Castling
Financial Planning, Ltd.

Helping You Secure Your Future ™

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Winter 2013 Newsletter:

Residential Real Estate Recovery?

Anyone who knows us and our approach to financial planning realizes that we are all about the long term, proceeding with caution and staying the course, once you establish your goals.

Not that many years ago, a housing mania gradually built up in this nation (and many others), driven by cheap money, lax lending standards and most importantly in our mind, lowered down payment requirements. Social engineering policy from the Federal Government pushed home ownership as an end whose means to achievement were always justified. This pushed demand throughout the country, but especially in those markets where low down payment loans were easy to get.

Residential real estate prices took off. Prospective home owners convinced themselves that they had to "get in the game before it was too late".

Much has been written about the disaster that unfolded soon thereafter. In retrospect, much of what happened followed the general course of an overheated or bubble market. Some would say that home prices have collapsed and that this caused the economy to sink. Others say that financial derivative products caused the economy to go into recession and with it, home prices.

Our view is that <u>in any overheated market for any asset, once a seller can no longer convince the next buyer that the property is worth paying an ever inflated price, those prices will fall</u>. The greater the overvaluation, the greater the potential correction.

At ***Castling Financial Planning, Ltd.***, we have been studying residential real estate over the last several months. We have come up with our own valuation model, which we are sharing here for the first time.

Many years ago, we learned what some would call a rule of thumb: that <u>residential real estate appreciates at about one and a half times the rate of inflation</u>. We are not usually too keen on using rules of thumb. But real estate has long since been considered a hedge against inflation.

Time-out for an anecdote? My parents long ago purchased a three bedroom ranch style home in the suburb of Niles, Illinois for $40,000 in 1970. They sold it for about $181,000 in 1991. While I am guessing somewhat, I estimate that the cost of their improvements was only around $10,000 and the rest was pure maintenance and replacement.

So let's assume their gain was about $131,000. This amounts to a total return of about 291% (for simplicity sake, we spread the cost of improvements equally over the time period). It seems impressive when judged from the perspective of the last decade. Or was it?

The Consumer Price Index (CPI-U[1]) stood at 39 for the month they purchased the home, in August, 1970. By the time they sold in 1991, it was about 136. This is a 249% increase. Our rule of thumb would have predicted a 373% gain (1.5 X 249%).

Of course, there are other things to consider. We never like to think of a primary residence as being an investment, since a direct economic benefit (also called "utility"), is derived from living there. We all need to live somewhere, after all. While we don't collect rent from ourselves, had this been a rental property and not a personal residence, we would have had a true investment. It would be tricky to go back and assign a rental value that is completely accurate. But adding it to the gain could easily bring us to the 1.5X inflation assumption that we started with.

<u>The caveat is in treating this as a pure investment and accounting for rental income received, or the equivalent of rents "earned" by living there and not paying someone else the rent</u>.

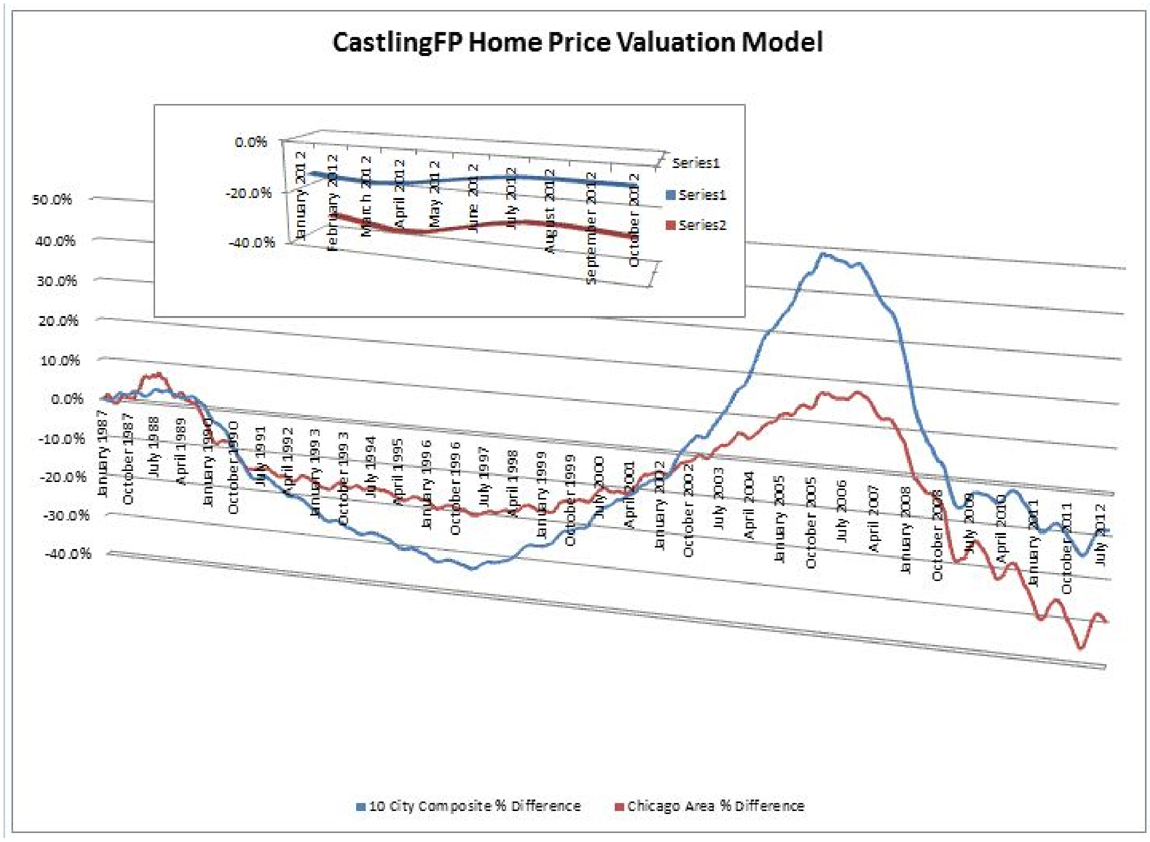
Of course, negotiations during selling and local market conditions affect the final price. But it was clear in this case, that over a long enough time period, the expectation to stay somewhat ahead of inflation was fulfilled.

