



*Helping You Secure Your Future™*

henry@YourIndependentAdviser.com

## ***Spring 2016 Newsletter:***

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## **Hang In There!...I'm Hanging, What Else Do You Want From Me?...Uh, Ultra Low Expenses, Schmarty-Pants!**

Clients, investors, retirees, the general public (maybe even bats in the belfry?) are constantly reminded to “just hang in there”. In other words, don't sell your investments at or near the bottom of a market cycle but instead, simply “stay the course”. All the while, their portfolios are sinking like stones in an almost bottomless pond. What is to be done?

Well, we cannot simply wave a magic wand and wish the misery away. Economic and financial storms invariably hit all of us, from time to time. We have described our approach to risk management as incorporating the “three dimensions of risk tolerance”: willingness to take risk, ability to take risk and need to take risk. Performing a balancing act among these three, the investor should carry their portfolio through the storm.

But in addition, the concept of lower costs has been gaining increasing prominence in the financial services industry, as compared to a generation ago.

In the past fifteen plus years since Y2K, investment returns have been noticeably lower and volatility has, at various times, been noticeably higher.

While we cannot control the business cycle or valuations, there is something that is more easily under our control: costs. For our purposes, we classify two sets of costs here:

1. Underlying investment vehicle costs, such as the total expense ratios of a mutual fund.
2. The added costs of financial advisory services that help us determine what we invest in, how we invest, when to invest, etc.

Our purpose here is not to label the lower cost examples that follow as being inherently “good” or the higher cost examples as inherently “bad”. We do think that the higher cost examples are inefficient investment vehicles and so, we do not recommend them in our own practice at the present time. The interesting thing is that these high cost products are typically sold by commission based product salespeople (CBPS) who hold themselves out as being financial advisors in the first place and may charge “fat fees” on top of these high expenses.

But even if you invest in low cost products, you may be charged asset management fees (AUM fees) by a registered investment adviser (RIA). These fees may add anywhere from 0.5% to 1.5% on top of the investment fund expenses.

The rise of online based “Robo-advisors” means that costs may be headed down. But even in this case, we still see that the total expenses being charged are beyond what we consider to be a reasonable threshold.

Over the years, we have come up with what we believe to be a useful cost benchmark that is easy for any investor or client to apply, yet challenges the industry and adheres to the fiduciary requirement of looking out for the best interests of clients.

Reviewing your entire investment portfolio and including everything you pay in underlying investment vehicle expenses, loads, commissions, brokerage fees and advisory fees (whether percentage of AUM, hourly or fixed), the total expenses should be no more than 0.5% of your investment portfolio on an annual basis.

We are pretty sure that the squawking from CBPS or asset based advisers would sound like a convention of mallard ducks. I'm sorry, but I don't care. One half of one percent is what we have concluded from the last two decades (of both personal investment as well as providing investment advisory services for the last several years).

If you are a do-it-yourself investor and find it impossible to accomplish this goal, while still investing in all of the usual asset classes we talk about, then you are misinformed. DIY is fine, but only if you are truly “saving” by not paying for any professional help.

On the other hand, if you have an adviser, we recommend challenging him or her to live up to this benchmark, on an annual basis. If you are truly receiving market beating returns year after year and do not mind paying for this privilege, that's fine. But these types of star advisers are exceeding rare. In fact, many “flame out”, along with their clients' portfolios.

Here is a real life example. Let's compare two index funds that track the large company S&P500® index and two that invest in short term bonds. We selected a neutral third party, FINRA and their Fund Analyzer tool, to supply the numbers. We encourage all readers to try this on their own, since the tool is free, but cost data is constantly being updated<sup>1</sup>.

We found two funds that are more proprietary and are typically sold by CBPS:

1. State Farm S&P 500 Index Fund Class B (ticker symbol: SNPBX)
2. Wells Fargo Short-Term Bond Fund Class C (ticker symbol: WFSHX)

Please keep in mind that CBPS may refer to themselves as being financial advisors, registered reps or brokers. In any case, if you are depending upon what they recommend

and sell (they have restrictions on not being able to recommend that which they do not sell), you may wind up with an investment similar to the above. In this analysis, we are focusing on costs.

Since we don't sell any products and would rather that clients purchase what they need directly, based on our independent advice, we oftentimes recommend Vanguard® Group funds, since they are available for direct purchase, maintain truly low expenses and have a lot of asset class choices.

Here are two alternatives for the above funds. Their underlying holdings are very similar:

1. Vanguard 500 Index Fund Investor Class (ticker symbol: VFINX)
2. Vanguard Short-Term Investment Grade Investor Class (ticker symbol: VFSTX)

What we focused on in our analysis is selecting a very low projected rate of return: just 5% for the stock fund and 3% for the bond fund, over an extended period of time: fifteen years.

By golly, guess what we have actually seen over the 2000-2015 time period? We have had ups and downs to be sure. But overall returns have been quite modest, to say the least. Large cap US stocks have had an annualized total return of under 5% over a 16 year period.

This is our central point. If you have been told repeatedly to stay the course, hang on, stay on track, etc., you may have tuned out the wild swings and the ups and downs of the markets. But when fifteen or more years go by, you do expect to have something to show for it, right?

So hypothetically speaking, if the annualized returns are only 5% for a long fifteen year period and you start out investing \$10,000 in the State Farm index fund, the amount would grow to \$17,804. Using the same conditions but investing in the Vanguard 500 index fund, your account value would be \$20,296! This is a difference of \$2,492 for what essentially is the same type of investment vehicle.

Let's say that you started out with \$20,000 to invest. The first \$10,000 went into the stock fund as we just mentioned. The other \$10,000 was invested in the short term bond fund. For bonds, we still invest for fifteen long years, but face much less volatility than in the stock market. For some of this time, we see decreasing bond yields and increasing bond prices. At other times, it looks as though interest rates are going to spike. Overall, we see low returns. Does this also sound familiar?

