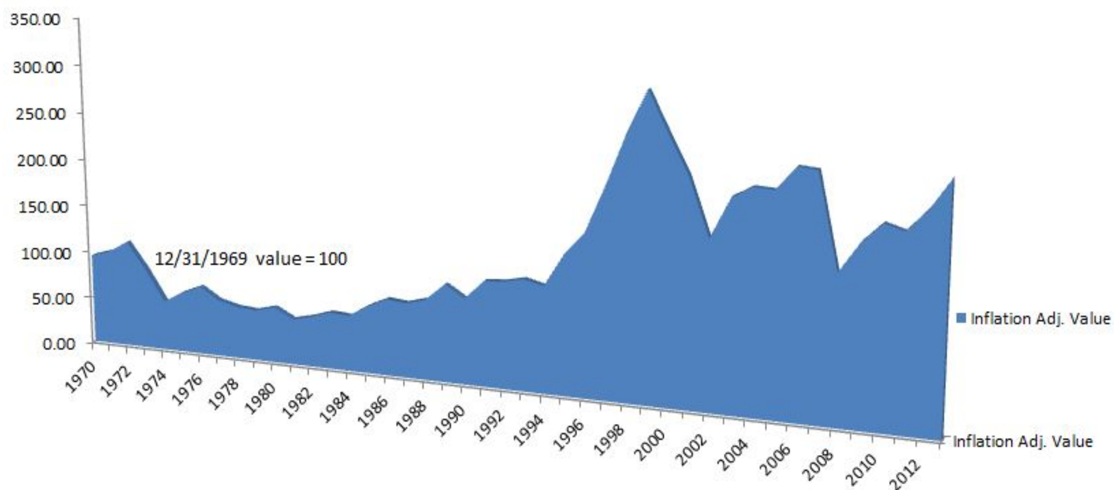
dangers they will face. A few folks learn and experience enough on their own to be do-it-yourself investors. For everyone else, we recommend professional level advice, free of commission and asset based conflicts of interest.

So let's get back to the initial question: Did we really set new market highs recently? The answer is that it depends (OK, we'll explain). It is true that the S&P 500 closed around 1669 on May 21st. As I write this, we have fallen a bit from this value. So yes, we did hit a new high in purely nominal terms. In March 2000, the index closed well over 1500, but never even made it to 1600, by contrast.

But is the level of 1600 in 2013 as good as 1600 in 2000? Absolutely not, due to the time value of money. While the index is not expressed as a price, it does represent market value of these 500 stocks. This cash dollar equivalent of S&P 1600 this year is not as valuable as it would have been in 2000.

We took this a step further and created a chart that adjusts the nominal level for the change in the Consumer Price Index (CPI). As the chart below shows, we have not yet surpassed the inflation adjusted value from 2000.

So is this the end of the story? Not entirely. The index does not include dividends, which make up a valuable part of the total return of investing in large cap stocks. If we use total return and still do our CPI adjustment, we come up with the last chart, below.



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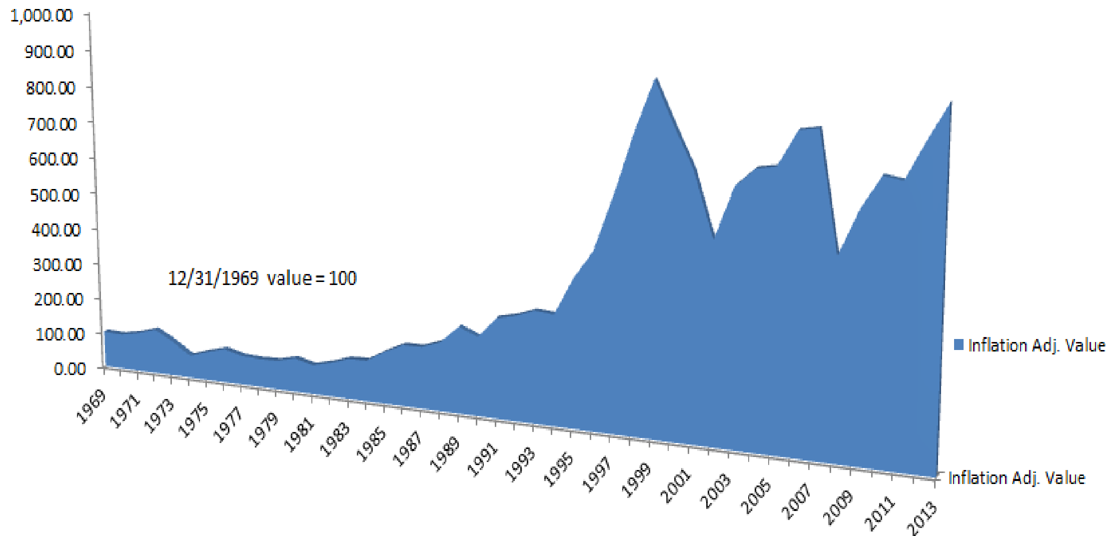
CastlingFP's Model for Inflation Adjusted Returns of Large-Cap US Stocks