So let's fast forward to the present. What the heck happened?

Just like any market, valuations can get out of hand. We used the rule of thumb above to create our own ***CastlingFP*** valuation model for residential real estate in the US and especially, the Chicago area. The best data we know of comes from the S&P/Case-Shiller US 10-City Composite Index[2]. You may have heard about the 20-City Composite Index which is now better known. But its data does not go back as far. For the 10-City Index, data reaches back to January, 1987. For lack of a better starting point, this is where we anchored our flag. We called it a point of "fair value" for both the 10-City Composite, as well as the Chicago area.

We then calculated a theoretical value based upon a one and a half times the rate of inflation rule. The difference between the actual index and our computed value becomes a percentage over/under valuation metric.

This is graphically depicted below. The blue line shows the 10-City aggregate valuation representing what was going on across major US cities. The red line displays valuation in the Chicago area. The inset merely stretches last year's picture and includes the latest data points.



What conclusions have we drawn from this chart and our overall analysis of the housing market?

1. Home prices have roughly bottomed in both the US as well as the Chicago area. Waiting for further price decreases may work, but is an awfully tricky proposition.
2. Mortgage rates are likely not to decrease further, in any meaningful way. The probability of the next 0.50% change in either direction? Much more likely to be up by the 50 basis points than down.
3. Think long term. We have always advised clients that real estate is a long term proposition. This is slightly in contrast to investments in commercial real estate made through REITS (real estate investment trusts) and REIT mutual funds. We do not feel that an investment in residential real estate should be looked at with less than a ten year time horizon.
4. Your home is not really an investment, but it's still an asset. An investment is a placement of capital in a profit seeking venture. A single family house, townhouse or condo purchased for rental income is certainly an investment. Please refer to the above example for another way to look at this, factoring in the “rent” you don't pay yourself, but that you would otherwise have paid someone else.
5. Expecting huge, quick profits is not reasonable, unless the greater fool theory can be counted on. This means that momentum can cause speculation that carries the market to higher prices. It works until it stops working. We have been reading some real estate books of the past decade that made the same faulty assumption. There was no valuation model presented that could rationalize what was happening as being normal. Remember

that the four most dangerous words in the English language are: "*It's different this time*". For various reasons, we almost never believe it's different.