For our hypothetical FINRA Fund Analyzer test, we assumed a 3% annualized return over 15 years, for the bond funds.

So how did our bond contestants perform? Well, they both lost to the stock funds, but this is not surprising since we set the return to be only 3% before expenses. But after costs were subtracted, what did we get to keep?

The Wells Fargo Short-Term fund ended up with \$12,478. The Vanguard Short-Term fund had \$15,119. This is a still significant difference of \$2,641.

In summary, comparing the results of two \$20,000 initial investments in what were meant to be essentially identical portfolios (allocated 50% stocks and 50% short-term bonds), could end up varying by over \$5,000. You could have ended up with just \$30,282 after fifteen years, or as much as \$35,415.

Some would say that you were getting advice from your “financial advisor” all the while, if you chose the high cost funds. I hope it was very good advice, because it certainly wasn't about efficient mutual funds.

These two sets of funds invested in essentially the same securities, taking the same inherent level of risk. No one gets “brownie points” or a “merit badge” for investing in expensive funds.

From our point of view, anyone who is a true adviser should be a strict fiduciary and should be getting your total expenses as close to zero as possible. This is what you should be paying that person for. We also could have picked Fidelity, Schwab, BlackRock, USAA, etc. funds that would have been cost effective. Our point here is that it's not simply about one mutual fund company. It's about costs in totality and the value you may or may not be getting from your adviser.

Our general principle can be stated as follows:

***Your investment portfolio should cost you no more than 0.50% per annum in total, for both underlying investment portfolio expenses, as well as any advisory fees. Pay much more than that and you are probably paying too much.***

The Wells Fargo fund clocks in at an eye popping 1.48% annual expense ratio, compared to the equivalent Vanguard fund's 0.20%. The State Farm index fund has a back-end sales charge. Hold it for the first eight years and get socked with a 1.36% in operating expenses. The Vanguard 500 Index is 0.16% and with no front or back end sales charges.

The secondary principle is:

***During periods of low relative returns, your investment expenses are magnified in importance.***

Asset based advisers may recommend the lowest cost funds, but then layer 0.50% -1.50% fees on top of this. We consider this to be essentially no different than the CBPS, just in reverse. The end result is roughly the same: high expenses.

This leads us to our third basic principle:

***The CBPS or asset based adviser may ratchet up the risk level in a client's portfolio, to make up for their increased expenses. This is rarely in the client's best interests.***

No, not everyone does this. But so many investors thought they had proper asset allocations back in 2007, some of which were professionally managed, only to be rudely awakened in 2008.

Many personal finance writers, pundits and advisers have made a strong case that costs matter. So we certainly are not the first to make this point. But we have showed you a useful benchmark to use (0.50%), we have explained what happens in a low return environment (like what we are experiencing) and we have reminded you to look out for increased risk taking that masks expenses (don't be fooled).

## **Castling Defensive Portfolio Gets Dinged in 2015, So Why's It Doing Better in 2016?**

In putting together the *Castling Defensive Portfolio* (CDP), our emphasis was trying to identify an asset allocation of funds that most people could invest in, that minimized volatility, but still reached for a 7.2% annualized return. This has become increasingly difficult to accomplish, due to the very low interest rate environment of the last seven years.

2015 was a difficult year in both the stock and bond markets, domestically as well as internationally. As a result, our hypothetical portfolio consisting of nine Vanguard funds as well as bank CDs, stumbled to a 0.22% loss. OMG! OK, we'll take our lumps, since the story has a nice twist.

In the first four months of 2016 (data as of the end of April), the CDP has gained a healthy 3.27%.

By contrast, the Vanguard 500 Index returned 1.25% in 2015 and 1.69% in 2016 through April 30<sup>th</sup>. In the table below, we show how the CDP stacks up to three Vanguard funds, including Wellesley Income, which happens to be one of the components of the CDP<sup>2</sup>.

We have not touched the asset allocation mix since creating the portfolio. There has been one fund change over all these years (Royce Special Equity was removed after 2012 since it was closed to new investors). The importance of keeping the asset allocation was due to our own research, which pointed to the decrease in risk that could be achieved.

If we measure this risk level by the standard deviation of the annual returns, the CDP still holds a significant advantage over the other funds we mentioned. Furthermore, if we take this risk level and measure it per unit of actual return, we get something called the coefficient of variation. Again, the CDP 's value is lower than the others.

So what is our present concern? The persistence of such low interest rates has lowered return expectations on the bond side a great deal. 7.2% is no longer a realistic portfolio return target in this environment. Please keep in mind that the CDP maintains an allocation to stocks of only 31%. If this percentage in stocks keeps you up at night, you probably should not be investing in stocks at all (or perhaps need to change your outlook on investing).

From 2000-2014, the CDP had a 7.35% annualized return with only one negative year (-6.15% in 2008). 2015 proved to be pretty flat in almost all of the underlying investments of the CDP, with international and small company stocks faring more poorly.



Still, there is reason for optimism if you compare against other investments with similar risk levels (meaning low risk levels). We stress the value of low expenses and the CDP has an expense ratio of just about 0.20%.

