Castling Financial Planning, Ltd.

Helping You Secure Your Future™

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Spring 2017 Newsletter:

The Castling Defensive Portfolio had a Solid Year in 2016, but Still Pulled Up Short of its Goal; Time to Dump it, My Fair Weathered Friend?

The Castling Defensive Portfolio (CDP) was our creation years ago, as an example of the analysis we do. It's objective was to find a very low volatility mix of investments that had a good chance of producing an annualized total return of 7.2% (over a rolling period of years), with the lowest allocation to stocks that we could come up with. If successful, this approach would result in a rough doubling of your money every ten years.

The stock bear markets of the early 2000s and 2008-2009 were no problem for the CDP. But today's persistent low interest rate environment? We must admit that this has been the number one constraint on achieving our measure for success. In 2016, the CDP had a total return of 6.77%, missing our bogey by 0.43%. Boo-hoo.

So what about the long game? Over the seventeen year period (2000-2016), the annualized return was 6.86%, still 0.34% away from our goal. Since the CDP consists of only about 31% stocks, it does not share in all of the upside when the equity markets do well, such as recently. On the bond side, when yields increase, bond prices move in the opposite direction, thus cutting into the total return (a combination of the coupon interest and the capital appreciation or depreciation).

When we work with clients, we evaluate their risk tolerances in three different dimensions: willingness, ability and need (to take risk). If something like the CDP is felt to be too risky by the client, then they probably should not invest in the stock market at all.

But with the low interest rate environment coupled with the notion that bond yields may begin to normalize (meaning up), the bond portion may contribute low returns for the CDP, over the next several years. However, we would not change the asset allocation unless we find some strong evidence coming from our proprietary Asset Allocation Database.

Our chief focus has been trying to maintain a very low volatility portfolio, without the need for constant supervision. Our preferred measure of risk is called the coefficient of variation (CV). Quite simply, it measures the variation in returns (the standard deviation) divided by the annualized return. This can be thought of as the “risk per unit of return”. We recommend that if you are investing on your own, you at least investigate this useful metric.

With this in mind, our table nearby shows that the CDP has a CV of only 0.69 over the 17 year period (2000-2016), which is still well below that of the high quality individual funds we compare it to. To invest significantly in equities really means accepting a CV greater than one, perhaps much greater. While there is nothing inherently wrong with a fund delivering this, the level of risk implied may be difficult for some investors to handle. As a result, they may cut and run after a market decline. <u>Bad idea, since they typically wind up selling closer to the bottom, than the top</u>.

The main point to keep in mind is that <u>we can compute CV and get a reasonable picture for an investment portfolio even before the next correction or bear market hits</u>. This does not imply that we are recommending market timing. It is, however, emphasizing that we need to calculate the risk inherent in any investment portfolio and then evaluate whether that portfolio aligns to our three dimensional risk tolerance model. Yes, this may be considered a trial and error process, but so are many other things in life. There is no need for you to feel stuck with a portfolio, that fits you about as well now as your wedding clothes do. It is best to figure this out before you even begin investing.

While we think that the fixed income/bond side of the CDP will remain challenged for the next few years as interest rates perhaps normalize, we still continue to see great value in showing what a very low risk and low cost portfolio can do on its own. As you can see in one of our tables below, the total expense ratio is only 0.19%, which is pretty remarkable considering that six out of the ten investment vehicles are actively managed and only three are index funds. I suppose that the 9% remaining in bank CDs could also be considered "actively managed", but by the individual investors themselves.

Finally, looking at 2017, the slow start for all of the bond funds continues. The overall return to the end of March stands at 1.37%. We would not be surprised to see an aggregate bond fund post a annualized return for the next five years, in the 0-2% range. The mix of the CDP gives you a flavor of other asset classes, including Treasury Inflation Protected Securities (TIPS), which are bonds that adjust their principal and interest with inflation (as measured by the Consumer Price Index).

As it stands, we would definitely not dump the CDP if we were already holding it in a portfolio. But we may want to go back and assess the willingness, ability and need of the investor (to take risk) and see if any of these may have have changed, or if the CDP was ever really suited for that person to begin with.

From the standpoint of the markets and economy, another dismal first quarter GDP growth number was recently announced and then revised upward, to 1.2%. Our overall read on the stock market is that it can only be considered fairly valued if a corporate tax cut is actually implemented. We think this along with prospects for deregulation, are the reasons for the Trump rally since the election. But over the past number of weeks, the bond market has told a somewhat different story. As I write this, the yield on the 10 year US Treasury note stands at 2.28%, which is off its recent peak above 2.60%. There is some concern that tax cuts may be delayed or cut down in size and scope. If there is no tax cut finalized this year, we believe this may cause stocks to correct. There is no need to panic, but the stock market is a true leading indicator of the "animal spirits" in the economy. Meanwhile, bonds tell more a tale of woe and caution.

<u>Understanding what kind of investor you really are is probably more important than understanding the minutiae of the markets</u>. Our CDP only lost money in two years out of seventeen during 2000-2016. In 2015, this was a miniscule 0.22%. In 2008 during the financial crisis, the loss was larger, at 6.15%. However, the turnaround was swift. All of this loss and then some, was made up in 2009. This was certainly not the case for portfolios holding a much larger stock allocation. Would this matter to you?

Identifying your true self as a person who cannot stomach higher volatility would ultimately be a good thing. To thine own self be true. But better to do this sooner and for longer. It is an expensive lesson to learn after markets drop. Plus, when do you buy back in again? The beauty of a rolling period based allocation is that there are multiple portfolios that you can probably live with, perhaps to retirement and beyond.

Castling Defensive Portfolio (CDP) Comparison	2012	2013	2014	2015	2016	2017 YTD
Castling Defensive Portfolio Yearly Returns	7.48%	5.74%	6.71%	-0.22%	6.77%	1.37%
Back-Tested Cumulative Return Since 2000	156.84%	171.59%	189.81%	189.16%	208.75%	212.97%
Hypothetical Growth of $10,000 Since 2000	$25,684	$27,159	$28,981	$28,916	$30,875	$31,297
Annualized Return (2000-2016)	***7.53%***	***7.40%***	***7.35%***	***6.86%***	***6.86%***	***6.54%***
Standard Deviation (2000-2016)	***4.99%***	***4.82%***	***4.65%***	***4.88%***	***4.73%***	***4.77%***
Coefficient of Variation (2000-2016)	***0.66***	***0.65***	***0.63***	***0.71***	***0.69***	***0.73***
Wellesley Income (VWINX) Yearly Returns	10.06%	9.19%	8.07%	1.28%	8.08%	2.20%
Back-Tested Cumulative Return Since 2000	161.54%	185.57%	208.62%	212.57%	237.82%	245.25%
Hypothetical Growth of $10,000 Since 2000	$26,154	$28,557	$30,862	$31,257	$33,782	$34,525
Annualized Return (2000-2016)	**7.68%**	**7.78%**	**7.80%**	**7.38%**	**7.42%**	**7.13%**
Standard Deviation (2000-2016)	***6.55%***	***6.30%***	***6.07%***	***6.10%***	***5.91%***	***5.87%***
Coefficient of Variation (2000-2016)	***0.85***	***0.81***	***0.78***	***0.83***	***0.80***	***0.82***
Wellington (VWELX) Yearly Returns	12.57%	19.66%	9.82%	0.06%	11.01%	3.43%
Back-Tested Cumulative Return Since 2000	135.53%	181.84%	209.52%	209.70%	243.80%	255.59%
Hypothetical Growth of $10,000 Since 2000	$23,553	$28,184	$30,952	$30,970	$34,380	$35,559
Annualized Return (2000-2016)	**6.81%**	**7.68%**	**7.82%**	**7.32%**	**7.53%**	**7.30%**
Standard Deviation (2000-2016)	***11.65%***	***11.65%***	***11.24%***	***11.06%***	***10.73%***	***10.47%***
Coefficient of Variation (2000-2016)	***1.71***	***1.52***	***1.44***	***1.51***	***1.42***	***1.43***
Vanguard 500 Index (VFINX) Yearly Returns	15.82%	32.18%	13.51%	1.25%	11.82%	6.03%
Back-Tested Cumulative Return Since 2000	22.36%	61.73%	83.58%	85.87%	107.84%	120.38%
Hypothetical Growth of $10,000 Since 2000	$12,236	$16,173	$18,358	$18,587	$20,784	$22,038
Annualized Return (2000-2016)	**1.56%**	**3.49%**	**4.13%**	**3.95%**	**4.40%**	**4.49%**
Standard Deviation (2000-2016)	***19.02%***	***19.83%***	***19.22%***	***18.61%***	***18.08%***	***17.54%***
Coefficient of Variation (2000-2016)	***12.16***	***5.68***	***4.65***	***4.71***	***4.11***	***3.91***