Here we see that the long term investor who has reinvested all dividends, has been rewarded (but barely) by surpassing the previous peak in 2000. 2007 does not compare. But what is most striking about this chart is that we see the enormous amount of volatility that this patient investor has had to endure along the way. <u>Therefore, we strongly believe that the most rational way to deal with this volatility is not through market timing or picking "hot/right/cool" investments. The best answer is asset allocation, as part of an overall Investment Policy Statement, executed in a low cost and conflict free environment.</u>

If these terms seem unfamiliar to you, please ask us about how we help you achieve your goals through an affordable, hourly approach to financial planing and investment advice.

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Questions to Ask Yourself if You Have Previously Had a Bad Investing Experience

Unfortunately, many folks missed out on the big gains of the stock market over the last four years. The worst case was probably not those who were out of the market in 2007. Oddly, many people working with asset based advisers back in 2007 were put into volatile investment portfolios, unprepared for what was about to happen. Then right as the market was in the bottoming process, many of these people simply could not take the pain any longer and got out.

They sold, at or near the bottom, on all or part of their portfolios. Some picked up and moved their money to different advisers. Some bought into the lure of "paychecks for life" and became involved in low risk but very low yielding annuities. Our Winter 2013 newsletter has a detailed article about annuities and the risks of the current interest rate environment.

Many folks gave up on investing entirely, calling it gambling (or worse).

Whether on your own or with an adviser (commission based product salesperson, asset based etc.) here are four critical questions to ask yourself.

If you can not answer each one with an unequivocal "yes", then you can not judge investing negatively as being gambling or too risky, any more than a person who gets behind the wheel of a car , has never taken a driving lesson, but expects to get from point A to point B today and finally quits in frustration and fear.

If your old adviser did not follow the approach inherent in these four questions, we seriously wonder whether you should retain him or her. If you have been your own DIY adviser and do not understand the process inherent in these four questions, we recommend you get some objective, non product selling, non asset based advice.

The future you save is your own. Ask us. Our motto has always been: "***Helping You Secure Your Future***".

- Q1. Did you invest according to a predefined asset allocation for which sufficient research was undertaken, to show that it had an expected rate of return that matched your required rate of return and that its risk level was within your willingness/ability/need tolerances for risk?

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- Q2. Did you ease into this asset allocation using some form of dollar cost averaging or value averaging, over a period of time measured in months or years?
- Q3. Did you re-balance back to this predefined asset allocation annually?
- Q4. Did you hold this investment portfolio for a length of time which was established when you started investing (i.e. when you identified this predefined asset allocation)?

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Excessive Risk Taking Caused the Financial Crisis? No, the Tooth-Fairy was More Responsible!

There seems to be general agreement that the financial crisis of 2007-2009 originated with real estate. A bubble in most real estate markets burst after peaking in 2006, causing major ripple effects throughout the economy. Many homeowners who lost their jobs could no longer afford to make their mortgage payments and defaulted. Some even simply walked away, creating a glut of homes that no one wanted, driving down prices.

We wrote about a residential housing recovery in our Winter 2013 newsletter. The indications are that our analysis is holding up nicely.

Many of us would not like to revisit this difficult chapter of American economic history. And yet, if we do not remember the past (certainly the recent past), we may be condemned to repeat it, paraphrasing the great philosopher, George Santayana.

CastlingFP spends a lot of time analyzing risk. In fact, if there is one major deficiency with the do-it-yourself approach to financial planning and especially investing, it's the lack of emphasis on analyzing risk, exhibited by gung-ho DIYers.

What is the nature of risk? Even the Wikipedia article on "Risk" carries the warning (uh-oh, dare we say risk?) that some other expert from another field needs to review this article for accuracy.