6. The overall cycle in US residential real estate can be much longer than in the US stock market. In the latter case, a trough to peak and back to trough took from October 2002 then to October 2007 and finally, to March 2009. This was extremely painful, but relatively short. A full real estate cycle can take twenty years or longer, by contrast.
7. A mature market always reverts to the mean, which implies a 0% cross-over on our diagram. For those who will object to our statement, my emphasis is on the use of the word "mature". We do not consider tulips to have been mature, nor the NIKKEI 225 in 1989, nor the NASDAQ in 2000. Think S&P 500 or other, similar, measure/index of large-cap US equity or other asset classes that have been around a long time.
8. While we did not draw control limits on this chart to maintain readability, our calculations show that "fair" value for the 10-City composite to be within +/- 22% of 0 and for the Chicago area, +/- 13%. What does this really mean? We never really got overvalued in the Chicago area until around 2005. There was apparently no real "bubble" overall, but certainly in some smaller areas and neighborhoods. The peak was reached later in Chicago than across the country. Appreciation was stratospheric in many other cities, earlier in the last decade.
9. What does a valuation chart mean to you even if you have no intention of buying or selling? It can help remind you to take **CAUTION** in not running up debt, such as using your home equity as an ATM machine (at least not during periods of overvaluation). Our old saying is that debt is the same as fire. It is fundamentally important to the survival of the human race. But it is also inherently dangerous and should only be used with extreme caution.
10. Reversion to the mean once the peak was established, was never going to be pretty. But by 2008, Chicago had not fallen as far, nor as fast. The two lines were close together. But then the bottom fell out. What happened to the Windy City? We think the brutal, bouncing ball shape of the curve is directly tied to the slow foreclosure process in the State of Illinois. A recent Wall Street Journal article discussed the slow rebound in home prices being at least partially caused by the lengthy legal proceedings in judicial states. Illinois is one of them[3].
11. Even politicians in Illinois may be coming around now. The Chicago Tribune reported recently that Governor Quinn signed legislation to speed up the foreclosure process on abandoned homes[4]. The Illinois Senate bill took almost two years to pass, but when the vote was taken last December, it was unanimous. It is remarkable to us why this was not completed two years ago. Our view is that this should be expanded. Markets should be allowed to work. While it is sad that many people have lost their homes, prolonging the inevitable hurts the market (and society) more in the long run. Government programs such as HARP and HAMP may help on the margins, but their success rates leave a lot to be desired. All in all, the current state of housing in Illinois, we believe, to be at a meaningful bottom and poised to improve.

We would like to be clear that the above diagram is not meant to be a market timing device, but merely a valuation model. This is one tool which was oftentimes overlooked during the residential real estate "gold rush".

Looking at current valuations across the Chicago area, compared to the country as a whole and coupling this with low mortgage rates, makes this a great time to be buying a house.

But a few years ago, many people could have saved themselves from making a huge mistake by simply discussing their real estate plans with an independent financial planner. Should I buy a house? Is now a good time? How much can I afford? How should I finance it? All of these are important questions. There are many competent professionals in the real estate and mortgage industries. However, when their compensation depends upon a transaction closing, do you really expect that you are going to be told “No, don't buy any house right now, because the market is overvalued”?

One of the most difficult things we do while running an hourly financial planning firm, is in telling clients what they need to hear, not just what they want to hear.

Compare Annuities Vs. Investments on an Apples-to-Apples Basis

Annuities are insurance contracts which come in many different types. The basic concept is that you turn over a sum of money to the insurance company in exchange for a set of cash flows: for some defined period of time, your remaining life, your life and that of your spouse, etc.

Fixed annuities are generally not considered investment products, while variable annuities (VA) are. A VA would consist of "sub-accounts" holding what appear to be regular mutual fund type investments.

The purpose of this article is not to describe annuities in detail, nor to launch a crusade against them. They serve a valuable role, but we need to understand that role and its limitations.

Our point is to remind readers that when comparing an annuity product to an investment portfolio, please keep the following points in mind. Failure to do so results in "apples-to-oranges" comparisons that do not serve your interests.

When we think back to the financial crisis, recession and severe bear market, some folks gave up on investing, sold out at or near the bottom, then took their depleted cash accounts and purchased annuity products, all because a commissioned based product salesperson (CBPS) assured them that the annuity had no risk and that they could "retain their gains".

OK, fair enough. The point is that a fixed annuity does not carry stock or bond market risk, as an investment portfolio does.

But does this mean that there are no risks to owning annuities? No, far from it.

Let's take a step back and discuss the concept of Risk Management. In any person's, couple's or family's situation, we identify a unique set of circumstances. So the first step would be to identify the risks, such as premature death, disability, providing income during retirement, responding to an emergency that requires cash, etc. The second step should be to quantify each risk, to understand its likelihood. Finally, we need to plan for managing each risk.

Please keep in mind that managing a particular risk may mean avoiding it entirely (if possible), accepting it (when no better solution is identified , but you still need to engage in the activity) or transferring it. Insurance is a typical form of risk transfer.

So our first major point is that when transferring the risk of running out of money during your lifetime (longevity risk), no insurance company is providing any sort of guarantee free of charge. And yet, you may not have a good handle on how much this will cost you, unless you make a detailed comparison with an investment alternative.

In order to receive that "monthly paycheck for life" that your friendly CBPS touts, you need to give up some of your wealth. For a fixed, immediate annuity, this single premium represents the total amount invested in the contract. This principal is usually no longer available once the contract is signed and in effect. That money is G-O-N-E! Sorry for the theatrics, but we would just like to emphasize the point that you are giving up the principal in order to receive a series of cash flows, based upon your actual lifespan or the joint lifespans of you and your spouse (or some term certain, etc). <u>This money is no longer part of your net worth</u>.

In exchange, you are getting a guaranteed set of payments.