	The Castling Defensive Portfolio:	Ticker	% Allocation	Expenses	Equity %	Weighted Exp.	Min. Invest.	Initial Min.	2016 Return	Contribution
1	FDIC Insured Certificates of Deposit (Avg. of High Yielding)	Bank CD's	9%	0.00%	0%	0.000%	Varies	$6,750	1.25%	0.11%
2	Vanguard Short-Term Treasury Investor Shares	VFISX	9%	0.20%	0%	0.018%	$3,000	$6,750	0.99%	0.09%
3	Vanguard Short-Term Investment-Grade Investor Shares	VFSTX	9%	0.20%	0%	0.018%	$3,000	$6,750	2.72%	0.24%
4	Vanguard Intermediate-Term Treasury Investor Shares	VFITX	12%	0.20%	0%	0.024%	$3,000	$9,000	1.19%	0.14%
5	Vanguard Inflation-Protected Securities Investor Shares	VIPSX	12%	0.20%	0%	0.024%	$3,000	$9,000	4.52%	0.54%
6	Vanguard GNMA Investor Shares	VFIIX	11%	0.21%	0%	0.023%	$3,000	$8,250	1.85%	0.20%
7	Vanguard Wellesley Income Investor Shares	VWINX	11%	0.22%	4%	0.024%	$3,000	$8,250	8.08%	0.89%
8	Vanguard Small Capitalization Value Index Investor Shares	VISVX	15%	0.19%	15%	0.029%	$3,000	$11,250	24.65%	3.70%
9	Vanguard REIT Index Investor Shares	VGSIX	8%	0.26%	8%	0.021%	$3,000	$6,000	8.34%	0.67%
10	Vanguard Total International Stock Index	VGTSX	4%	0.18%	4%	0.007%	$3,000	$3,000	4.65%	0.19%
	Totals		**100%**		**31%**	**0.19%**		**$75,000**		**6.77%**

All That's Gold Does Not Always Glitter... Creating your Own Goldilocks Scenario

The commercials seem to be everywhere on news and business channels all over cable and satellite TV. Surf the Web and pull up news, weather and sports and you've probably seen more than your share of these advertisements. *Buy gold. Buy now. But above all else, buy your gold ONLY from us!*

The various reasons given are: economic uncertainty, social turmoil and unrest, the US national debt, inflation, the next financial crisis and so on. Oftentimes, these urgings are accompanied by statements claiming that some (we are led to believe) smart investors are putting 20% or more of their assets into gold. Almost always, the emphasis is on getting the gold into your hot little hands. Gold that you can touch and feel and look at in awe and wonderment. There is almost an obsession with making it a near sensual experience.

How non financial planning is that? How could we ever hope to compete with such a spiel?

Since so much of what we do comes back to answering the basic questions of who, what, when, where, why and how, our discussion here is meant to be an introduction to the subject of gold, what it is, how best to own it and where and how it can provide an increased level of diversification in your investment portfolio. But we also touch on what gold is not and some of the fallacies that have sprouted up around the yellow metal.

Finally, we have some real life data to show you. What if we were to add gold to our model ***Castling Defensive Portfolio*** (CDP)? We invoke the Goldilocks principle, but show you that what glitters best may also be partly in the eye of the beholder.

Gold as a precious metal has been used as a means of exchange for thousands of years, perhaps longer than anything else in recorded history. Today, its usefulness in industry has appeared to have been eclipsed by other precious metals such as silver, along with rare earth elements such as titanium. But gold is still scarce enough and pleasant enough to look at, that it has been shaped into jewelry and minted into coins used by most sovereign governments throughout the past two millennium. But what about dentistry? Don't get us started on that one.

Gold has been shown to back the currencies of governments to such an extent, that once this backing was removed, inevitable price inflation took control to one extent or another. Today, virtually no government and especially not any of the large economic powers, backs their currency with gold. This gave rise to the concept of “fiat currency”: where a government maintains that its currency has value as legal tender, simply because they say so.

Anyone who remembers the decade of the 1970s in the US, has experienced significant inflation. The last tie between the US dollar and gold was severed in 1971. What followed was not very pretty, even though politicians from both major parties claimed the inflation problem was caused by something else, especially something coming over in barrels from the Middle East. But those oil barrels were always priced in US dollars and the value of those dollars was gradually cheapened over time, principally by creating too many of them (whether in circulation or as reserves).

Two initial points must be made. Gold is often described as *being* money, or as a way to back money. Secondly, once this backing is removed, the threat of price inflation causes people and institutions to seek some hedge against this risk, simply by owning some gold.

There have been long periods of time when the price of gold climbed higher and higher (1970s and 2000s), while through other extended durations it seemed to be in permanent decline (1980s and 2013-2015). By contrast, most cyclical stock market corrections are over in less than eighteen months.

If inflation is the economic symptom indicating the need for gold, deflation can be the contra-indicator. In 2008, there was a temporary big sell off in gold, coinciding with the financial crisis. This was likely due to fears of potential major deflation.

Another important point to keep in mind is that there is no evidence that just buying it and burying it (maybe in your safe deposit box), will assure you of success even a decade or more, later. Or even of a decent return. Or even of any positive return. Maybe yes. Maybe not.

Closely related to this point is the observation that gold has no income potential. It generates no interest. It pays no dividend. Unless you have a business renting jewelry, it pays no rents or royalties. (We could make an exception here and state that gold mining stocks can do some of these things. But we would then be holding an equity security, representing ownership of a business that is involved in extraction. This is not really the same thing, although it is related. Therefore, we will not be discussing gold mining stocks here.)

So why should we even bother? We would like to put forth the following reasoning. Gold is not well correlated with any financial assets, almost all of the time. This simply means that its price does not tend to move in the same direction and by the same magnitude, as many other asset classes. Owning a mixture of low or inversely correlated asset classes, results in a higher level of diversification.

Diversification, in turn, is not about achieving maximum rates of return. It is really about avoiding large losses, while experiencing less volatility over time. By holding the right asset classes in the right mix, for the right period of time, you stand the best chance of achieving your goals, while encountering the least amount of downside risk. There will still always be some risk. But the idea of reducing it in any measurable way creates a "less negative" feedback loop.

As an example, imagine the following conversation:

"How's it going?"

"Oh, bummer. I'm way down in my investments and I don't know what I should do. I'm losing sleep over it. Maybe I should just get out completely. What about you?"

"Haven't really paid that much attention, actually. I see we're down a bit, but it doesn't really look like any reason to panic. I think I'll just let it ride and see how it goes."

Can you tell who has the more diversified portfolio?

If by now we have established our argument that owning gold, to some extent, may be an inflation hedge, we should move on to answering the other 5 Ws and H questions related to owning it. How can we buy it? But more importantly, how should we buy it?

Direct physical ownership is often the method touted in TV commercials. We can generally split this up into two types: coins (usually one oz. each) and gold bullion in bars and ingots of various size, weight and purity. Gold in the form of legal tender coins from popular countries, is very well trusted. Bars and ingots need to be *assayed*, which means that they are weighed precisely and also tested for their exact gold content. This is an expense of gold ownership (with bars). While owning coins avoids assaying, there is still a premium to be paid for purchasing coins.

Here is an example. **Kitco** is a popular and reputable dealer in the US. On April 25, 2017, we browsed their Website and found that we could purchase a 1 oz. Gold American Eagle coin for $1,328.80. Immediately thereafter, we checked the price for which we could resell this exact coin back to them. It was $1,260.90[1].

However, all dealers are going to have a difference (or spread) between what you can buy a coin for and what you can sell it back to them for. We are not saying that this spread is any less at another dealer, especially those who spend lots of money on TV commercials. All the same, let's round it off a bit and estimate that it's a 5.4% dealer margin. We'll come back to this number a little later on.

Whether we buy coins or bars, the issues of storage and security need to be addressed. Many people are perfectly happy taking delivery of their coins by mail and then storing them in their local bank's safe deposit box, since the annual cost of renting a box is quite nominal. Homeowner insurance policies will provide very little, if any, coverage for gold stored in the home, under the typical limits for a homeowner HO-3 or HO-6 (condo) policy. It is possible to increase these limits by using an additional rider/endorsement and paying the additional premium. But wasn't the gold supposed to be providing *you* with portfolio insurance, instead of you shelling out additional dollars to insure it?

Direct physical ownership is also possible with a custodian who will store your gold in their vault. This should relieve you from worrying about your gold's safety, but it does mean that you incur higher expenses for storage, than simply using your bank's safe deposit box.

Whether you pick coins or bars, your safe deposit box or a custodian's vault, <u>another problem you face is the simple lack of integration with the rest of your portfolio</u>. There is not a smooth process to dollar cost average small amounts each week or month. You can buy one coin or sell one coin, for example. If you wanted to maintain a 5% weighting in the precious metal and your year-end actual mix was 6%, selling this fractional amount could result in less than one full oz. needing to be transacted. While this is possible to do given the existence of some very small size coins (i.e. 1/10 oz.), it's not that practical given dealer markups.

On the other hand, if the price of gold went down and it now represented only 4% of your investment portfolio, you should technically sell other investments and buy more gold. Sure thing, but maybe not that easy? Selling within non-retirement accounts will potentially generate capital gains taxes in those other accounts. This could be avoided if everything was transacted in retirement accounts only. But let's suppose we free up X dollars which, coincidentally, turns out to be the exact sum needed to purchase one additional ounce, including transaction costs. If the source of this cash was an IRA (or other retirement account), this means that we just took a distribution. This may not have been intended (or even desirable in most cases), since income taxes and penalties could result.