Contributing to the 3.27% year to date gain to April 30<sup>th</sup> have been three asset classes that did poorly in 2015:

1. Inflation Protected bonds (+4.75% versus -1.83% in 2015)
2. Small Cap US stocks (+5.60% versus -4.78% in 2015)
3. International stocks (+2.04% versus -4.37% in 2015)

Castling Defensive Portfolio (CDP) Comparison	2012	2013	2014	2015	2016
Castling Defensive Portfolio Yearly Returns	7.48%	5.74%	6.71%	-0.22%	3.27%
Back-Tested Cumulative Return Since 2000	156.84%	171.59%	189.81%	189.16%	198.62%
Hypothetical Growth of \$10,000 Since 2000	\$25,684	\$27,159	\$28,981	\$28,916	\$29,929
Annualized Return (2000-2016)	7.53%	7.40%	7.35%	6.86%	6.65%
Standard Deviation (2000-2016)	4.99%	4.82%	4.65%	4.88%	4.81%
Coefficient of Variation (2000-2016)	0.66	0.65	0.63	0.71	0.72
Wellesley Income (VWINX) Yearly Returns	10.06%	9.19%	8.07%	1.28%	4.71%
Back-Tested Cumulative Return Since 2000	161.54%	185.57%	208.62%	212.57%	227.29%
Hypothetical Growth of \$10,000 Since 2000	\$26,154	\$28,557	\$30,862	\$31,257	\$32,315
Annualized Return (2000-2016)	7.68%	7.78%	7.80%	7.38%	7.22%
Standard Deviation (2000-2016)	6.55%	6.30%	6.07%	6.10%	5.95%
Coefficient of Variation (2000-2016)	0.85	0.81	0.78	0.83	0.82
Wellington (VWELX) Yearly Returns	12.57%	19.66%	9.82%	0.06%	3.38%
Back-Tested Cumulative Return Since 2000	135.53%	181.84%	209.52%	209.70%	220.17%
Hypothetical Growth of \$10,000 Since 2000	\$23,553	\$28,184	\$30,952	\$30,970	\$31,998
Annualized Return (2000-2016)	6.81%	7.68%	7.82%	7.32%	7.08%
Standard Deviation (2000-2016)	11.65%	11.65%	11.24%	11.06%	10.76%
Coefficient of Variation (2000-2016)	1.71	1.52	1.44	1.51	1.52
Vanguard 500 Index (VFINX) Yearly Returns	15.82%	32.18%	13.51%	1.25%	1.69%
Back-Tested Cumulative Return Since 2000	22.36%	61.73%	83.58%	85.87%	89.01%
Hypothetical Growth of \$10,000 Since 2000	\$12,236	\$16,173	\$18,358	\$18,587	\$18,668
Annualized Return (2000-2016)	1.56%	3.49%	4.13%	3.95%	3.82%
Standard Deviation (2000-2016)	19.02%	19.83%	19.22%	18.61%	18.04%
Coefficient of Variation (2000-2016)	12.16	5.68	4.65	4.71	4.73

Why go through this level of detail? Just to show that markets move in cycles and what may work well one year may be a dud in the next, or vice-versa. In addition, some asset classes work more reliably, while others come and go. But each was selected because over many rolling periods of analysis, they added something special to overall performance.



It is worthwhile to give these asset classes a chance to work together. But it may be that a longer term annualized return objective should be reset closer to 6%, rather than keeping it at 7.2%. This is rather unfortunate. But is there any solution? We'd like to keep the CDP as it is, but perhaps augment it with another asset class and see if this could provide us the bump up with are looking for. We'll research this and report on it in the future.

Clearly, if you need a higher return, you will need to take more risk. But how much more? Ah, there's the rub. Risk and return are obviously very closely related. But there is no perfect linear relationship. As the expected return increases, the level of risk goes up disproportionately more. Our work with individual clients focuses on assessing their “three dimensions of risk tolerance”:

1. Willingness to take risk
2. Ability to take risk
3. Need to take risk

and only then recommending a customized investment portfolio. For others interested in very low risk, do-it-yourself type investing, we offer the *Castling Defensive Portfolio*, as a free example. Boring, yes. But volatile? Heck, no.

<b>The Castling Defensive Portfolio:</b>										
		Ticker	% Allocation	Expenses	Equity %	Weighted Exp.	Min. Invest.	Initial Min.	2016 YTD	Contribution
1	FDIC Insured Certificates of Deposit (Avg. of High Yielding)	Bank CD's	9%	0.00%	0%	0.000%	Varies	\$6,750	0.42%	0.04%
2	Vanquard Short-Term Treasury Investor Shares	VFISX	9%	0.20%	0%	0.018%	\$3,000	\$6,750	1.20%	0.11%
3	Vanquard Short-Term Investment-Grade Investor Shares	VFSTX	9%	0.20%	0%	0.018%	\$3,000	\$6,750	2.19%	0.20%
4	Vanquard Intermediate-Term Treasury Investor Shares	VFITX	12%	0.20%	0%	0.024%	\$3,000	\$9,000	3.29%	0.39%
5	Vanquard Inflation-Protected Securities Investor Shares	VIPSX	12%	0.20%	0%	0.024%	\$3,000	\$9,000	4.75%	0.57%
6	Vanquard GNMMA Investor Shares	VFIIX	11%	0.21%	0%	0.023%	\$3,000	\$8,250	2.09%	0.23%
7	Vanquard Wellesley Income Investor Shares	VWINX	11%	0.23%	4%	0.025%	\$3,000	\$8,250	4.71%	0.52%
8	Vanquard Small Capitalization Value Index Investor Shares	VISVX	15%	0.20%	15%	0.030%	\$3,000	\$11,250	5.60%	0.84%
9	Vanquard REIT Index Investor Shares	VGSIK	8%	0.26%	8%	0.021%	\$3,000	\$6,000	3.68%	0.29%
10	Vanquard Total International Stock Index	VGTSX	4%	0.19%	4%	0.008%	\$3,000	\$3,000	2.04%	0.08%
<b>Totals</b>								<b>\$75,000</b>		<b>3.27%</b>

## **You Said You Lost \$50,000 on Your Rental Property, But It Was a Good Investment? Want to Borrow My Screwdriver to Tighten Your Loose Screws?**

One interesting observation we have made over the years is that many personal finance authors, investors, as well as the various types of financial advisers, seem to have rather extreme views when it comes to residential real estate. They either love it or they hate it. When someone loves it, real estate then becomes the silver bullet and almost single solution. Otherwise, they tend to stay away from it as though it were the plague.