But who is offering that guarantee? In other words, you may have a choice of several insurance companies that offer you different annuity payment amounts, for your lump sum premium. Sometimes, the amounts can easily differ by 5% or more. Simply taking the highest offer of a monthly “paycheck for life” does not factor in the financial strength of the insurance company itself.

While we can check various agency ratings, such as S&P, Moody's and A.M Best, we know that ratings agencies have had some issues in the past.

Keep in mind that the annuity is a contract with the insurance company and they are the counter-party. While it seems unlikely for a highly rated insurer to become insolvent, it is possible for some lesser company to become financially impaired at a point in the future.

Then what happens? For a fixed annuity, there is a state run guarantee fund that kicks in, which is funded by the other insurers. In Illinois for example, the amount of coverage the state provides is limited to $250,000 per (fixed annuity) contract, with a $300,000 limitation per person[5].

This would imply that sinking huge amounts of money into a single fixed annuity with a single insurance company would not be the most risk averse strategy. But we think it is somewhat troubling that if a major meltdown were to occur, the State of Illinois is not exactly standing behind prudent folks who spread their money across multiple insurers (except for that first $300,000). This certainly does not work like FDIC insurance. Remember that insurance companies are regulated at the state level.

The next risk we would like to identify is inflation. A dollar received today is worth more than a dollar received tomorrow. But with an annuity, we are depending upon those dollars to provide for all of our tomorrows. A guaranteed paycheck for life is one thing. But purchasing power is something else. It is possible to buy a fixed annuity whose payments increase each year by a set amount, such as 3% or with a price level, such as the CPI-U. While these are available, they are not that common and are not offered by all companies. The main point is that the starting payment will be lower. In fact, it may look shockingly low, as we demonstrate below.

Another risk is the change to interest rates over time. We would like to distinguish this from bond market risk. If we purchase an annuity with a sum of money today, we will receive monthly payments based upon the current level of interest rates. But how can we be sure this will still be a good decision (or at least not a bad one), years from now?

As an example, consider what turned out to be the beginning of the thirty year bull market (give or take) in bonds. Long term US Treasury bonds delivered a total return exceeding 40% in 1982[6]. The reason for this was a sharp drop in bond yields, as rampant inflation was brought under control. Bond prices move inversely to interest rates. So as rates dropped, existing bonds with higher (coupon rates) became much more valuable.

Now let's back up a little, to 1981. Interest rates, actual inflation and inflation expectations are all running high. Suppose we are getting ready to retire in this environment. We ask our friendly agent for a nice fixed, immediate annuity. The insurance company receives the single premium and it becomes part of their general fund, invested in long term US Treasury bonds. The interest rate the annuity calculation is based upon assumes a then fat 13% bond coupon. Had you purchased this annuity, you would have locked in a spectacular payment, given what was about to happen over the next three decades. Very smart annuity purchase and cushy retirement, no?

Now, fast forward to the present. As I write this, Bloomberg reports a yield to maturity of 3.17% on the US 30 year Treasury bond[7]. By all accounts, bond yields are at multiple decade lows, although perhaps not at all time lows. So unless these bond yields hover over these extremely low levels for years, one would expect the next significant change to be an increase, not a decrease.

Point to Ponder:
If a 1981 annuity purchase, in retrospect, was the annuity buy of a lifetime because of the major drop in interest rates that followed, what will the annuity purchase in 201X turn out to be, if we get a major increase in interest rates starting in 201X+1 and beyond? Hint: It rhymes with "***Bucker's Set***" (pun intended :-)

Finally, let's close our discussion with an example comparison of a fixed annuity with an investment portfolio. We begin by collecting the necessary information from the client. We checked an actual annuity to get the below quote. However, we are not allowed to disclose the insurance company, not the agent, as part of the terms of use of the participating Website. We do believe that the insurer, agent and financial services firm running the Website are all highly regarded. The insurer's rating from A. M. Best is A+.

We would be happy to discuss the details with anyone interested.

The clients in the example are both aged 65. The annuitant is the husband. He pays in $500,000, while the joint annuitant is his wife. In order to compare with any investment, you must select 100% joint and survivor benefits. The highest annuity payment will always be given based upon using a single life. But an investment portfolio would not be forfeited if the husband were to die. So let's compare apples-to-apples.

Next, we select a 3% cost of living adjustment. This insures that at least some of the purchasing power is preserved. While this is feasible with an investment portfolio, it is a challenge for both it as well as the annuity.

The payments begin early this Spring and amount to almost $1,604. However, they would have been almost $2,277, without the inflation adjustment.

The joint life expectancy of our couple is 26.2, according to IRS Publication 590[8]. However, let's assume that payments last until age 100, which is about 10% beyond the current, normal life expectancy for our couple. The longer the time period used, the better the annuity should appear (By contrast, an accident resulting in the premature death of both of them at age 76, would result in the $500,000 premium giving back only eleven years of payments).