Broadly speaking, the concept of risk is that any action (including inaction) can lead to an undesirable outcome[4]. This leads us to conclude that the undesirable result, if it were to come to pass, must somehow make us worse off in a materially significant way.

For example, losing a friendly game of Monopoly results in the loss of Monopoly money, not US Federal Reserve Notes. So it does not appear to involve risk. By contrast, stashing the down payment (saved up carefully over a number of years of diligent weekly saving) for the upcoming purchase of your first home, in the stock market in August, 1987, appears to be quite the opposite on the risk continuum.

We can only learn from our study of how things work, based upon how they have worked in the past. An event that has already occurred is therefore not "risky", it is simply a fact. The probability of its occurrence is 100%, since it already happened But it should also give us an indication of what is possible and also (the degree of) likely to happen in the future, if we study it closely enough.

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For example, life insurance is not protection against death, since eventual death is a certainty. It is really a protection against the risk (uncertainty) of when death will occur, especially if its occurrence during a particular period of time would be a financial calamity for those related to the deceased.

So who took excessive risks that led up to the real estate bubble? We've studied this and concluded that it was moral hazard, not risk taking, that led to the housing bubble and therefore, the financial crisis.

The concept of moral hazard is related to risk but is fundamentally different, in that the party taking what would otherwise be considered the risk, does not face the true consequences of the potentially undesirable outcome resulting from that risk[5].

Here is a real life example. If someone offered you a loan to buy a home for no money down, would you take it? Knowing how the housing bubble turned out, you may be very hesitant. But bathed in the warm glow of steadily appreciating home values in the first half of the last decade, your answer may have been different. But how much risk were you really taking? The answer is: proportional to the size of your down payment, assuming the lender had no recourse but to take back the property, in case of you defaulting (this is the typical case, you don't face wage garnishment or seizure of other assets).

The vast majority of sub-prime loans and cash-out refinancing deals that ended in default, were also situations where the borrower put up little in the way of a down payment or wound up with little resulting equity.

Those borrowers who took a cash out refinance, splurged on luxuries that provided little or no lasting value and ended up losing their home in the process, did indeed take a grave risk and failed miserably. But they also had a large amount of cash in their hands at one point. Did they seek any professional financial advice before making these decisions? Was their only advice coming from the person selling them on the deal? If so, we'll repeat our usual recommendation:

Don't take financial advice from anyone who sells you a financial product. No exceptions. (We can explain ourselves, but this would be getting off the current subject. The first edition of this newsletter covered this topic in detail. Please ask us if you would like a free copy.)

If the cash out "re-fi" folks did take risk with their owner equity, then what about all those people taking new loans? It is precisely these borrowers and their lenders, that form the focus of this article.

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The growing trend in banking since the Savings and Loan crisis of the 1980's and early 1990's had been for government sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac, to buy mortgage loans on the primary market (from the lenders) and to package them into mortgage backed securities (MBS), to be resold in the secondary market. US government policy became more lenient in terms of lending standards, especially with respect to down payments, since around the mid 1990s. The root cause of this problem cuts across political party lines[6].

It is important to note that historically speaking, residential housing and home mortgages were both very stable and relatively lower risk asset classes. Government policy helped to shift the demand curve for lower cost housing, since most of the subsidies, lenient terms, low or no down payments, were concentrated among those buyers of lower priced homes. This gave an incentive for those borrowers to go ahead and buy. The lenders were simply interested in making sure that they could then resell the mortgage in the secondary market. As long as a Countrywide or a Washington Mutual or a Citi Bank or a Bank of America could then resell the loan, all was good. They earned fees on every mortgage loan originated, resold the loan to a Fannie, Freddie or other similarly functioning entity and then received the funds with which to do it all over again.

So what could go wrong?

Our favorite source of economic data is probably the American Institute for Economic Research (AIER). In early 2012, they published a short piece analyzing home prices over time in the same market, but segregated into three tiers, based on price levels (low, mid and higher priced homes, prior to the bubble).

What their analysis and that of the S&P/Case-Shiller Home Price Index demonstrated, was that the run up in prices was greatest among lower priced homes. The resulting crash and fall in residential real estate prices was also most pronounced among these same homes[7].