There is a middle ground. Real estate is very useful for diversification away from simply holding financial assets. While REITs (real estate investment trusts) represent ownership in commercial real estate, they are still securities. Owning shares in REITs is valuable in diversifying a stock portfolio. But it is not the same thing as owning real estate directly, especially residential properties.

We have previously made the point that your primary residence is never an investment, but is an asset that forms part of your long term savings (in addition to its main role of giving you a roof over your head). By contrast, real estate that you own for investment purposes should be something you hold for capital gain, production of income, or both.

In this article, we focus on aspects of holding rental property for its income potential. While we would hope for its eventual price appreciation over time, there is of course no guarantee. But imagine if we did not need such a guarantee.

The essential factors we are identifying are local knowledge and what can be called “sweat equity” (active participation), combined in an approach that can be termed “active investing”.

Various famous investors and mutual fund managers, such as Peter Lynch, have advocated for “investing in what you know”. What we are describing is a similar approach, but on a very localized level.

For example, let's suppose that we have an investor couple who has some interest in rental real estate, but no prior experience. But what they do have is an abundance of local knowledge of their neighborhood's real estate market. It is not so much that they go out searching to buy, as they prepare themselves financially and then look out for opportunities in their own backyard. So let's continue this as a “thought experiment” and we'll show you the twist at the end that shows bad things can happen, but the end result can still be favorable.

First of all, they decided they did not want to carry two mortgages, both on their primary residence and a second on a potential rental property. So they diligently spent the last number of years making mortgage pre-payments. This was nothing major at first and they continued funding their employer sponsored retirement plans. But they thought, why build up savings beyond a simple emergency fund, if yields on bank products were always so low?

After ten years of pre-payments, the principal balance on their mortgage was so low, that they decided to refinance at absolutely zero cost by going to a home equity line of credit (HELOC). They figured that it was worth doing at such low interest rates. By the time rates rose, they might have it paid off completely. The HELOC did not cost them a dime to get (they even got an appraisal of their home, for free). The HELOC does cost them a nominal \$50 a year going forward. In a couple years, their balance was paid off. A HELOC that replaces a first mortgage enjoys a first lien position that will usually prevent it from being frozen during a financial downturn or recession. This was not the case during the financial crisis when many homeowners had HELOCs that were in second lien positions behind their primary mortgages.

The major point about the HELOC is that it allows the small real estate investor a source of funds that, combined with other cash being accumulated for future investment, makes them appear as “cash buyers” who can demand lower prices and better terms.

But this is not meant to be a permanent solution, since interest rates can and do rise, causing the HELOC to become more expensive. So once the rental property has been purchased, the debt caused from taking out of the HELOC, can be refinanced with a another fixed rate mortgage.

Some people would assume at this point that we propose getting a mortgage loan against the rental property that was just purchased. While this could be done, interest rates to finance a rental property may be a couple points above what you would pay to refinance the mortgage on your primary residence. This way, it's just a whole lot cheaper.

The difference between 3.25% and 5.25%, for instance, can be significant over the life of the loan. For example, on a \$200,000 loan at 3.25% for 15 years, the total interest expense is \$52,961. If it were at 5.25%, the interest cost would be over \$36,000 more. Please keep in mind that rental income is going to be used to pay these interest costs, so saving wherever possible, is paramount.

**CAUTION:** We treat home equity as part of your savings and not as an investment, in itself. If and when someone uses a HELOC to drain that equity, in order to make an investment, it must be something they will commit to and be willing to hold for the long

term. Rental real estate may fit this plan. Stocks would rarely be appropriate. Why? Well if you open a margin account with a brokerage firm, you would be limited to 50% leverage. Stocks' year to year volatility is typically much greater than that of residential real estate, even considering the recent property bubble of the early 2000s. Our twist at the end of this story may seem to contradict this, but that was purposefully done.

Now back to our little thought experiment. Our folks are debt free and searching for a great deal. They are nothing if not patient, since they waited this long. But they know their local townhouse development and one of them even serves on its HOA board. They are looking for a situation in their own backyard. They have a HELOC ready to go and no other mortgage debt.

All of a sudden they find out that their neighbor, a friendly, well off widow who had recently not been feeling well, has just passed away. It appears that her family would rather sell their mother's townhouse than hold on to it, since it was never the home they grew up in. They desire a quick sale and then drop the asking price on the unit to something well below what our investors would accept for their own (nearly identical) townhome.

Local knowledge triumphs. Our investors view the property inside, confirm its excellent condition and similarity to their own home. They begin the process of negotiating and snag the townhome for \$200,000 when their own unit would probably sell for around \$225,000. Good deal. Being cash buyers when cash is king certainly did not hurt. They did not need any mortgage contingency clause in the sales contract. This captured the attention of the sellers, who had inherited a townhouse that they didn't know what to do with. But it was already burning holes in their wallets, with monthly HOA fees, property taxes, utilities, etc.

Our investors local knowledge continues to be worth money. They wanted to buy in this development since they knew that these townhouses are highly desired by renters, especially ex-patriot Japanese businessmen and their families. The units' styling is contemporary, each has higher end finishes, especially in the kitchen. Above all else, their 1,800 square feet layout is prized by those who will, one day, return to tiny apartments back in Tokyo.

Our investors did their homework in estimating costs ahead of time and in comparing to the likely rental income to be received.