It is certainly possible to hold gold coins or bullion in an IRA, but you should use a custodian such as with a so-called *self-directed IRA* (geared to holding alternative assets), or through a gold dealer who then keeps custody or sets up custody with a third party.

We definitely do not recommend that any investor attempt to hold physical gold inside an IRA and retain possession at home or in a bank safe deposit box. We have not found any literature from the IRS or other sources, that prove that such physical possession (inside an IRA), is going to survive a challenge by the IRS[2].

When using a custodian, you may be required to do small trustee to trustee transfers to perform the re-balancing activity. This could soon become tiresome. So unless the investor is naturally very diligent, it simply will not get done every year (our recommended re-balancing frequency). Instead, it may be far easier to use a *range* for the allocation to gold and then make infrequent transfers every few years, that add to or subtract from, the gold holdings.

To summarize, we have covered several issues resulting from physical ownership and have commented on their negatives:

1. Dealer markup/bid versus ask price spread/commissions or transaction costs (High).
2. Storage and security costs (Varies, but can be high).
3. Reduced ability to dollar cost average in portfolios with smaller account balances (Need to have a larger portfolio, in order to do this efficiently and effectively).
4. Cumbersome to re-balance when other investments are in IRAs or employer plans and the gold is stored with a separate custodian.

How could we avoid these negatives but at a very low cost?

Gold **ETFs** (Exchange Traded Funds) have now been around for more than a decade and have revolutionized the way we can buy gold. There are two major ETFs that carry gold bullion as their sole asset class and have been around for more than a decade:

1. **SPDR® Gold Trust** (ticker symbol: **GLD**) – distributed by State Street Global Advisors Funds Distributors, LLC[3]
2. **iShares® Gold Trust** (ticker symbol: **IAU**) – distributed by BlackRock, Inc.[4]

These ETFs are trusts and are not set up as investment companies, in the way other ETFs or mutual funds are. They are set up to hold their physical gold in vaults run by third party custodians and are required to report on their holdings. Their objective is to mimic the movements of the "spot price" (market price) of gold. Looking over the last decade, it appears to us that each has been successful. There has been some concern that on an intra-day basis or during a "flash-crash", the ETF's price movements could begin to divorce itself from the underlying spot price of gold. But the true investor is not buying and selling multiple times per day.

We believe that for the purposes of almost all long term investors, owning gold via an ETF would be very adequate. None of the problems cited above, involving physical ownership, exist.

ETFs are bought as shares on exchanges, in regular brokerage accounts that can hold mutual funds, stock, bonds, etc. ETFs sell at a price which can be higher or lower than the fund's NAV (the value of the underlying assets it holds), although this spread is tiny compared to a physical gold dealer's markup on coins or the spread between share price and NAV, on most closed end mutual funds.

Share pricing allows us to buy fractional amounts of gold. For example, a recent price for one share of IAU was $12. This would not buy much gold. But if we wanted to re-balance in a small investment portfolio and include IAU instead of coins (each costing perhaps $1,295 or more), you could adjust your allocation by 1%, more easily. A standard brokerage commission applies on a buy or sell order, but this could be in the range of $0-$20, depending upon the broker and the size and service level of the account. It is also easy to set up the purchase or sale as a "limit order", thus giving you extra control regarding what price you will accept, although at the risk of potentially not seeing your order get executed (as it would at the current market price, when using a "market order").

Next, let's look at the performance of gold bullion on the spot market versus IAU. Once again, the latter is one of the ETFs and has been around for slightly more than a decade. One can make the argument that this time period is not long enough to judge how ETFs perform versus owning the metal directly, but it's all we have to base our judgments on. Actually, it is somewhat adequate since it includes portions of both rising and falling markets.

The table below shows the total return of IAU alongside that of gold bullion, for each year of the 11 year period from 2006 through 2016[5,6]. We tried to perform this analysis by looking at the percentage change in the gold price over each calendar year during the period in question. There were limitations encountered in arriving at the final year end prices (i.e. we could not always get the exact December 31st closing price of bullion). This gave us the initial impression that the ETF may have had a higher return than the spot gold price, during some years. But since all ETFs have some management fees and other expenses, we expect that spot gold's return (price change) will always be a little higher. In our case, IAU carries a 0.25% expense ratio. So in those years (i.e. 2008)

Year	Ending Gold Price	Approx. Gold Price Change	IAU Total Return	Delta When Positive
2005	$516.60	N/A	N/A	N/A
2006	$636.00	23.1%	22.3%	0.78%
2007	$838.80	31.9%	31.0%	0.94%
2008	$874.90	4.3%	5.5%	0.00%
2009	$1,096.50	25.3%	23.5%	1.88%
2010	$1,421.60	29.6%	27.9%	1.72%
2011	$1,566.40	10.2%	8.7%	1.53%
2012	$1,656.30	5.7%	8.4%	0.00%
2013	$1,213.80	-26.7%	-27.9%	1.22%
2014	$1,189.80	-2.0%	-0.4%	0.00%
2015	$1,061.00	-10.8%	-11.7%	0.88%
2016	$1,150.90	8.5%	8.9%	0.00%
	ETF Simple Average Discrepancy:			0.81%
	Spot Gold Minus 5.4% Dealer Margin:			$1,088.87
	Cumulative Spot Gold Net Return:			**110.8%**
	Cumulative ETF Net Return:			**116.7%**
	ETF return also lowered slightly by brokerage commissions			

where IAU seemed to have a higher total return than the spot gold market, we just set the difference (in the absence of better information) to zero. All in all, spot gold seemed to enjoy less than a 1% average annual improvement over the IAU ETF. But wait! As mentioned earlier, if we buy coins, we pay a premium and if we buy them from any dealer, there will also be some dealer markup. We estimated this to be 5.4%.

So at the end of 2016, we assume we have not $1,150.90, but $1,088.87 after hypothetically selling back a coin to a dealer. This translates into an almost 111% cumulative return. Pretty good, except for the fact that IAU delivered an almost 117% return over that same time period (net of its own management expenses). While brokerage commissions for both buying and selling the ETF would have eaten into these returns ever so slightly, this is still ample evidence that a gold ETF can hold its own.

For those who are still somewhat skeptical that ETF gold shares represent ownership where the underlying asset is true physical gold, we recommend that the reader look over the daily report from the ETF, which lists the location of the vault, along with the shape, weight, purity and stamped serial number, of each gold bar contained therein[7].

Lastly, if we have made our case that a gold ETF is an efficient and effective tool for gaining exposure to gold within an investment portfolio, the natural next question is: how much should you buy? This is certainly not a trivial pursuit. Recall at the outset of our discussion, some in the industry (especially those who would benefit from gold coin sales) advocate for a 20% or more allocation in one's portfolio.

<u>We could not disagree more strongly</u>. After performing our analysis, we have some results to share. While we were only able to use an eleven year period, from 2006 through the end of 2016, this was still quite useful, since gold exhibited both a peak as well as a trough, in its price. It was no uniformly bull or bear market. Keep in mind that if we want to find the appropriate percentage allocation for a gold ETF, we would be looking to permanently diversify our portfolio. Therefore, we would expect to hold the gold ETF through *both* bull and bear markets.

By contrast, if you wanted to time the gold market and sell out completely because you felt the gold price had hit a peak, you would no longer have it as an asset class within your overall portfolio. If this is your approach, then it simply is not long term investing. Trading in the market instead of investing, is certainly valid. Just let's not call it investing. Therefore, this approach is not relevant to our discussion.

We used our ***Castling Defensive Portfolio*** (CDP) as the guinea pig for our analysis. This hypothetical model portfolio is composed of real investment vehicles that are all accessible to the average investor. The objective of the CDP is to provide a very conservative portfolio as an example to those who may be very risk intolerant. So if the CDP is too risky for you, you probably should not be an investor at all (in which case, you may find it very difficult to reach your financial goals).

We performed various calculations using absolutely zero gold (so 100% CDP), all the way up to 25% gold (75% CDP). Here is what we found. Please refer to the table below.

Adding gold appeared to increase the overall return of the mixed portfolio (let's call it ***CDP-gold***). But increased return usually comes with increased risk. Our favorite risk measure is the **Coefficient of Variation** (CV). Our baseline CV is a subdued 0.91, along with an 11 year annualized return of 5.69% (using 100% CDP).

When we increased gold to only 1%, we improved the return to 5.72%, while CV stayed the same. So far, so good. We then increased gold to 5%. This improved our return to 5.83%, but the CV only went up to 0.92. Making gold 10% gave us a 5.96% return and CV still stayed low (0.95).

But then things took a turn for the worse. At a 15% allocation, the return was 6.09%, but now CV had increased to 0.99. The issue here is that a CV greater than 1 implies that there was more variation/volatility (risk) than the commensurate amount of return.

At 20%, this was also demonstrated, as well as the fact that the total return in 2013 turned negative. A 25% allocation fared even worse, with 2013 and 2015 showing poor returns. <u>The objective of the CDP is stability and any additional asset class (and its mix) should be adding to this stability, not subtracting from it</u>.