While it is a severe disruption and sometimes tragic to see people forced into selling their homes or getting evicted, let's get back to the question of risk. Borrowers who default on their loans and are foreclosed on, while seeing major damage done to their credit scores, rarely if ever face confiscation of their other assets or wage garnishment, to satisfy their mortgage when the value of their real estate has fallen below the unpaid balance. The homeowner simply gives back the keys to the lender.

So who took the risk?

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The borrowers? If the borrower put up nothing or next to nothing as a down payment, then the borrower lost next to nothing. Yes, their lives/residence were disrupted and their credit damaged. This part of the risk equation was still in play. Of course, we can also argue that if they could stall out the foreclosure process, as is the case in judicial states such as Illinois, they may also be able to live in their home, effectively rent free, for an additional couple of years.

No, not the borrowers.

The lender? The financial institution made its fees and satisfied the requirements to sell the loan to the GSE. The recent robo-signing scandal was related to sloppy paperwork during the foreclosure process, but did not show any real problem of up to date borrowers being evicted from their homes. Since the major banks were rewarded with TARP during the crisis, especially for those who needed it most, this seems more like a reward for bad behavior.

No, not the banks.

Fannie and Freddie? They were at the epicenter of the crisis. Their stock price plunged to almost nothing. Obviously, their shareholders took a huge hit. The Federal Government took them over. But previous management, such as Fannie CEO Franklin Raines, got off relatively unscathed. Also, current management enjoys positive feedback from the US government, as they pay back their bailout slowly, the firms benefit from extremely low interest rates and some executives still even get bonuses.

No, not the GSEs.

So where did the risk go? To the non-participants, of course. The US taxpayer saw the total debt to GDP ratio hit 100%, the diligent saver saw a 10% haircut in the purchasing power of their money in banks (2009-2013) and some of the long term homeowners may have seen their home's value fall to at or below what they paid for it, 15 years ago. Were these non-participants the ones who signed on to the risk in the first place? Of course not. Moral hazard was the sludge served up by a government, paving the way to you know where, all with good intentions.

<u>The person who saves diligently and then puts up a 20% down payment on the home of their dreams, is the actual risk taker</u>. And we salute you! Prudent risk taking is what built America!

Our view is that <u>if only there had been 10%-20% down payment requirements in order to get any mortgage, there never would have been a financial crisis</u>. There probably would

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not have been a real estate boom either, but this would have been a small price to pay for avoiding the disaster.

We at ***CastlingFP*** challenge anyone to disprove the above statement. Also, we emphasize that all aspects of your financial life require at least some analysis. Make sure that you either learn how to do this on your own, or seek conflict free help, to determine what course of action is in your best interest.

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Who is a Valued Customer or Client Nowadays?

We recently played “musical chairs” with several of our providers from the category “wired and wireless” that we analyzed in our last newsletter. Generally speaking, these include cable and satellite TV companies, Internet service providers (ISPs), the various telephone carriers and even security monitoring companies. We demonstrated how the typical American household is spending a relatively large part of their budget on such services, compared with just fifteen years ago. (If you would like a copy of that newsletter, please send us an email.)

We examine the somewhat different issue as to who receives the best value from these service providers and why. We include a few commonsense tips on how to negotiate with these companies.

Some of these issues also apply to insurance companies as well. The bottom line is that the cost of acquiring a new customer is relatively high. Once safely in the fold (or clutches, depending on your point of view), does this customer get treated with the same level of consideration? By and large, we think that most of these companies do treat their existing customers with respect. We don't harbor any notion of these companies as being “evil”. Far from it. But we think that the attention and expense directed to new customer acquisition can leave existing, loyal customers feeling that they are being taken advantage of.

We tie this back to the Financial Services Industry and how you receive financial planning and advisory services. Do you feel neglected by your current adviser? Maybe this is more than a feeling. Maybe it's a fact. Do you know why? Here is our take.

Service providers in the “wired and wireless world” are in the business of producing free cash flow. This depends upon attracting and retaining an ever increasing number of customers. They started with huge amounts of capital investment, to create an infrastructure where the marginal cost of running the next customer account is tiny, compared to the fixed costs of running their various networks.

The inconvenience of switching providers is not insignificant, just like with bank checking accounts. You have your life somewhat structured around something or at least, tied into a fixed term contract. Break the contract and you pay dearly in extra fees and other costs.