Local knowledge extends to knowing what needs fixing up and what does not. Let's say that a total of \$4,000 is spent to spruce up the interior, such as by repainting walls and replacing some carpeting that had looked worn.

They quickly turn the house over to the rental market. There, they find a qualified tenant, his stay at home wife and their small child. They receive monthly rental payments on a two year lease, of \$1,950. This is about as high as any landlord can get in the development. They knew this because of their knowledge serving on the HOA Board.

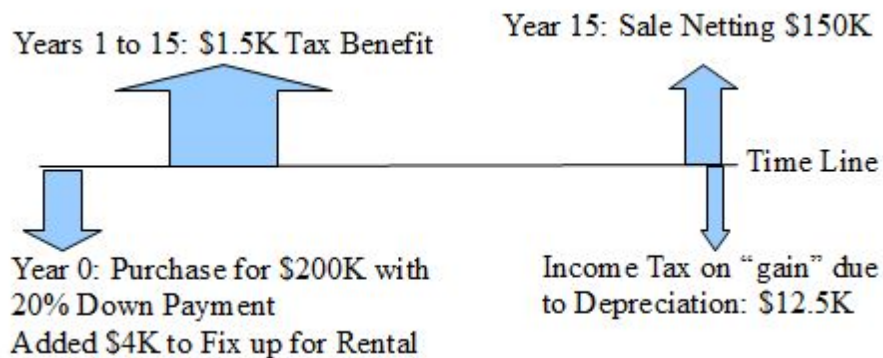
We keep bringing up the local knowledge issue, because consider the following. A stock investor who closely follows Chevron Corporation and the crude oil market is competing with literally hundreds of analysts and fund managers, as well as tens of thousands of other investors. This investor may make a timely call on when Chevron is a good buy. But this person cannot hope to compete successfully against the rest of the market or to obtain any “inside” information (not to mention the legal considerations, therein).

However, our investors may know very well that their townhome is worth \$225,000, based on Websites such as Zillow and Trulia, as well as paying attention to recent sales in the area. Furthermore, how many other people are potential investors that knew that the unit next door was virtually identical, well maintained, but just lacked some sparkle? A few perhaps, but not many.

By using their local knowledge, our investors benefited in the analysis portion of the investment process.

Next comes the active participation side. In this scenario, our investors are not “paying themselves” out of the rental income for their efforts. Instead, they are trying to plow back every single dollar of rental income to pay expenses such as: HOA fees, property taxes, maintenance, repairs, savings for eventual capital replacement (i.e. appliances) and last but not least, making the mortgage payment.

Even while there are a number of costs and cash flows occurring every month, we can simplify what this looks like from the outside, with this simple time line:



This simplification appears to hide the rental property details. Although this is an example and thought experiment, it is based upon our past experiences with rental real estate. If we research the numbers for each category of expense, the amount of rent that is feasible for us to obtain and what would be an attractive purchase price, we lower our risk considerably (although there is no way to eliminate the risk entirely).

Back to the example, our investors report the following details:

<b>Monthly Rental Income Planning</b>	
<b>Property:</b>	Townhouse
<b>Address:</b>	123 Main Street
<b>RENTAL INCOME</b>	
Gross Monthly Rent	\$1,950
<b>AVERAGE MONTHLY OPERATING EXPENSES</b>	
HOA	\$250
Insurance	\$30
Real Estate Taxes	\$430
Maintenance/Repairs	\$35
Supplies	\$20
Advertising	\$5
Attorney and Legal	\$10
Ordinances and Licenses	\$5
Utilities	\$0
Miscellaneous	\$24
<b>TOTAL MONTHLY EXPENSES</b>	<b>\$809</b>
<b>NET MONTHLY OPERATING INCOME</b>	<b>\$1,141</b>
<b>ESTIMATE OF ANNUAL OPERATING INCOME</b>	<b>\$13,692</b>
Mortgage Interest – Year 1	\$5,075
Depreciation	\$6,534
<b>ESTIMATE OF TAXABLE INCOME</b>	<b>\$2,083</b>
Mortgage Principal – Year 1	\$8,416
Reserve for Future Capital Expenses	\$201
<b>ESTIMATE OF FREE CASH FLOW</b>	<b>\$0</b>
Marginal Tax Bracket	25%
<b>Income Tax Benefit from Depreciation</b>	<b>\$1,634</b>



Would everyone know these numbers with complete accuracy before they make a decision to buy? Definitely not. Furthermore, you may disagree with any of these values as being unrealistic. For instance, in some parts of the US, property taxes are excessively high. In others, they may be low, but rental incomes may also be lower still. The main point is that many of these costs can be ascertained and a spreadsheet model quickly developed. It may demonstrate that for any given property, it would be unlikely to achieve the above results. Fair enough.

If performing this kind of analysis leads you to walk away from various rental properties that appear to be money pits, consider yourself fortunate. Our investors were patient and always performed their due diligence.

By contrast, let's assume the above costs are accurate for our investing duo. What does this show? NOI, or net operating income, is one of the most basic measures of rental property performance. From our rental income after we subtract all the costs necessary to operate the rental as a business, what is left over? This is the amount that is left to pay the mortgage. Here, we separate interest versus principal. The interest is income tax deductible as an expense associated with the production of rental income (or potentially as home mortgage interest if secured by a mortgage against the investors primary residence – consult your income tax professional for what is best in your particular case).

Once again, the reason for the mortgage being secured against the investors primary residence (and not the rental property) was simply the major savings in interest costs. Without these savings, they may not have gone through with the rental purchase in the first place.

In the table above, we show that the free cash flow turns out to be a big fat zero. This was the desired result. Cash coming in matches the cash going out. But the mortgage gets paid from this rental income month after month. A few dollars are left over to fund a reserve for future capital expenses, such as replacing appliances.