Our conclusion is not much different from Goldilocks finding “the one that was just right”. <u>Somewhere between a 1%-10% allocation to the gold ETF, is helpful as a diversification tool. Go much further beyond this point and you risk gold price volatility detracting from your overall portfolio returns</u>.

Castling Defensive Portfolio (CDP) Comparison	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017 YTD
Castling Defensive Portfolio Yearly Returns	9.37%	5.71%	-6.15%	13.15%	10.05%	5.26%	7.48%	5.74%	6.71%	-0.22%	6.77%	1.37%
Total Return: BlackRock iShares Gold ETF (IAU)	22.33%	30.95%	5.45%	23.45%	27.93%	8.66%	8.37%	-27.94%	-0.43%	-11.71%	8.88%	7.35%
Return: CDP: 100%; Gold ETF (IAU): 0% Alloc.	9.37%	5.71%	-6.15%	13.15%	10.05%	5.26%	7.48%	5.74%	6.71%	-0.22%	6.77%	1.37%
Annualized Return (2006-2016)											5.69%	
Standard Deviation (2006-2016)											5.18%	
Coefficient of Variation (2006-2016)											0.91	
Return: CDP: 99%; Gold ETF (IAU): 1% Alloc.	9.50%	5.96%	-6.03%	13.26%	10.22%	5.29%	7.49%	5.40%	6.64%	-0.34%	6.80%	1.43%
Annualized Return (2006-2016)											5.72%	
Standard Deviation (2006-2016)											5.21%	
Coefficient of Variation (2006-2016)											0.91	
Return: CDP: 95%; Gold ETF (IAU): 5% Alloc.	10.02%	6.97%	-5.57%	13.67%	10.94%	5.43%	7.53%	4.06%	6.35%	-0.80%	6.88%	1.67%
Annualized Return (2006-2016)											5.83%	
Standard Deviation (2006-2016)											5.36%	
Coefficient of Variation (2006-2016)											0.92	
Return: CDP: 90%; Gold ETF (IAU): 10% Alloc.	10.67%	8.23%	-4.99%	14.18%	11.83%	5.60%	7.57%	2.37%	5.99%	-1.37%	6.99%	1.96%
Annualized Return (2006-2016)											5.96%	
Standard Deviation (2006-2016)											5.65%	
Coefficient of Variation (2006-2016)											0.95	
Return: CDP: 85%; Gold ETF (IAU): 15% Alloc.	11.31%	9.50%	-4.41%	14.70%	12.73%	5.77%	7.61%	0.69%	5.64%	-1.94%	7.09%	2.26%
Annualized Return (2006-2016)											6.09%	
Standard Deviation (2006-2016)											6.04%	
Coefficient of Variation (2006-2016)											0.99	
Return: CDP: 80%; Gold ETF (IAU): 20% Alloc.	11.96%	10.76%	-3.83%	15.21%	13.62%	5.94%	7.66%	-0.99%	5.28%	-2.52%	7.20%	2.56%
Annualized Return (2006-2016)											6.21%	
Standard Deviation (2006-2016)											6.50%	
Coefficient of Variation (2006-2016)											1.05	
Return: CDP: 75%; Gold ETF (IAU): 25% Alloc.	12.61%	12.02%	-3.25%	15.73%	14.52%	6.11%	7.70%	-2.68%	4.92%	-3.09%	7.30%	2.86%
Annualized Return (2006-2016)											6.32%	
Standard Deviation (2006-2016)											7.02%	
Coefficient of Variation (2006-2016)											1.11	

Why Don't Humans Treat Their Human Capital More Humanely?

The 21st century seems to be a great time to bandy about the phrase "the value of human capital". Back thirty or forty years ago, it was common to think about most (let's say 80%) of a company's value being comprised of its tangible, physical assets, such as plant and equipment. Today, it has been estimated that the same proportion of value resides in intangibles of intellectual property, brand and people[8]. Or at least that's one major point of view. Meanwhile, Investopedia defines human capital as "*a measure of the economic value of an employee's skill set*"[9].

But wait a moment. Why are these perspectives so organizationally/corporate based? It seems rather obvious to us that you simply cannot treat human capital as some kind of asset on the balance sheet of an employer. An employee who has the most valued skills can simply say "take this job and shove it", while another without any valued skills could conclude that it's someone else's responsibility (the employer or government) to "give" them those valued skills. If this does not happen, would protesting for a fifteen dollar minimum wage become a productive use of one's time?

Let's keep in mind that a valued employee (or any employee for that matter) is not chattel to the employer. Counting on retaining an employee is not the same as counting on retaining a tangible asset that generates income for the employer. *The business owns the drill press, but not the drill press operator*.

By contrast, an employee lacking skills may not immediately grasp the true nature of his predicament. If it is commonly believed to be the employer's or government's role to retrain a worker or to develop their human capital, this mindset may lead many people to neglect that which would otherwise be of most value to their own selves.

So instead of looking at human capital from some organizational or public policy point of view, we would rather reverse this and look at it from the perspective of the individual. Why doesn't each person guard and grow their human capital, in the same way they guard and grow their savings and investments?

The basic principle we have learned from experience is that you never own your job (unless of course you own the business), but you ALWAYS own your job skills.

The right to organize into unions, obtain arbitration of labor disputes, seek redress of grievances over labor laws, or report abuses to State and Federal Departments of Labor, have all been integral to the history of labor in the US. But our concern here is not specifically over how labor is treated, but what the economic value of that labor is and how to protect and enhance it.

In order to relate all this back to financial planning, let's first review our **Castling Principle**:

The simultaneous use of two fundamentally different things, in such a way that you achieve a result that could not have been achieved using just the one or just the other.

This principle has been around forever. We simply gave it a name derived from a particular chess move. (When we first analyzed what would cushion against downturns in an investment portfolio during retirement, the obvious answer seemed to be something that did not incur losses to principal in the way that any investment portfolio would. So the concept of a "savings portfolio" was first seen as that "fundamentally different thing". While we have discussed many of the different elements of a savings portfolio elsewhere, the point to be made here is that identifying these other fundamentally different things, is what's really critical.)

Over several years of thinking about a person's complete financial life, we came up with the following list of ***fundamentally different things***, as our scope:

1. Investments
2. Savings
3. Job/Business Skills
4. Life Skills
5. The ability to manage money (including how you choose help, if and as needed)
6. Health
7. Time

It is no mere coincidence that only the first two items on this list would be included on a person's/family's net worth statement. The other five seem so much more intangible. Yet we contend that the individual who optimizes all seven of these, has the best opportunity for a successful and prosperous life.

<u>In contrast to the aforementioned organizational/corporate definitions of human capital, the bottom five on our list form the ingredients for our definition of human capital</u>. We next briefly describe each one.

Job Skills and **Business Skills** are treated as being of the same category. Not everyone is destined to be an entrepreneur (or would even want to be). But each of us is the CEO of a little shop called *Me, Inc*. Some of these skills can easily be acquired by taking classes, but even with advanced degrees, getting hired may be predicated upon demonstrating actual and relevant experience. A classroom exercise or project in software development may be "throw-away". Taking the next step and actually using that skill in developing even a part of a real solution for a business, is where value gets created. One's first experience in any new technology may be awkward and the deliverable may be sub-optimal (or worse). But this may demonstrate that the individual has what it takes to move from the classroom to a real-life project and ultimately, to a successfully implemented solution. <u>When this person moves into the next project using this same technology, but it is now combined with that great teacher called experience, the essence of human capital value is on display</u>.

The human capital value of a 23 year old barista with a liberal arts bachelors degree, but with no other marketable skills and no experience (in his desired profession), is fairly low. While this is not the politically correct thing to say, it is the economically accurate thing to comprehend. To say that a person deserves a higher minimum wage in order to "make a decent living", is a completely irrelevant argument from the standpoint of economics. We think this person may deserve some government assistance in order to avoid poverty, but this has nothing to do with their market based wage rate. Give them a wage that is higher than their economic value and you will soon be saying bye-bye to that job.

Centuries ago, the idea of going to a university in order to get an education, was something reserved for the aristocracy, the ultra-wealthy and the clergy. Even the merchant class was focused on gaining specific skills that could be used in business, from the first day. Laborers hoped to gain admission to an apprenticeship program, in order to acquire the skills that they would then use for a lifetime. The emphasis was on gaining marketable skills and not going deeply into debt, trying to acquire them. And time was of the essence.

Contrast that with many liberal arts students today, who graduate with dubious degrees where problem solving, analytical skills, modern math and information technology basics are all missing. How many take more than four years to finish? How many accumulate \$50K-\$100K (or more) of debt? All of this to what end?

Yes, these are truly the second dark ages in education. Consider that the basics of a bachelor's degree, the core curriculum, is really driven by one thing: delivering content. And the cost to deliver content has fallen by at least 90% over the last twenty years. So why should the educational experience be so expensive?