Plugging in the numbers yields an effective "rate of return" of: **4.2%** without the inflation adjustment.

How confident are we of generating a rate of return in excess of this, with relatively low volatility? For one such example, please see the last article on the ***Castling Defensive Portfolio***. For help in this area, please contact us.

Including the inflation adjustment, you would need to wait until the 13th year in order to begin receiving a monthly payment that exceeded the non-inflation adjusted $2,277. In our analysis, we looked at what would happen if we chose the non-inflation adjusted annuity, but only spent the amount that was specified by the inflation adjusted version. In other words, save the difference in the early years. Unless these savings earn some significant interest, the surplus would run out around age 88-89. Since this is less than normal life expectancy (91.2), it does appear that the inflation adjusted amount adds value in this case. If one of the two (at least), lives a long life, getting these cost of living increases will be worthwhile.

While an investment portfolio does not offer a guarantee of any sort, the "price" of the assurance in this case seems quite high. Since the effective rate of return is only 4.2%, assuming life to age 100 and not even including cost of living adjustment, a properly structured investment portfolio has a very high probability of exceeding this rate of return over the long term.

Adding the 3% inflation adjustment and believing we are secure in the knowledge of a normal (or longer) life expectancy, the annuity looks good. However, parting with $500,000 in one shot is problematic, for the reasons mentioned above.

So is there a simple answer that tells us what to choose (annuity or investment) in every case? Unfortunately, no. It takes some analysis. So here are our final thoughts:

1. Develop a retirement income plan that considers your overall situation and that of your spouse. Discuss it with your spouse and if necessary, the rest of your family. Seek consensus.
2. Try to plan for multiple sources of income and plan out the timings, so that income can be distributed as you age. Get financial planning help, unless you are confident of your calculations.
3. Keep the current level of interest rates in mind and in what direction the next big move could happen. Do not lock a large portion of your wealth into annuity products all at one time, especially when interest rates are at multi-decade lows.
4. Try to "dollar cost average" into annuities by buying smaller amounts across a time diversified period of a number of years.
5. Pay attention to the limits of your state's guarantee fund and do not over commit unless you are sure of the financial health of the insurance company.
6. Consider longevity insurance, which is a type of deferred annuity, where payments do not start until later in life, but the annuity is purchased today.
7. Consider a hybrid solution including investments and annuities and seek the appropriate help, as needed.
8. Remember that the cost of living increases are expensive, meaning that they result in very low initial payments. However, they do deliver in the long term. If your income needs can be met through various sources, including investments, until late in life, the value of the inflation adjustment diminishes. So the 65 year old annuitant with no inflation adjustment could be hurting by age 85, while another person who makes it to 80 and then buys the annuity, could possibly forgo the inflation adjustment altogether (the loss of purchasing power occurs over fewer remaining years of life expectancy).
9. If charitable giving is in your retirement and estate planning picture, consider a Charitable Gift Annuity (CGA) which pays you income based upon a percentage of the amount contributed and also gives you a tax deduction in the current year of the purchase, even though the charity will not actually spend the money until after your death or the death of your spouse. We will have more to say about CGAs in a future Newsletter. Stay tuned!

Budget Killer No. 1: Our Wired and Wireless World

OK, let's get one thing out in the open. We are not against technology, nor are we negative on all the modern day conveniences that have made our lives more connected to the world and have made that same world a lot smaller. However, what price have we paid in the process? Put another way, are these same electronic gadgets actually preventing us from accomplishing our financial goals?

Maybe.

We will not rehash the harsh numbers of median household income dropping in the US, over the past few years. But please keep in mind that discretionary income must first be earned and then saved, in order to have something to invest with. This has become difficult for more people to do.

Perhaps some folks are doing just fine and continuing to fund their financial goals during the accumulation phase of their lives. This article is not really for them. It's about everyone else who is struggling to maintain middle-class credentials, yet falling behind in the ***"What have you got to show for it?"TM*** metric (this is a calculation we came up with a number of years ago and then published in our Summer, 2011 newsletter).

The table below shows the typical monthly cost of maintaining a single land line telephone, a cable TV system with DVR and more than one receiver, a high speed broadband Internet connection and two so called smart phones with data plans on each. These are rough estimates and by no means do they represent premium services. Also, the separate cost of any hardware has not been included in the below estimates. However, we have added typical taxes and fees to each.

The sum total wired and wireless bill amounts to almost $400 per month. But what does it take to pay for all these? We need to earn the income first (assuming we are not already retired). This means looking at pretax income. I first saw this thirty years ago in a book from personal finance expert Andrew Tobias. Assuming 25% Federal income tax (their marginal rate), 5% State of Illinois tax and payroll taxes, our couple needs to earn almost $600 gross in order to afford these conveniences. Annualized, <u>this amounts to more than seven thousand dollars</u>!