Providers, because they have their existing customers held somewhat captive, focus on growing their subscriber base. The time tested and successful approach is to offer recurring promotions. Limited time only! Just $19.95 for the first six months! No activation fee! Call now! The overwhelming best deals appear to be offered to the new

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customer, not the long time, loyal (to a fault) customer. The results are obvious. The existing customer may be saddled with a contract, too busy to notice, too complacent to change or last of all, even satisfied with the cost and quality/features of their services.

Bagging a new subscriber is so lucrative, that service providers can offer incentives to third parties, such as retail stores, to hand out gift cards or other discounts, just to sign up the next person.

How do we deal with this? Here is our commonsense approach. Our financial planning objective is that by optimizing these services, you will be able to free up cash flow in your monthly budget, to reallocate to your long term saving and investing goals.

1. Almost everyone needs some type of budget/sending plan/cash flow tool or tracking device. We like to use a very flexible Excel template spreadsheet that we then customize to fit the exact needs of the client. It's available from us for free, simply by asking.
2. Track these costs by reviewing your current statements. This may involve a lot of unnecessary paper, so we suggest signing up for paperless "e-billing" when possible. This may also make one or two years of previous statements available for viewing. Review how these costs have changed over the last couple years. Think back ten years ago and imagine how much smaller these costs were, as a percent of your household spending.
3. To bundle or not? If you use separate providers for different services, it may be more economical to bundle multiple services. But first analyze how much you will be saving, if anything, AFTER the promotion period has ended. Making a switch simply to benefit from a six month promotion, may be a bad move. However when the provider, such as a satellite TV company, can give you a written quote for each year of a two year contract, you can immediately compare to what you are currently paying. Be sure to ask about (and then add in), various amounts for taxes and fees.
4. Is there a sweetener for this deal? For example, the home hardware retailer Menard's recently offered customers a $100 gift card for new customers signing on with a satellite TV company. If this was the only benefit of a two year contract, it may not be worth switching. But taken together with at least a slightly lower monthly rate, this could all add up to a non trivial amount.
5. Remember that a dollar saved is worth more than a dollar earned. Do you know what gross amount you need to earn in salary or wages in order to have an extra $1,000 cash sitting in your checking account at the end of the year? This depends upon your MARGINAL federal income tax rate, state income tax rate and the FICA payroll taxes. Don't be surprised if it's over $1,600. By comparison, simply

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save $83.34 per month in total, on various wired and wireless services and you're there.

6. Complain, but not too aggressively. Negotiate with your current provider assertively. Call them up and ask to speak with someone in the Customer Retention Department. This person may be in a position to offer you a better deal if you politely threaten to leave. Note their name, the details of the offer or promotion and the date you spoke to them. This may not always work, but it's worth a try. You may be up-sold or cross-sold during this call. It would be advisable to do your homework on your other services before calling, so that you are not forced to make a snap judgment and lock yourself into a new agreement on additional services, simply because they came up with a counter-offer.
7. Be ready to leave, if you can not get a better deal. This does not mean getting angry with them. And I must admit to my share of argumentative conversations with service providers. <u>But planning for the exit was my best action</u>. This includes transitioning service to the new provider(s) as smoothly as possible, to minimize disruption to your family's life, while also minimizing the overlap inherent in carrying two sets of services for an extra day, week, month, etc. Can you simply gather up all the old equipment on one free day and physically take it all back to a service location? Make sure you get a written receipt showing the return of the material in satisfactory condition on that same date and an applicable credit on your account from that day until the end of the current billing cycle.
8. Be willing to come back, but this time as a “new” customer. This means understanding the terms of the new provider's contract, especially when it expires, versus the old company's definition of a new customer. Understand the physical equipment and infrastructure you own or that the old service provider has effectively “abandoned”. For example, my own TV provider switchover gave me a chance to reacquaint myself with every line of coax cable strung in our home. I labeled and tested each, to make sure that I knew where each was connected. I took the responsibility to make sure that a TV service switch would not affect my Internet connectivity. This included the outdoor interface box and understanding how the new satellite signal came into the house. Why? So that if and when we need to switch to another provider and perhaps back to the previous one, we can be ready in minutes. I verified that the satellite company does not come back and rip the dish antenna off the home, after customers terminate their service.
9. To summarize, I know my agreement term is for two years, what the price of each of those years will be and I satisfied other terms required for their best pricing (such as signing up for automatic bill pay and paperless statements). I know what it would take to go back to cable (my previous TV service) and when I should start hunting for new promotions. I could also try a self install kit of the equipment, since the infrastructure is already in place. While the cable company lost one of my services, I negotiated a new service with them, in order to retain

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the same pricing for our Internet connection. This new service was also on promotion, but duplicated an existing one we had. My goal had been to shed this last service because the technology had not improved, nor could we get more favorable pricing, since there was no bundle (it was stand alone).