<u>Our advice in terms of gaining job and business skills, is to de-emphasize expensive educational programs and to re-emphasize experience, wherever it can be acquired</u>. We

have previously discussed the junior college to bachelors degree route, as well as advanced placement courses in high school and the use of on-line education, as valid alternatives. Getting a foot in the door with an entry level job, even if the subject matter is boring but the pathway is open, should be the goal. There are relatively few people who are truly successful in life simply because of the connections they made in college, or the prestige of the university they attended. After a few years, while seeking a promotion or another job opportunity, the rah-rah Big U memories will not buy you much. But your lingering student loan debt may be more than a memory and certainly feel more like a nightmare. Keep in mind that a new employer is more concerned with what you can do for their bottom line.

Get over the education hang-up. If you finished your degree(s), fine but quite frankly, who cares? It was only an admission ticket to the game of life. Job Skills and Business Skills are what really matter in the long run.

Going beyond the initial degree programs, there are often professional certifications that represent where a particular career or industry is at, or where it is going to. Quite often, these certifications require relevant experience to accompany the completion of coursework and usually include an examination. <u>It is quite interesting to note that most bachelors degree programs allow a student to get a diploma without having demonstrated any level of skill or mastery of any subject area</u>. Completion is usually based upon accumulating a certain number of credit hours. This seems painfully close to the notion that time on the job is the main prerequisite for promotion, not actual accomplishment.

A professional designation or certification may require a bachelors degree, but many do not require that degree to have been earned in any particular discipline. This is hugely important. <u>It means that a “BA in BS” (pardon our pun) may be *upgraded* with only a few additional courses, along with some entry level experience, into something far more valuable</u>. Usually, this can be acquired at a reasonable cost, with many offerings available online.

Life Skills may seem like a strange addition to a discussion of human capital value. It's easy to see how knowing the elements of accounting thoroughly, when you're starting a new job as an accountant, would be important. But what about the ability to get to work on time every day, because of the ability to drive, “read” traffic patterns and use maps? Or the ability to cook a delicious meal for someone instead of going to an expensive restaurant? Does our accountant have enough skills to prepare her own incomes taxes, even though she doesn't work with personal income taxes on the job? What about the blinds she just installed by herself in her new apartment?

Simply put, we define life skills as representing everything outside of job/business skills, that are of a non-trivial nature. These require at least some learning. Each needs to be experienced. In other words, one does not learn how to properly install window treatments by only reading a book. This skill is learned by doing, but in consultation with other learning materials. <u>Life skills are important because each represents something that, in the absence of which, you would otherwise be paying someone else to do, or that enhance your potential job/business opportunities</u>. Add all of them up and you may find that if you did have to pay someone else for doing each, the total cost could be prohibitively expensive. You may also find that (if missing the life skill) your level of flexibility in job and business pursuits, could be reduced. For instance, the young person who is already a skilled traveler, may find that employment that requires 50% travel is not only a career enhancing opportunity, but is also a piece of cake. The book smart colleague who never traveled may be just as skilled in job task domains, but is unprepared to even seek out the same kind of employment.

As a further example, consider that in some countries and cultures, a significant percentage of the population does not learn how to drive an automobile. They may depend solely on public transportation, with their wealthier brethren actually being driven to their place of employment each day. Now consider what would happen if they are both considered for a foreign job assignment in the US, in an area where public transportation to a particular office location is hard to come by. Would the driving skills of candidate A be a better match for the job than the lack of those same driving skills in candidate B (assuming everything else was roughly equal)?

Next, it may seem odd that a financial planner such as myself, would stress all other individuals' **Ability to Manage Money**. The more helpless you are or become, the better for the business of us advisers, right? While on the surface this thinking is true, it is also very detrimental to society as a whole.

One of the most striking observations I noted during the Bernie Madoff fraud and ponzi scheme case, was that some of his victims showed not only a complete lack of knowledge of the industry, but a lack of knowledge of basic, commonsense principles. For example, some of his investors turned over literally all of their financial assets to him, with the exception of their homes and Social Security benefits. Some explained to the news media that the US government had “approved” of him, so why should they have bothered to be skeptical?

While it is feasible and practical for some people to learn enough about all areas of personal finance and become their own financial planners, this is not a necessity for all. What we mean by mentioning this skill is that the person should always remain somewhat engaged, apply commonsense, be always ready to learn new concepts, look for ways to decrease the costs of working with professionals and last but not least, <u>learn and perform the due diligence for selecting the professionals who are going to work for you</u>.

In the case of Bernie Madoff, if one client understood the concept of separation of duties and insisted that her investment advisor and stock broker should always be separate people/entities, she would not have been scammed. Furthermore, basic checking on government Websites would reveal that no investment adviser or stock broker is ever "approved" by the SEC or by any other regulator. Instead, they are registered not approved.

One reason we are among (and advocate for) the tiny 1% of advisers who are hourly and not commission or asset based (AUM), is that the level of interaction with clients is much greater. The client is naturally more involved and gets some education in the process. Part of this may stem from a thrifty and frugal attitude. If an hourly client is not that wealthy enough to be courted by an AUM based adviser, he or she may may be more motivated to get involved and do more in the process, in order to save a lot on fees.

One of my most interesting observations during the time I worked in the IT industry in my previous career, was the number of people who admitted that they had no time or inclination to study their personal finances. Given that this result seemed to hold back the financial progress that they otherwise wanted to make in their lives, the ability to at least find some professional help, to at least some extent, should still be valuable.

To say that "*Bernie made off with my wealth*", would not be a good adage to use in your old age. It's still YOUR money and YOUR life. Own it first, then seek out professional help, to the extent needed, on YOUR terms.

What is **Health** doing on our list? Health impacts personal finances. Finances may affect health. The value of your human capital is impacted by how you feel, how healthy or ill you may actually be, the stresses you may be under, including the stress of taking time off to see doctors to address your health concerns. Your health affects your job performance. Some of us are blessed with strong bodies, strong minds and strong genes. Some of us may have to struggle, due to issues in one or more health care areas during our lives.

Back in our Winter, 2016 Newsletter, we covered Health Savings Accounts (HSAs) in detail. We will not be repeating that information here. Suffice it to say that HSAs are one of the best innovations that fuse health care and financial planning. Let me know if you would like a copy of that issue.

Health is not the same as health care, which is not the same as health insurance. No other country spends as much on health care as the US, yet outcomes are not perceived to be the best that they could be. While we certainly see the need for general access to health insurance and health care, we definitely do not view it as being some sort of "right". It is not an enumerated right in the US Constitution. Let's not confuse “right” with “need”. The need for food and personal transportation would easily meet or exceed the need for health care, on any given day. But government does not subsidize autos or burgers for one group, while making it more expensive for another.

Unfortunately, US government interference, occurring for decades in the health care marketplace and with state level insurance regulation, has distorted the free market. The basic concept of price discovery is prevented from happening, or is manipulated.

When individuals begin demanding accountability from their health care providers, insurance companies and most of all, from their political leaders, the situation may yet improve.

For instance, I was recently accused of being argumentative, for insisting that the billing for a medical test be done in a certain way in order to receive the discounted price from an off-site laboratory. In this case, my insurance did not cover the test, but my research found that the lab provided a lower price for “self-pay patients”. Getting this coded correctly was important. Many medical offices and hospitals are not focused on keeping overall expenses down. It is, therefore, up to the consumer of the health care (the patient) to demand not only effective treatment, but to have it delivered in a more cost effective manner.

Since we are not health care professionals, we are not going to give advice in this area. But we would stress the importance of thinking about your health as being a component of your human capital value.

Finally, we list **Time**. No, we're not talking about the magazine, or the notion that time heals all wounds. But for most people, in most circumstances, time is the great equalizer. Rich or poor or middle class, everyone has the same number of years to play with, from age 22 to 62, for instance (as long as we make it to that age in the first place). What we do with that time is of vital importance. Many financial planners hear a common lament from clients: they wish they had started saving and investing sooner.

Society seems to provide more ways to procrastinate or to avoid any harsh realities of life. To us, the idea of taking a year off after finishing college is a great example of this preposterous notion. Embracing the challenge early on and sacrificing small things today for a larger reward down the road, nowadays, seems to be an outdated virtue. But we think it's still a rock solid principle to live by.

The human capital value of the person who is proactive in developing and safeguarding items (3) through (7) on our list, will surely rise. Moreover, items (1) and (2), representing the financial (balance sheet/net worth) view of that person, will also increase over time. Waiting for an employer or government to recognize human capital value or provide retraining, is a very passive approach. It may well lead to disappointment.

The proactive person will understand that doing a good job for their present employer, while necessary and virtuous in itself, is no guarantee of job security. It is only a guarantee of one thing: EVENTUAL OBSOLESCENCE.

<u>The proactive person owns their human capital value, safeguards it, helps it grow and especially (realizing it will one day decline): uses it to fund their future investments</u>.

Your Personal Moon Shot: Income Planning for Retirement

Although not every baby boomer may personally remember the Apollo 11 moon landing, most everyone of whatever generational group, can readily associate the term "moon shot" at least in a figurative way, with something long, difficult and costly, requiring extensive planning and preparation. One of my clearest memories of this time, as a nine year old, was the emphasis NASA put on using the terms "stages" and "modules". The Saturn V rocket had various stages. The lunar module decoupled from the command module to begin its descent onto the lunar surface, etc.

If we analyze any endeavor as having more than simply a beginning and an end point, we can usually split it up into smaller, more manageable pieces. Perhaps we wind up calling them phases or maybe something else. But to divide and conquer, is a well known ancient principle.