There is also a small amount of taxable income resulting from this rental. However, the depreciation of the real estate is a non-cash expense that provides some tax savings. We estimated this as being \$1,500 per year for each of the next 15 years. This was just a simplification for our purposes.

The rental property chosen was one that appeared to be able to break even on a cash flow basis and to generate a small amount of tax savings. There was no need for it to perform spectacularly. Instead, it gave the appearance of being quite boring. We will also stress the point that our investors did not “pay themselves” for the time and effort they put in,

selecting, analyzing, purchasing and managing, their rental property. There certainly was no extra cash even if they wanted to pay themselves.

The important concept is recognizing whether the prospective rental property can generate enough income to cover all of its costs, especially any debt servicing used to finance its purchase. Oftentimes, a very attractive property seduces buyers who only later determine that it has no real chance of generating income to recoup its costs. But by then, it is too late.

If we are successful in matching the cash coming in with the cash going out (as expenses and mortgage payments), it can be seen that the rental activity is its own self contained "microcosm". This leads us back to the diagram above, which hides this fact (i.e. what is going on inside the microcosm). Instead, we see only the net cash flows in and out of the investment, over its lifespan.

We mentioned how our investors purchased the townhouse for a \$25,000 discount by seizing the opportunity. Their \$200,000 purchase price was due to finding motivated sellers. A 20% down payment amounted to \$40,000 being invested and \$160,000 financed with their HELOC. This practically max'ed out their credit line, but they refinanced to a 15 year, fixed rate mortgage at 3.25%.

We also show a \$4,000 investment in sprucing up the property to get it ready for the rental market. Had it needed a much more extensive fix-up, our folks would have passed up on purchasing it in the first place. Be patient and be willing to walk away, if the deal does not add up. Therefore, \$44,000 was the upfront cash flow we labeled as "Year 0".

We accounted for the small annual tax benefit of the depreciation of the real estate by estimating \$1,500. This is for illustration purposes only. The calculations (i.e. MACRS tables) behind this are beyond our scope and we encourage you to investigate a wonderful book on rental income by Michael C. Thomsett<sup>3</sup>, or to consult with your income tax professional.

Our investors held this property as a rental for fifteen years, until the mortgage was paid off.

Now we add our odd "twist" to this thought experiment. They bought a property for \$200,000 that could have been worth \$225,000 at the time. The local market inched up year after year. This townhouse was worth \$300,000 after fourteen years. Then, disaster struck. Real estate nosedived after the local job market tanked.

Our folks had to move out of their adjacent property, due to an emergency job change. They could no longer manage the rental after they moved out. They sold it at a sacrificial price, which netted them only \$150,000, after all closing costs and real estate sales commissions.

The final cash flow in our diagram was due to the income tax recapture of the depreciation they had taken over the previous fifteen years. Even though they sold for a price lower than their purchase price, they had a taxable gain based upon the difference between the sales price and their “adjusted basis” (depreciation taken decreases the basis in the property – please consult your tax adviser for more details). This came out to be \$12,500 of tax.

Wow! Major bummer, dude! Please forgive our melodrama. Our point is simply to show that even though the whole process of selecting and managing a rental property may seem to work well, bad things can still happen.

Let's look at the end result. It's rather surprising.

<b>Total Initial Investment</b>	<b>-\$44,000</b>
<b>Annual Tax Benefit for 15 years</b>	<b>\$1,500</b>
<b>Net Proceeds After Sale</b>	<b>\$150,000</b>
<b>Income Tax Due to Depreciation</b>	<b>-\$12,500</b>
<b>Annualized Return (Internal Rate of Return)</b>	<b>10.06%</b>

Our investors **sold the townhouse for \$50,000 less than they paid for it, fifteen solid years earlier and yet, they still achieved an annualized return of 10%** over this period of time.

Of course, there is no magic trick or sleight of hand here. The objective was to buy a property that could generate rental income and use ALL of that income to pay ALL the associated expenses. Still, they were not compensated for their personal time and efforts.

In conclusion, rental real estate is certainly not for all investors. Perhaps only for some of them. It does NOT replace financial assets in your portfolio. But it is a diversifier from simply holding those financial assets. Solutions that integrate both can be more resilient than simply holding one or the other. Your local knowledge and active participation can be the key to unlock this asset class.

## **Applying the Castling Principle to Charitable Giving - Charitable Gift Annuities**

While often it has been said that “it is better to give than to receive”, could there be a way to receive a little more when giving in a certain way? Our central theme has always been the *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 the other.***

We try to apply this to as many things as we can, especially in personal financial planning. Charitable giving is certainly part of both our estate planning concerns, as well as current year budgeting.

Many seniors find themselves at a crossroads. On the one hand, they would like to donate to their desired charities, but they must make sure that they have sufficient incomes to last for the rest of their lives.

We do not necessarily point to only those very affluent seniors who can afford to fund charitable remainder annuity trusts (CRATs) or charitable remainder uni-trusts (CRUTs). What about middle class and mass affluent seniors?

One aspect that makes giving worthwhile is the way it makes us feel, when we give. At the risk of sounding slightly morbid, giving makes us feel good when we're still able to physically have this feeling (or feel anything, if you get our point). Would you rather save all of this giving for after your death, instead? This would make it an estate planning issue.

For many people, year to year giving to beloved family members and charities, is what is extra special, because of the feelings it generates for us NOW. Still, the more one gives now, the question of having enough to live on later, is never too far away.

Could there be two fundamentally different things used at the same time, to give us a better result? As we have said in the past, we did not invent the *Castling Principle*. It has been around forever. We gave a name to it. We describe it. We analyze examples of its use. Here is how it can be used in charitable giving, while providing income in retirement. It's called the Charitable Gift Annuity (CGA).