Slightly more than a decade ago, things were much different. We may still have had high speed Internet, cable TV and certainly land line phone service. But our cost estimates come in at about half their present level. We know that the Consumer Price Index has not gone up by anywhere near this amount.

Obviously, some things such as mobile data and nationwide cellular calling represent either improvements to service and/or quality, or increases in service level being purchased.

But have our incomes grown in lock step with the financial demands that these wired and wireless gizmos have placed on our budgets? Probably not. This means that the money to pay the increasing costs is coming from somewhere else. The clear opportunity cost is the foregone alternative. That which builds your future: money for investment.

In order for wealth to be created, money must first be earned, then saved from those income sources and finally invested, in what we hope will be profitable enterprises or income generating instruments.

Our Wired and Wireless World Kills Your Budget:	**Today's Typical Cost**	**Cost 10-15 Years Ago**
Land-line Telephone with Calling Package	$50.00	$25.00
Tax and Fees on Above	$6.00	$3.00
Cable/Satellite TV, DVR, packages, etc.	$103.00	$50.00
Tax and Fees on Above	$5.00	$3.00
Broadband Internet	$52.00	$40.00
Tax and Fees on Above	$3.00	$3.00
His Cell Phone with Calling Package	$50.00	$30.00
His Data Plan	$20.00	N/A
Tax and Fees on Above	$5.00	$3.00
Her Cell Phone with Calling Package	$50.00	$30.00
Her Data Plan	$20.00	N/A
Tax and Fees on Above	$5.00	$3.00
Total	$369.00	$190.00
What you need to earn in order to pay the above: (assumes 25% Fed, 5% State and 7.65% payroll taxes)	$591.82	$304.73
Above Annualized:	$7,101.84	$3,656.78

By trying to prune back some of these expenses, without hurting their overall standard of living, this family could potentially have a couple thousand dollars more each year to add to their 401(k) retirement accounts.

But how? Here are some suggestions:

1. VOIP or Voice Over Internet Protocol has been perfected as a suitable replacement for land line phone service, assuming high speed Internet is in place, which is the case in our example. There are a number of providers. As far as we can tell, MagicJack is one of the cheapest. It can be connected so that it provides whole house phone service for one year, at less than the cost of one month's traditional land line shown above.
2. Since VOIP depends upon the speed and reliability of the underlying Internet service, we don't feel that scrimping on broadband would be wise. However, there is no need to go overboard in improving on it either. Useful free tools, such as Speakeasy's Speed Test (http://www.speakeasy.net/speedtest/) can be used to test your connection, especially when changing Internet service providers. If you buy a VOIP phone service, test using your existing connection and determine whether it is working well enough. If so, there would be no reason to upgrade further.
3. Complaining to your cable or satellite TV provider's Customer Retention department may help snag a slightly lower rate or current offer. But it may also be beneficial to move your service every couple years, from one company to another, based upon who has the best current promotion. Often, coming back to the first provider after two or three years, will reset your status as being a "new customer" and qualify you for the best current deal.
4. While cellular phones are truly a must have for most people nowadays, carriers appear to be trying to convince customers that they need more and yet more minutes of voice and gigabytes of data. This may not be true at all. Review your statements over the last six

months and see if you are using most of your minutes. You may be better off with a cheaper plan, but the phone companies are under no obligation to tell you that you have low utilization.

5. Do you really need a fully loaded smart phone with a contract and monthly plan? Users with less intensive demands can find prepaid phones that offer around 120 minutes per month for a year, that also includes an entry level smart phone, all for under $150. ***TracFone***, for example, is one of the lowest cost prepaid services.
6. Prepaid phone cards can still be much cheaper than phone service packages, when factoring in all costs, especially taxes and fees. In fact, this is one point that bears repeating. Most prepaid type services have much lower taxes and fees. In our above example, almost $300 per year was spent not on the service per se, but on taxes and fees alone.
7. Make use of free WiFi connectivity. Most current smart phones will work on WiFi networks with full functionality. Therefore, if you already have it in your home (i.e. wireless router), place of business, school, library, many restaurants and stores, etc., do you really need a data plan?
8. Even if you still do need a data plan, you may be able to re-size it and save money. An alternative would be getting one hot spot device with a data plan. Or with less usage, getting one with prepaid data and no plan. Either way, this could be much cheaper than paying for data on each wireless device separately.

Castling Defensive Portfolio: Recap of 2012 and the Long View

Our (hypothetical) model portfolio for conservative investors, is one whose asset allocation and other details we freely share with the general public. It's an example of our analytical abilities, knowledge of asset allocation and ability to recommend real life, low cost investment products. This combination attempts to meet an objective that we have labeled as "target return". Specifically, it seeks a 7.2% net pretax annualized return across multiple rolling periods, while maintaining the lowest risk metric we can find.