All too often, we see many folks assume retirement planning is only about reaching their "*number*". Do you know what your number is? Are you on track to reach your number? I've reached my number, so nothing more for me to worry about, right?

Retirement planning, just like many things in financial planning, involves a multi-step/stage/phase process. We created the following matrix in one particular client situation and later found it to be generally useful, to begin the discussion from the bottom up.

Made Retirement Plan	Reached Planned Date	Reached Target Amount	Still Employed in Career?	Desirability of Outcome or Action
YES	NO	NO	YES	**WORK-IN-PROGRESS:** This is where we are right now
YES	NO	YES	YES	**AHEAD-OF-GAME:** Retire sooner? Needs longevity assessment
YES	YES	YES	YES	**PLANNED:** Can immediately retire or slowly move into retirement
YES	YES	NO	YES	**OK:** Can continue saving and investing to reach goal
YES	NO	NO	NO	**PROBLEM:** EBRI study shows 50% retired earlier than planned
NO	N/A	N/A	YES	**TREADMILL:** Luckily this isn't you since you're actively PLANNING
NO	N/A	N/A	NO	**DARK-CLOUDS-OVERHEAD:** This is the sad reality for many folks

The worst possible outcome occurs when no retirement plan was ever created and the person lost his or her career oriented employment and has little hope of replacing it with a similar job. By contrast, this person's co-workers who also have done zero planning, at least get to continue their employment. Hence the description: “treadmill”.

But here is the eye opener. Even for many folks who had planned their retirement, according to a study by the Employee Benefit Research Institute (EBRI), about half of them actually retired before they had planned[10]. We do not dwell on this to discourage anyone. Quite the contrary, this should be a call to action.

For those who did their retirement planning and reached their milestone date while still employed in their careers, the moment of truth may be more than checking their “number”. The difference here is that if the target amount was not reached, no one else needs to be the wiser, unless there is some mandatory retirement date. Most probably, they can toil on, continuing to invest and save toward their goal, reassessing how long this will need to continue. If they did reach their target, this is exactly the sort of private victory we should be stressing. It was planned and it was accomplished. Retirement can be immediate or eased into, perhaps as a slow transition to a reduced workload, fewer hours, a part-time role, search for a voluntary buyout or severance, etc. The difference here is that you are more in control than you've ever been. It's time to act smartly and use it wisely for your own benefit and without your ego becoming dominant.

What happens when things seem too good to be true? We've planned and reached our target ahead of schedule, while still employed in our careers. Time to tell the boss to take this job and... Hold your horses. This is exactly the situation that occurred in the couple years pre and post Y2K. A long period of very high returns had driven the stock market to absurd levels. Especially in the Dot Com economy, it seemed that technology millionaires were being minted every single day. Before we recommend that anyone pull the trigger on an early retirement, we think it is vital to do a longevity assessment to determine if your investment portfolio and savings could last longer than you do, at a high enough level of probability.

Answering the following questions will guide you:

1. Where do you want to live in retirement and how sure are you of your answer?
2. What will that housing cost be compared to where you are currently living?
3. If you stay put, do you have your mortgage paid off?
4. Do you have two years of after tax spending needs available in liquid savings accounts (subject to inflation but not market losses)?
5. Do you have a budget prepared for retirement that is based upon a realistic working budget from your last couple years? This is absolutely critical. If you do not know how much you are currently spending and what exactly you need now, to maintain your lifestyle, then you are not totally prepared.

For many people who have begun their retirement planning, the first entry in our table is where the discussion should proceed to. They are still working at their careers and continue to fund their employer plans, perhaps supplemented by outside investments and IRAs. Their targets and milestone dates are at some point in the future. Things are moving along, more or less as expected.

Our purpose here is to add a new ingredient to this mix. While the journey to retirement may involve an asset allocation designed to achieve some long term rate of return (akin to some steady velocity while traveling from outside earth orbit all the way to lunar orbit), at some point our cosmic pre-retirees should begin thinking about a more detailed plan for their income needs, when they touch down into retirement. Planning for income in retirement is exactly that.

For some folks, this will involve moving toward a desired "second act" or part-time job, after having ended their primary career. But income planning does not require that this need must be fulfilled by new employment.

An investment portfolio in retirement can be oriented towards generating income, or could be split up into two portions: one which focuses more on income, but does contain other assets as well (the ***core***) and a second containing longer term, growth oriented assets (which we like to refer to as the ***longevity*** portfolio).

Before we move on, some discussion of the choice between ***capital utilization*** and ***capital preservation*** is necessary. Optimally, this choice would have been made at the beginning of the retirement planning process. Oftentimes, it is not. When nearing retirement, clarifying this choice is a must, especially for couples. Being on the opposite side of your mate on this one, is a recipe for trouble.

So what do these terms actually mean? Your capital represents all financial and real assets and tangible personal property that you would ever contemplate liquidating to cash. Utilization is a not only a formal word describing "using" that capital, but more specifically, it means using it up, as in *finito*. "Preservation", on the other hand, implies protecting or keeping the amount (if not its original value) intact.

A quick example may illustrate these concepts more easily. Imagine our favorite character from the old television show, *Gilligan's Island*, Thurston Howell III ("the millionaire"), played by the late actor, Jim Backus. He appeared to be the epitome of what was called "*old money*". He may have inherited as much wealth as he would ever need to live on. However, the requirement was that, at least in a nominal value sense, that this wealth was expected to be passed down to the next generation.

So if by age sixty he and his spouse had a net worth of let's say, $100 million, the expectation was that at least that much would be passed down after his death. Of course, many wealthy persons have donated vast sums to charitable organizations, have founded universities, hospitals and museums, etc. But that is not our point here.

What is our point is that the focus of their wealth management was wealth preservation and income generation. So while they could certainly eat the fruit from the tree they had, they couldn't just cut it down and expect it to maintain the family for future generations. The implication for the average person in today's economy, is that capital preservation has grown to be increasingly more difficult, these last 15-20 years. It may even be out of reach for the majority of people, but this holds true throughout most of the world and has usually been the case throughout all of human history. Moving from mere survival, to making a decent living with some basic comforts, and then on to providing a foundation for the next generation to build on, have been the usual benchmarks of long term success.

Very low short and long term interest rates and two severe bear markets separated by fewer than ten years, have only made matters more difficult. So while capital preservation may be more of an aspiration than practical reality for most people, the goal of leaving behind some form of legacy for family, friends or charities, still remains. This is one of the areas where financial planning, long term investing and estate planning all intersect.

One of the most vivid examples of the capital utilization concept was when a client explained that he would be fine with the idea of his last dollar being used up, while his coffin was being lowered into the ground. This should not be construed as a purely selfish motive. This is really an example of the survival instinct we mentioned above. Once survival with a certain level of comfort and dignity have been assured, we can begin talking about a legacy for others. Until then, we understand the need to “look out for number one”.

Capital utilization means that we should be able to spend from principal just as freely as we spend from income. This is the simplest approach at looking at an investment portfolio in retirement, which is seen as being composed of a number of liquid asset classes (such as mutual funds or ETFs). We then begin by selling X number of shares to generate Y dollars that match the income requirement Z, specified by our detailed budget and spending plan. The 4% spending rule, an old rule of thumb in retirement planning, specifies that no more than 4% of the initial value of the portfolio, is spent in the first year of retirement and that this resulting dollar amount (not percentage) is then adjusted upward in the subsequent years, to account for inflation. However, the underlying assumption built into this rule is that the actual dollars can come from principal, as well as income.

We mentioned that a couple needs to agree on capital preservation or capital utilization. Today, the percentage of blended families is rising. The number of retirees with children from a prior marriage or relationship, appears never to have been higher. Providing for a surviving spouse, such as with the remaining household wealth, is generally taken as a given. But the deceased spouse may have had a special wish to leave a certain amount, or type of assets, to his own children. This further complicates the future income needs of the surviving spouse. So while full capital preservation will not be possible for most people, some form of ***partial preservation*** should be discussed and jointly agreed to, before creating an income plan in retirement.

The necessary first step in creating this income plan in retirement, is to refer back to a relatively accurate, prior budget. Knowing what you spend on and where the money comes from and goes to, during the last year or two of your working career, is probably the best tool to use in making a budget that works in retirement. Please, this should not be done on the back of an envelope or in your head! Treat this seriously and you will have a better chance of making retirement successful and easy. Guessing during this step leads to inaccurate data getting pushed all the way through the rest of the process.

A sample budget template appears below[11]. One column is used for the current year (labeled “Today”) and the other for the first year in retirement. While we know that things can and will change during this time, being overly concerned at this point with your entire retirement life-cycle will simply lead to frustration and anxiety. Instead, focus on where the money comes from and where it goes to now. Then imagine all the same categories in your first retirement year. The values in the retirement column should be adjusted for inflation. In fact, custom inflation factors can be used for the different spending categories. This simply means, for example, that if you think your health care costs will be going up by two or three times the rate at which your utilities will be increasing, you could inflate one category of spending differently from another, thus creating more flexibility as well as more precision.