First, we need to define what a CGA is. For this, we turned to the American Council on Gift Annuities (ACGA), a non-profit association that set standards for gift annuities, such as the payout rates used. Their definition is:

“A gift annuity is a contract under which a charity, in return for a transfer of cash or other property, agrees to pay a fixed sum of money for a period measured by one or two lives. A person who receives payments is called an "annuitant" or "beneficiary". The contributed property becomes part of the charity's assets, and the payments are a general obligation of the charity. The annuity is backed by all of the charity's assets, not just by the property contributed.”<sup>4</sup>

Next, we may ask why would we use a charitable gift annuity? Consider the following:

1. Getting that feeling of donating something today, as opposed to waiting until after one's death.
2. Earning an income tax deduction in the current year, for a portion of the contribution.
3. Receiving a periodic income flow that will continue for the rest of one's life, guaranteed by the charity.
4. Having a relatively large portion of that income stream come free of income tax, for a number of years.
5. Preventing or reducing the taxation of gain when contributing appreciated property (such as stock) to the CGA (instead of cash).

How does a gift annuity work? We cover the single life scenario here, but please keep in mind that just like a commercial annuity product from an insurance company, the annuity can be based on one or two lives (i.e. joint and survivor). A payout rate based on age is multiplied by the contribution amount to arrive at a yearly income stream back to the donor (or other defined beneficiary).

Donors usually start the process by requesting information about CGAs from their favorite charitable organizations, or by seeing mention of them in literature distributed by the charity. Some may offer gift annuities but keep them mostly hidden, since demand for them may be low, compared to other methods of planned giving. It may be necessary to ask for them.

Typically, a CGA will be described along with a table of payout rates listed by age. It may be an immediate annuity (payments begin right away, although for smaller amounts this may mean only once per year) or a deferred annuity, where the contribution is made first and then invested for a period of years. After this time, payments begin. Charitable organizations typically maintain a written policy regarding the minimum age acceptable

for a donor (usually 60 or 65), as well as the minimum amount contributed. Also, the vast majority of reputable charities follow ACGA suggested payout rates<sup>5</sup>.

While determining the payout rate is mostly influenced by the age of the donor(s), it is also impacted by the level of interest rates. The very low interest rate environment of the past number of years has meant lower payout rates than in prior decades. Our general advice regarding annuities has been to go slow and annuitize over time, as opposed to buying one giant annuity. This lowers your interest rate risk.

Here is a single life example:

1. A single donor aged 70 contributes \$10,000 in cash to “HelpUS” charity.
2. HelpUS assigns a 5.1% payout rate for a single life annuity at age 70, resulting in \$510 per year of income to the donor, for the rest of her life.
3. About \$390 of the income stream is considered income tax free for about 16 years.
4. If the donor survives past this point, the entire annual payment would be considered ordinary income and be taxed.
5. The donor receives about a \$4,000 current year Federal income tax deduction.
6. After the death of the donor, the charity makes use of the remaining amount of the contribution/earnings to fund its charitable purpose.

The income tax deduction is a lovely part of the process. Of course, the donor would need to be a taxpayer who itemizes her deductions on Schedule A, in order to take advantage of this. But if this were the case, it's like having a future gift have a present impact on the life of the donor. Here's why. The IRS looks at this from the standpoint of the following equation:

Your Income Tax Deduction	=	Present Value of the Remainder Interest	=	Charitable Gift Annuity Amount	minus	Present Value of the Annuity Interest
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There are IRS publications, tables, annuity factors and calculations involved, which are beyond the scope of what we can cover here. Simply put, with the payout rate quoted by the charity and an IRS annuity factor based on age, the present value of the annuity interest portion (what the annuity is supposed to be worth based on your life expectancy today) can be calculated. The amount that you gave the charity today minus what the annuity to you is worth, is supposed to be your net charitable gift, hence your income tax deduction.

Now for what we would call the best part, based on the *Castling Principle*.

What if you would have contributed X dollars to a number of charities this year anyway, getting Y income tax deduction? But then what if you also would have bought a commercial annuity from an insurance company for Z dollars, as well?

Let's demonstrate this with realistic data for a 70 year old single female, who itemizes her deductions, donates thousands to charity each year, but also would like to build up a guaranteed income stream for the rest of her life. We will analyze what this looks like using what we call the "conventional approach": as two separate actions.

Afterwards, we will apply the CGA solution. We call this applying the **Castling Principle**, since we are simultaneously using both charitable giving and income for life solutions in such a way that we get a result that we could not have achieved in the first case, by using them separately.

<b>Conventional Approach:</b>	
<b>Step 1: Donations to Charity</b>	<b>Amount</b>
a. Local House of Worship	\$7,596
b. World Vision	\$3,798
c. Consumer Reports	\$3,798
<b>Total:</b>	<b>\$15,192</b>
 <b>Step 2: Purchase Commercial Annuity</b>	 <b>Amount</b>
a. Single Life Immediate Annuity @ age 70	\$24,808
<b>Total:</b>	<b>\$24,808</b>
<b>Total Cash Outflow:</b>	<b><u>\$40,000</u></b>
 <b>Resulting In:</b>	
a. Total Current Year Income Tax Deduction	<b>\$15,192</b>
b. Guaranteed Annual Income for Life (monthly x 12)	<b><u>\$1,760</u></b>

Here, our hypothetical client donates to three major charities, her local parish church, World Vision and Consumer Reports. In all, she believes strongly in the tithing principle and contributes about 10% of her \$152,000 annual income, which consists of principal distributions from her former employer's 401(k), as well as dividends, interest, rental payments, annuity payments, a small pension and Social Security benefits.