For 2012, the ***Castling Defensive Portfolio*** (CDP) achieved its objective, returning **7.48%**. This follows a **5.26%** return in 2011.

All stock index mutual funds, such as the Vanguard 500 Index, cheaply and efficiently return what the broad market has to offer. So during market advances such as 2012, this was over 15%. But during weak markets, as in 2011, it was just under 2%.

The ***Castling Defensive Portfolio***, just like our overall approach to mutual fund investing, is about consistency. Real consistency needs to be measured across multiple time periods. We refer to these as rolling periods. Our approach emphasizes smoothing out the peaks and valleys where possible, but without market timing.

It must be pointed out that no investment portfolio can guarantee returns in any given period and that our CDP is based upon the same asset allocation year after year.

The next table displays the specific investments that make up the CDP, as well as their allocations, expense ratios, minimum initial investment amounts and how to apportion an investment in each so as to meet the minimums, while still adhering to the overall asset allocation requirements of the portfolio. $75,000 would be required.

In 2012, the Royce Special Equity (RYSEX)[9] fund was closed to new investors. We recommend the Vanguard Small-Cap Value Index fund (VISVX) as a very good replacement for those who have not previously invested in this Royce fund. We do commend the Royce funds for recognizing when to close a mutual fund, as cash inflows make future investments more difficult.

We close with a table showing various statistics of the ***Castling Defensive Portfolio*** and comparisons with a couple excellent balanced funds from Vanguard: Wellington and Wellesley Income, as well as the 500 Index[10].

The CDP continues to hold its own. It has slightly surpassed its objective of a 7.2% net pretax annualized return, in the 2000-2012 period, while holding the risk per unit of return (coefficient of variation) to lower levels than that of the excellent funds used for comparison purposes. We would be happy to show anyone the background asset class data that helped us arrive at this mix. Only a 31% allocation to stocks is used. There have been no market timing or allocation changes. Annual re-balancing is assumed at year-end.

The ***Castling Defensive Portfolio*** is an example of the kind of work we do. Everyone's situation and needs are at least somewhat different. That is why we believe financial planning is about a process and not about product selling. And that it needs to be customized to YOUR needs. If this kind of analysis interests you and you are not already a client, please contact us. Also, please review our disclosures at the end of this report for more information.

	The Castling Defensive Portfolio:	Ticker	% Allocation	Expenses	Equity %	Weighted Exp.	Min. Invest.	Initial Min.
1	FDIC Insured Certificates of Deposit (Avg. of High Yielding)	Bank CD's	9%	0.00%	0%	0.000%	Varies	$6,750
2	Vanguard Short-Term Treasury Investor Shares	VFISX	9%	0.20%	0%	0.018%	$3,000	$6,750
3	Vanguard Short-Term Investment-Grade Investor Shares	VFSTX	9%	0.20%	0%	0.018%	$3,000	$6,750
4	Vanguard Intermediate-Term Treasury Investor Shares	VFITX	12%	0.20%	0%	0.024%	$3,000	$9,000
5	Vanguard Inflation-Protected Securities Investor Shares	VIPSX	12%	0.20%	0%	0.024%	$3,000	$9,000
6	Vanguard GNMA Investor Shares	VFIIX	11%	0.21%	0%	0.023%	$3,000	$8,250
7	Vanguard Wellesley Income Investor Shares	VWINX	11%	0.25%	4%	0.028%	$3,000	$8,250
8	Royce Special Equity Investment Class Shares	RYSEX	15%	1.15%	15%	0.173%	$2,000	$11,250
9	Vanguard REIT Index Investor Shares	VGSIX	8%	0.24%	8%	0.019%	$3,000	$6,000
10	Vanguard Total International Stock Index	VGTSX	4%	0.22%	4%	0.009%	$3,000	$3,000
	Totals		**100%**		**31%**	**0.34%**		**$75,000**