So we see that we are not powerless. The wired and wireless providers are usually huge corporations, with enormous marketing budgets. But we can negotiate, assert our rights as consumers to choose, move on when necessary and back when it is in our best interests.

Comparing this to the financial planning world, how is your relationship with your adviser? 99% of all financial advisers are paid based on a "push" or "pull" mechanism. Push means to push products to you for a sales commission or load. Pull means to pull in your assets under management for a percentage. Once the push or pull has been completed, how much time is he actually spending advising you and analyzing your financial details? If his compensation does not require you to actually write a check (i.e. automatic fee deduction), you may not realize how much you are paying, especially in light of the amount of time he spends on your behalf (it may be far less than you think).

Whether commission or asset based, these advisers share a unique conflict of interest. Bagging (sorry, "acquiring") the next client may be far more lucrative for him then developing a deeper relationship with you, the existing, loyal client. Why? You're already signed up. Products have been sold. Your assets have been locked up. And it may seem inconvenient for you to switch.

Castling Financial Planning, Ltd. (***CastlingFP***) is uniquely different, because we are an hourly based firm. The existing client is NOT taken for granted, since we respond to the needs and wants of individual clients in a personalized way. While we also look for new clients, the prospective client never sets up a conflict of interest with an existing one. The existing client is paying us for each hour worked on their behalf. And unlike the push and pull advisers, we inherently document every hour we spend on every client.

There is absolutely no proof that commission or asset based approaches are better for clients, net of all expenses, as compared to the hourly model. But they certainly are very lucrative to the commission or asset based adviser.

We can even show you how ***CastlingFP*** is the lower cost alternative, for those readers who are not yet clients. Some people have even tried ***CastlingFP*** while still with their old adviser! We aren't product sellers and we don't take custody of assets, so we can focus on giving advice and doing analysis, the way financial planning was meant to be.

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Of course, you could continue to do the same old thing with the same old adviser (even if that adviser is you) and expect a different result. But that's a different story for another time...

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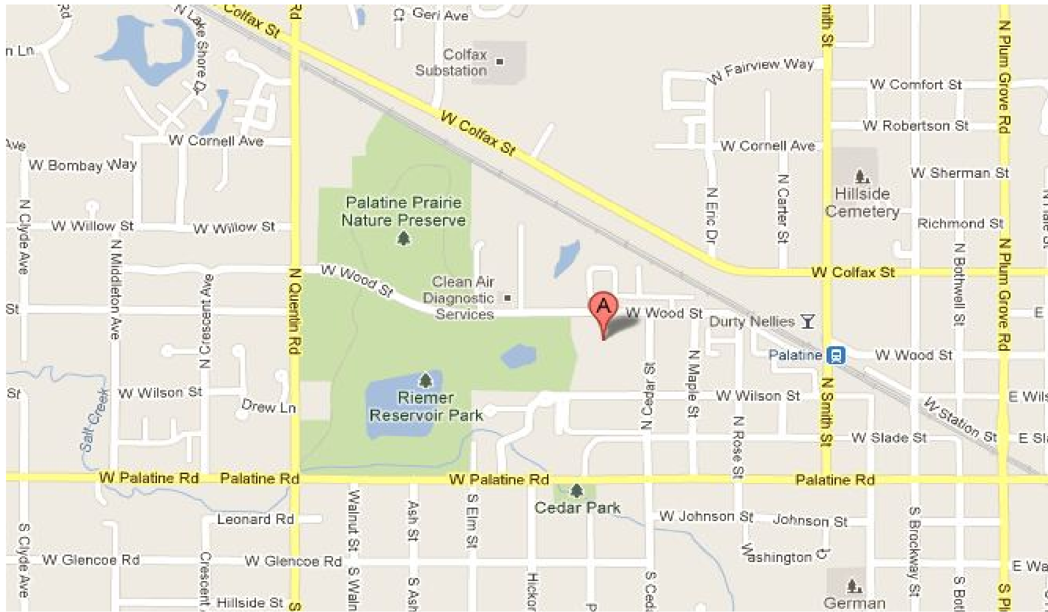

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