(1) Income Computed on a Monthly Basis	Today	Retirement
Wage, Salary and Tip Income		
Dividends Paid in Cash		
Interest Earned		
Social Security Benefits		
Pension and Annuity Pmt.		
Net Rental Income		
Misc. Income (Options, etc.)		
Total Monthly Income	**$0.00**	**$0.00**

Total Annual Income	***$0***	***$0***

(2) Fixed Expenses on a Monthly Basis	Today	Retirement
Mortgage Payment or Rent		
Vacation or Second Home		
Automobile Loan Payments		
All Personal Loans		
Revolving Credit Card Pmt.		
Life Insurance		
Disability Insurance		
Medical Insurance		
Long-term Care Insurance		
Homeowner Insurance		
Automobile Insurance		
Umbrella Liability Insurance		
Federal Income Taxes		
State Income Taxes		
Social Security/Medicare Tax		
Real Estate Taxes		
Misc. Other Taxes		
Allocation to Savings		
Allocation to Investments		
Retire. Plan Contributions		
Trad. and Roth IRA Contrib.		
All Mortgage Prepayments		
Total Fixed Expenses	**$0.00**	**$0.00**

(3) Variable Expenses on a Monthly Basis	Today	Retirement
Electricity		
Natural Gas		
Water, Sewer and Garbage		
Landline and Cell Phones		
Internet & Cable/Sat/ TV		
Home Maint. & Cleaning		
Home Repairs		
Home Improvements/Rehab		
Food at Grocery Stores		
Clothing and Laundry		
Child Care		
Personal Care/Grooming		
Automobile: Gasoline		
Automobile: Maint & Repair		
Automobile: Future Buy(?)		
Other Reg. Transportation		
Education Expenses		
Dining Out		
Recreation & Travel		
Club and Association Dues		
Entertainment & Hobbies		
MedicalDental Not Reimbur		
Gifts to Others (Noncharity)		
Charitable Contributions		
All Misc. (KEEP SMALL)		
Total Variable Expenses	**$0.00**	**$0.00**

(4) Resulting Net Cash Flow	Today	Retirement
Total Monthly Income	$0.00	$0.00
Total Fixed Expenses	$0.00	$0.00
Total Variable Expenses	$0.00	$0.00
Remaining Cash Flow (Recompute until = ZERO)	**$0.00**	**$0.00**

The budget template is divided into four sections: 1) income categories; 2) fixed expenses; 3) variable expenses and 4) a residual amount. We input values into every applicable cell of the first three sections and then the remainder amount is computed for us automatically. For those experienced in Excel spreadsheets, setting this up by hand is a very straightforward matter. If this is not the case, we would be happy to provide our template, free of charge, to any of our readers. The original source and idea for this worksheet has been cited in our References section. For those who are advanced DIYers, this is still an excellent book to purchase.

We always begin with the "Today" columns. Remember that each amount is computed as a monthly value. For example, many people who pay their own property taxes get billed by their counties on an annual or semi-annual basis. So this will require taking the most recent actual amount (or estimated current year amount) and adjusting as appropriate, to get to a monthly number.

Fixed expenses are considered those that do not necessarily change from month to month, such as housing or car payments, insurance and taxes. If you happen to be paying the US Treasury something more each April (in addition to taxes withheld), you should be accounting for it here, as well.

In addition, we have added several savings and investment categories and even a spot for mortgage principal prepayments.

<u>The guiding principle is that every dollar that comes in and goes out, has its own "bucket"</u>. This means that the number displaying in section (4) in the lower right hand corner should be as close to zero as possible (preferably at $0.00).

Variable expenses change from month to month, typically based upon the usage of something, such as natural gas for heat and cooking, water, gasoline, etc. Added to this are some related categories that make sense when grouped together, such as TV and Internet, along with the rest of utilities.

The exact placement of all of these items is not as important as the mere fact of their presence and the accuracy of their data. If this layout does not work for you, by all means feel free to change it. However, we recommend against winding up with any significant dollar value in the "All Misc." category. Use Miscellaneous as a temporary placeholder as you work through all the other categories. Your entire budget may take a few iterations to complete fully and accurately. Stay patient and walk away from it, should it ever get frustrating. If you have lived without it for so long, waiting a little longer will not hurt. Then seeing it again later, with a fresh set of eyes, will trigger new ideas and potentially fill in the remaining gaps.

When the "Today" columns have been completed and you have lived with and verified the general accuracy of your budget over a number of months (preferably a year or two), you will have the data necessary to analyze what your retirement needs really are. Some categories may disappear entirely, such as wages and salary, or a mortgage payment. Some may need small inflation adjustments, such as food and utilities. Others may change from small (or even zero) to big dollars, as you begin a new hobby or start traveling extensively. Even so, the foundation created by completing "Today", will serve you well.

Our next major principle is that for retirement, we are trying to minimize discretionary income distribution needs, subject to maintaining the same standard of living as before (or what our nominally desired standard of living needs to be in retirement).

By contrast, during our prime working years, we never asked our employers to lower our pay to match our expenses. We needed to earn as much as we could and then we allocated spare dollars to savings (including mortgage prepayments) and to investments. If the salary and wages bucket will now show zero, the savings and investment buckets may also wind up with zeros (no new contributions). Some of us may have pensions, annuity payments and Social Security benefits at this beginning stage of retirement, but this is not always a given. By entering all of these fixed income sources first, we then need to distribute from our other income sources (discretionary sources, such as retirement accounts) only as much as is needed, to get the worksheet to balance in the lower right hand corner.

To demonstrate using a simple example, imagine a 66 year old couple who has $100,000 in income prior to retirement. Because of savings and investment contributions which are no longer needed (including paying their mortgage), the amount required in the first retirement year is estimated to only be $75,000. They begin to take Social Security benefits at the same time (while this particular timing may not be the best or only choice, this example has been simplified) and this will produce $24,000 and $16,000, respectively. Only one of them has a defined benefit pension. This will also be tapped. But it's pretty small and amounts to only $8,000, annually. This leaves $27,000 as the income shortfall for the first year of retirement.

After careful consideration, our couple has decided that a significant level of capital preservation is necessary, in order to satisfy their estate planning objectives. But how much is feasible, given their total financial picture and available resources?

In our case, they state that they would like to leave their primary residence (currently valued around $500,000) to their only child. Their financial planner suggests a slight modification to this goal and rephrases it as "*leaving the value of their primary residence, to their only child*". This distinction is important. Their planning involves the potential use of a reverse mortgage line of credit (HECM), in order to cushion their core investment portfolio during down market periods. They plan on leaving the residual value of their investment portfolio, to pay back any reverse mortgage loan balance, if necessary. This is how they plan to leave the value of their home to their child.

As we introduced earlier, the capital preservation method seeks to satisfy the annual cash flow gap, by using income producing assets. With a capital utilization strategy, we would not care about this and simply take a distribution of X shares of a fund that equates to the dollar amount we need. In our case, the analysis of their situation along with a discussion of their desires and risk tolerances, leads to a hybrid solution, resulting in 80% capital preservation along with the remaining 20% as capital utilization. This means that 80% of the $27,000 gross income gap in year one, or $21,600, must come directly from income generated by the assets in their portfolio. The other $5,400 could simply come from the sale of enough shares of one of their mutual funds, that totals to this amount.

Today, what are their major income oriented asset choices? Just as the Apollo moon missions featured a long ride outside of earth orbit, where it appeared that not much was happening (while the astronauts were coasting along), the approaching lunar landing calls for a lot more activities and unique actions to be taken. Here is our main list of options, sorted by relative risk, along with some abbreviated commentary.

1. Interest paid on FDIC insured bank savings accounts (especially including online savings accounts, which may yield around 1%, but are poised to increase albeit slowly).
2. Interest from FDIC insured bank certificates of deposit (***laddering*** has traditionally provided a better yield with a new, longer term CD replacing a maturing one; however, the current low yield environment has severely hindered this strategy).
3. Interest from bonds (both government and corporate could be considered, but their principal value will be whacked as bond yields go up, due to rate normalization at some point in the future).
4. Balanced funds (pay attention to yield and asset allocation; the dividends are set to be paid in cash and not reinvested in additional shares).
5. Dividend paying large company stocks (these are often called ***blue chips*** where the company's management maintains a strategy to pay a good portion, if not most, of their earnings out as dividends; these are not considered major growth stocks; the dividends are set up to be paid in cash and are not reinvested in additional shares).
6. Rental income (through active participation real estate that is owned directly; other tax incentives are involved; being a landlord is not everyone's choice).
7. Real Estate Investment Trust (**REIT**) dividends (through REITs owned directly or through REIT ETFs and mutual funds; stick with publicly traded REITs).
8. Private mortgage notes with interest only payments or fully amortized with monthly interest and principal payments (this means getting a lien on the property and having knowledge of its value; it is important to know the financial standing of the property owner).
9. Option trading for income (through ***covered call writing***; here the real risk is not with selling the call options, but with holding the underlying stock).