Castling Defensive Portfolio (CDP) Comparison	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Castling Defensive Portfolio Yearly Returns	11.50%	10.23%	8.73%	11.98%	8.55%	3.45%	9.37%	5.71%	-6.15%	13.15%	10.05%	5.26%	7.48%
Back-Tested Cumulative Return Since 20000	11.50%	22.90%	33.63%	49.63%	62.43%	68.03%	83.77%	94.27%	82.33%	106.31%	127.03%	138.96%	156.84%
Hypothetical Growth of $10,000 Since 2000	$11,150	$12,290	$13,363	$14,963	$16,243	$16,803	$18,377	$19,427	$18,233	$20,631	$22,703	$23,896	$25,684
Annualized Return (2000-2012)													***7.53%***
Standard Deviation (2000-2012)													***4.99%***
Coefficient of Variation (2000-2012)													***0.66***
Wellesley Income (VWINX) Yearly Returns	16.17%	7.39%	4.64%	9.66%	7.57%	3.48%	11.28%	5.61%	-9.84%	16.02%	10.65%	9.63%	10.06%
Back-Tested Cumulative Return Since 20000	16.17%	24.75%	30.54%	43.15%	53.99%	59.35%	77.32%	87.27%	68.84%	95.89%	116.76%	137.63%	161.54%
Hypothetical Growth of $10,000 Since 2000	$11,617	$12,475	$13,054	$14,315	$15,399	$15,935	$17,732	$18,727	$16,884	$19,589	$21,676	$23,763	$26,154
Annualized Return (2000-2012)													***7.68%***
Standard Deviation (2000-2012)													***6.55%***
Coefficient of Variation (2000-2012)													***0.85***
Wellington (VWELX) Yearly Returns	10.40%	4.19%	-6.90%	20.75%	11.17%	6.82%	14.97%	8.34%	-22.30%	22.20%	10.94%	3.85%	12.57%
Back-Tested Cumulative Return Since 20000	10.40%	15.03%	7.09%	29.31%	43.75%	53.56%	76.55%	91.27%	48.62%	81.61%	101.48%	109.23%	135.53%
Hypothetical Growth of $10,000 Since 2000	$11,040	$11,503	$10,709	$12,931	$14,375	$15,356	$17,655	$19,127	$14,862	$18,161	$20,148	$20,923	$23,553
Annualized Return (2000-2012)													**6.81%**
Standard Deviation (2000-2012)													***11.65%***
Coefficient of Variation (2000-2012)													***1.71***
Vanguard 500 Index (VFINX) Yearly Returns	-9.06%	-12.02%	-22.15%	28.50%	10.74%	4.77%	15.64%	5.39%	-37.02%	26.49%	14.91%	1.97%	15.82%
Back-Tested Cumulative Return Since 20000	-9.06%	-19.99%	-37.71%	-19.96%	-11.37%	-7.14%	7.39%	13.17%	-28.72%	-9.84%	3.60%	5.64%	22.36%
Hypothetical Growth of $10,000 Since 2000	$9,094	$8,001	$6,229	$8,004	$8,863	$9,286	$10,739	$11,317	$7,128	$9,016	$10,360	$10,564	$12,236
Annualized Return (2000-2012)													**1.56%**
Standard Deviation (2000-2012)													***19.02%***
Coefficient of Variation (2000-2012)													***12.16***

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http://www.roycefunds.com**.**

10. 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/.

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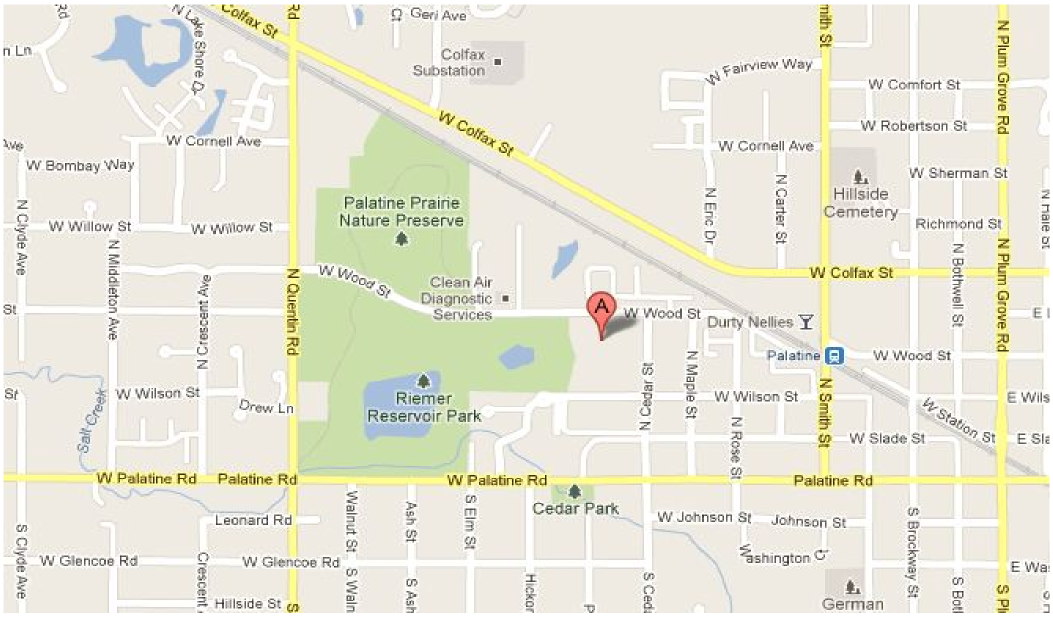

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