One of her primary concerns has been that the level of bond and bank CD interest being earned is very low. This has increased the level of her principal distributions she has had to make each year, for the last seven years. As a result, her adviser has suggested that she annuitize small portions of her wealth each year, thus creating an income stream that will



last the rest of her life. If and when the interest rate environment were to increase, this strategy is expected to provide increasing payouts for the same amount of cash going into her annuities.

So we see that \$40,000 of cash outflows are split between \$15,192 going to her favorite charities, while \$24,808 is used to buy an immediate annuity<sup>6</sup>. The highest annual income for a single life annuity for this 70 year old female, was found to be \$1,760.

Now, here are the details regarding the second approach:

<b>Castling Principle: Charitable Gift Annuity (CGA)</b>	
<b>Step 1: Funding CGAs Directly Through Charities</b>	<b>Amount</b>
a. Local House of Worship	\$20,000
b. World Vision	\$10,000
c. Consumer Reports	\$10,000
<b>Total Cash Outflow:</b>	<b><u>\$40,000</u></b>
<b>Resulting In:</b>	<b>Amount</b>
I. Current Year Income Tax Deductions	
a. Local House of Worship	\$7,596
b. World Vision	\$3,798
c. Consumer Reports	\$3,798
<b>Total:</b>	<b><u>\$15,192</u></b>
II. Guaranteed Annual Income for Life <i>(Frequency of Income Received Depends on Charity)</i>	
a. Local House of Worship	\$1,020
b. World Vision	\$510
c. Consumer Reports	510
<b>Total:</b>	<b><u>\$2,040</u></b>
III. Increase in Annual Income Over Conventional Annuity	16%

The same total cash outflows of \$40,000 occurred, as in the prior example. However, all of it was used to purchase charitable gift annuities.

Based upon our own calculations, as well as CGA calculators available on multiple charity Websites and the ACGA payout rate of 5.1% (for a 70 year old single life), the current year income tax deductions were computed. We admit that it is no coincidence that these numbers exactly match the charitable contributions made in the first example. Our objective was to make sure the income tax deductions were identical in both cases.

So what happened to the income stream? With three CGAs, we see \$2,040 per year for life, versus \$1,760 using the commercial annuity. This is a 16% increase in income by using charitable gift annuities.

It is interesting to observe that CGAs count one or two lives when quoting a payout rate, but do not make a distinction between male and female. However, a commercial annuity would normally always make this distinction. Statistically, since women live longer than men, annuity payment amounts for females are lower across the board.

However, when we checked this difference using the Immediate Annuities Website (male versus female 70 year old), we found that this accounted for only 7.4% of the difference<sup>7</sup>.

This demonstrates that there is inherent value in using charitable gift annuities. Depending upon who the charity is, you may be able to fund a CGA for far less than \$10,000, thus making it practical for more middle income, retired persons, who contribute less than what we have shown in this example.

The individual charity may also control the frequency of payout. Obviously, for very small amounts, it may be a burden for them to send you a check monthly. You may need to accept one annual payment. For others, depending upon the amount, a quarterly or monthly payment is feasible.

We expect that some charities may not be too thrilled if suddenly, people who contribute on a regular basis, make annual purchases of gift annuities as their contribution. But this needs to be put into perspective with yields on various income producing investments.

If I am a retired person living on a relatively fixed income and have always tried to make these significant, annual, charitable donations from what is now my dwindling income stream, do I have an alternative?

The answer is yes: the charitable gift annuity. We call this using the ***Castling Principle*** to do good for others, but still get a good result for yourself!

## References

1. **FINRA *Fund Analyzer*** is available on their Website by selecting “Tools and Calculators” and then by selecting “Fund Analyzer”. The Website can be accessed using the following link:

<http://www.finra.org/>

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

3. Thomsett, Michael C., **Getting Started in Rental Income**, John Wiley & Sons, Inc. 2005. This is an extremely useful book for anyone interested in determining whether rental real estate is feasible for them. It is available from Amazon via the following link:

[http://www.amazon.com/Getting-Started-Rental-Michael-Thomsett/dp/0471710989/ref=sr\\_1\\_1?ie=UTF8&qid=1463273922&sr=8-1&keywords=getting+started+in+rental+income](http://www.amazon.com/Getting-Started-Rental-Michael-Thomsett/dp/0471710989/ref=sr_1_1?ie=UTF8&qid=1463273922&sr=8-1&keywords=getting+started+in+rental+income)

4. **American Council on Gift Annuities** has informational resources which can be used by charities and others and can be accessed using the following link. The definition used was taken from their FAQ Section.

<http://www.acga-web.org/>

5. Ibid. Please refer to the **Recommended Charitable Gift Annuity Best Practices** that can be accessed via the following link:

<http://www.acga-web.org/about-gift-annuities-top/gift-annuity-best-practices>

6. **Immediate Annuities** Website. This is an excellent place to perform comparisons regarding annuities and receive data without getting sales calls. While the minimum purchase amount for an annuity is set at \$30,000, we simply multiplied the values we used by ten, in order to bypass this edit. We then divided the monthly annuity cash flow by ten and multiplied the result by twelve, to arrive at the annual value we used. The Website can be accessed using the following link:

<https://www.immediateannuities.com/>

7. Ibid.

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Henry F. Glodny,  
CRPS®, MBA, MS  
Principal

### **Chartered Retirement Plans Specialist(SM)**

### **Mailing Address and Main Office Location (Office Hours by Appointment Only):**

#### **Castling Financial Planning, Ltd.**

1337 Hunters Ridge East  
Hoffman Estates, IL 60192

#### **Telephone:**

224.353.8567 (Office)  
847.284.6647 (Mobile)

#### **Email:**

[henry@YourIndependentAdviser.com](mailto:henry@YourIndependentAdviser.com)

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