Pension payments and Social Security benefits have already been mentioned in our example. They should always be included in any analysis. However, be careful with annuities. Fixed immediate annuities pay a static monthly amount, while variable annuities may be sold with a myriad of riders that promise to increase monthly income or pay a guaranteed amount. The premium you pay to purchase the annuity can produce the income you need, but will terminate at a future point, perhaps at your death or that of you and your spouse. If the purpose of your financial planning was to develop a plan for capital preservation, annuities best accomplish this ***indirectly*** by allowing you to preserve ***other*** assets. Keep in mind that once the event that terminates the annuity has occurred, such as a death or a term certain that has passed, payments cease and there is no longer any asset to generate a cash flow. The annuity can be viewed as an insurance contract where you give up access or ownership of an asset (your funds), in exchange for periodic cash flows that extend until some event occurs.

It should be kept in mind that ownership of any asset leaves you with all of the responsibilities and risks inherent in owning that asset (such as no guaranteed level of income from the asset and no fixed value for the asset). But you are also entitled to all of the income that the asset generates, as well as any potential appreciation in its value. This is analogous to the idea that the one who owns a tree is entitled to all of its fruit, but is not assured that there will be any, nor is assured of the tree's survival.

Our retiring couple along with their financial planner, have made some decisions about how much of their portfolio to allocate to income generating assets, as follows.

Asset Description	Principal Value	Yield	Annual Gross Income Expected
Private Mortgage Note – Interest only for 5 years	$150,000	4.00%	$6,000
Vanguard Wellesley Income Fund (Admiral)	$200,000	3.06%	$6,120
Vanguard REIT Index Fund (Admiral)	$100,000	3.92%	$3,920
AT&T Stock held in a brokerage account (1,315 shares)	$50,614	5.09%	$2,577
Covered Call Writing in separate brokerage account	$50,000	Varies	$3,000
Totals	$550,614		$21,617

Our list of nine income producing assets is by no means exhaustive, but it does frame the issue. The first two are banking products that, under the current level of interest rates (as well as during most of the past decade) are simply not capable of generating adequate income. This was not always the case and we caution readers on assuming that interest rates will forever be this low. But the purpose of any analysis is to review the current environment and pick alternatives that will accomplish your current goals. Since (1) and (2) do not, our retirees reject these two choices completely, for the time being.

Bonds (3) could be feasible, but US Treasuries are still very low yielding and purchasing corporate bonds directly involved more research effort than our folks want to expend. Instead, a very conservative balanced (4) fund (Vanguard Wellesley Income) was selected. In the general case, this is a way of getting anywhere from the 60%/40% classical stock/bond allocation, to a conservative 40%/60% (such as Wellesley), depending upon the fund and its management's recent decisions. We took the yield as reported for this fund on the Vanguard Website, as of this writing.

Individual stocks (5) carry more risk than diversified mutual funds. However, our folks enjoy the higher dividend yields paid by some companies. They believe that since AT&T has been around for more than 100 years, it should continue to earn profits long enough to provide them good income. It's current yield is more than 5%.

Next up, real estate is one of our favorite investments from an income generation standpoint. We show three possible ways. In the first, active participation rental real estate (6), the investor is also the landlord. This is not everyone's cup of tea. Our couple rejected it immediately. On the other hand, commercial real estate is oftentimes owned by real estate investment trusts (7) (REITs). We recommend that most investors own these through a diversified mutual fund or ETF. Our couple picked a low cost REIT index fund that has an almost 4% yield.

The last real estate related investment we discuss is a private mortgage note (8). Our couple made a significant investment here simply because they knew the borrower very well, along with the property. In this case, they helped their daughter purchase her first home: a two bedroom condo. They feel that she got a good price since she came in as a cash buyer. The note could be structured in a customized way. In this case, it was to minimize the payment that their child needed to make, while maximizing income to her parents. This was not done by accident. It is also expected that within five years time, their daughter may seek to refinance, using a conventional lender. Her savings, plus a little appreciation, may result in her getting to the 20% equity threshold (thus avoiding private mortgage insurance).

Our last income alternative is option trading through covered call writing (9). A brokerage account is required, though it may or may not be separate from the one you may already own. We recommend the stocks of mature, large cap US companies that: have earnings, pay above average dividends and where the stock's ***beta*** is greater than 1. Beta represents the systematic risk of a stock as compared to its market benchmark (in this case, the S&P 500®). The true risk in covered call writing is not in selling the options. It is in simply holding the underlying stock. The act of selling the call option gives the buyer the right (but not the obligation), to purchase the underlying stock from you at a set price (the strike price) within a set period of time (ending at market close on an expiration date). If the strike price is less than the current market price of the stock, then the option is said to have intrinsic value, also known as being "***in the money***". In this case, the option buyer could exercise the call and buy the stock from you at a cheaper price than would otherwise be possible. The option sells for what is called a ***premium***, which equals the sum of its intrinsic value along with a time value. Since counting on intrinsic value every time you sell your call options would be unrealistic, an option with no intrinsic value is said to be "***out of the money***". But providing this alternative to other traders, especially professionals, is part of what makes a market work. <u>Your stock's price may be moving sideways over weeks or even months, but the fact that it goes up and then down and then up again, makes for a dynamic and profitable options trading market</u>. But please remember that this is not the same thing as investing. It is trading. Having very low commission rates on trades is of critical importance here, since this activity will generate costs.

We have already discussed options trading to generate income, in great detail in a previous article. Let's just say that our retired couple have decided that now they have a few spare hours a week, with which to follow a handful of their favorite stocks. They have purposefully made this a very small part of their overall portfolio, devoting only about 10% ($50,000 out of over $550,000 in the capital preservation portfolio; they also have somewhat less in a capital utilization portfolio). Dividends paid by these companies are taken in cash and used to help maintain the capital base at $50,000. This means that while the stocks' price may gyrate, we are looking to either hold them when they are down, or to otherwise buy. When an option gets exercised by the purchaser, your stock is sold in your account automatically, without any further action on your part.

The rate of return on covered call writing varies widely. Here, we simply show a conservative case of achieving $3,000 of income over the next 12 months (using some, most or potentially all, of that $50,000). Since individual option selling transactions have their own rates of return/yield, we do not simply refer to this as being 6%. For example, you may have $28,000 tied up in 300 shares of a stock, then sell three call contracts (each contract represents 100 shares of the underlying stock) and net $398.99 of income, after all commissions and fees. This looks like a 1.4% yield. But we need to consider how long we need to wait until the expiration date. The shorter the time-frame (measured in weeks), the quicker you can either do it over again to generate more income (with potentially far different results), or get your original investment back and buy some other stock.

Reviewing the table of income producing assets above, our retired couple have taken a moderate path. There is some risk in their capital preservation portfolio. They have allocated about $550K of their assets to try and generate $21,617 of income, in their first year. This appears on the surface to be a 3.9% yield and may look suspiciously similar to some readers, to the well known ***4% rule***. <u>But the two are not the same</u>.

While the principal value is not locked in, we do have an income return that is very much based upon both the current realities of the market place, as well as the economy. If interest rates were back to 1988 levels, the choices we would have recommended and they would have made, would have been far different (simply to minimize risk). But given the need to generate a certain amount of income, our couple used an appropriate mix that balanced their willingness, ability and need to take risk.

To summarize, our couple created their budget in retirement based upon accurate information from their previous twelve months of spending. They were first able to eliminate the savings and investing needs that were no longer required (they now have a paid off house and no longer make retirement plan contributions). They then computed the income gap remaining after subtracting the standard income sources of Social Security and pensions/annuities.

Filling this income gap has been the real core of our discussion. We listed a number of choices, ranging from the truly dull but very safe, all the way to the much more profitable but much more volatile.

Living on this income means that even when the principal value fluctuates (and be assured that it will), your focus should still be on generating the income that you need. Assuming that you can afford to hold on to the asset even if it were to drop in value, as long you are generating the required amount of income, there is no need to panic. No need to make sudden moves. When there are both lower risk and higher risk methods to use, why take unnecessary risk?

Consider the following as examples of an unduly risky approach:

1. Giving private mortgage notes to strangers or on properties you do not know much about.
2. Buying Rental property without estimating the net operating income and financing costs, to determine if the bottom line income level is acceptable.
3. Purchasing non-publicly traded REITs.
4. Using non-dividend paying stocks in a portfolio meant for income.
5. Selling covered call options without doing some small trial runs first and getting used to the mechanics of trading.

6. Using a high cost balanced fund that may be hiding excess risk (in order so they could make up for their increased expense ratio).

The ultimate goal of our couple was ***capital preservation***: having a very good chance that at least the nominal (non inflation adjusted) value of the assets in the table above, could be left to their daughter. They live from the income generated by those assets, instead of using the principal. But they also realize that they may need to draw on a reverse mortgage line of credit (HECM) some day, during a prolonged down market. Their home's equity will then act as a cushion, to protect their other investments (those not listed above, that are part of their capital utilization portfolio), from having to make deeper distributions from principal, during those down years.

After their death, proceeds from selling the investments listed in the table above, can be used to pay off the HECM balance, thus preserving the value of the house. This is yet another example of the ***Castling*** principle at work. Your personal moonshot planning.

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https://www.amazon.com/s/ref=nb_sb_noss?url=search-alias%3Daps&field-keywords=Deena+Katz%2C+Tools+and+Templates+for+Your+Practice
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