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Helping You Secure Your Future™

henry@YourIndependentAdviser.com

Summer 2014 Newsletter:

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What a Poor Boy From an Ancient Village Can Teach Us All About Choosing and Funding Higher Education

When was the last time you performed a "thought experiment"? Just to be clear on what we mean, a thought experiment begins with some theory or principle and thinks through its consequences in a logical fashion[1].

We believe that thought experiments have tremendous value, especially regarding anything with financial consequences. Oftentimes when you find yourself struggling to understand something, it can be quite useful to lift it out of its current context (that you do not understand fully) and then place the issue back down into another context that you do understand. Play the outcome in your mind to its logical conclusion. Is it still the same or does it seem radically different? Did you spot some inconsistency or even an ethical or moral breakdown?

At this point you may be wondering where the heck we are going with this explanation. So without further ado, here is our thought experiment in the form of a very short story.

There once was a poor, young boy who lived in a humble village about a thousand years ago, somewhere in early medieval Europe. His family could not afford to send him to school for more than a couple years. He is about sixteen years of age and mostly illiterate. However, he did learn the alphabet and can sign his own name.

While he has been helping his family eke out a living by working on the small plot of land owned by his father, just outside the village, he knows his options in life are very limited.

Being the second son, he also knows that his older brother will be inheriting the family's farm. While other boys his age may be disappointed that they will not be receiving much from their parents, our young lad has grown bored with tending to the routine, daily chores of farm life and would like to try something new. But he really doesn't have much of a choice in the matter.

Put simply, what will he do to provide for himself in the short term and hopefully for his future wife and children?

Since he has never traveled further than the local village during his entire life, he naturally sets his focus on finding something over there. With his mother's and father's blessing, he sets out to walk into town the next morning and begin calling on the merchants and tradespeople.

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Let's keep in mind that our young boy is not in a position to pay for a private tutor. Nor was he regarded as having potential, by either the local schoolmaster or clergyman.

So what does he do? He first takes a tour of the town, peering through the few shop windows and across the stables, mills and smithies of the town. He thinks about which of these trades could potentially interest him. He then works up the courage to begin asking the owner of each business, “Kind sir, would you please consider taking me on as your apprentice?”.

“Absolutely Not!” and “Get out of my way!” were the two most frequent responses he received that morning.

Despondent and on the verge of tears, he bumbles along near the edge of the village, when he suddenly hears a commotion. “This is an outrage!” screamed the old man to one much younger, who leaps back onto his wagon. He then sits next to a young woman who appears to be his new bride. He whips his scrawny horse into motion and off they ride.

“Ungrateful leech! I taught him everything he knows. Now that he's taken a wife, he gets to take over her father's smithy after his death. Lucky bastard! Good riddance to you!”

“But what will I do now?”, he bellows to himself, at first unaware that our young lad has now come into his view.

“I am very sorry about what has happened sir, but if you would be willing to take a chance on me, I promise I will work very hard and learn your trade.”

“You? You are some very young boy who knows nothing! Absolutely nothing!”

“But I can learn, sir. Please, please sir, consider me for an apprenticeship. My mind is a sponge and my hands are strong from working on my father's farm.”

The old man, seeing that no other, better alternative, was immediately available, gave the young boy the apprenticeship.

For the boy, this would mean long hours of learning the trade, starting with very menial tasks. It meant little to no pay most of the time. He did receive a cot to sleep on and enough food to eat during the week. He was able to go back home on the weekends and be with his family.

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However, the old man, who was considered a master of his trade in the village, was now obligated to instruct his young charge. The code of ethics meant that while the young boy needed to follow the directions set by the master smith, he was not an indentured servant, nor some sort of slave. The boy was instead, making an exchange of his labor for the instruction that would lead him to become a journeyman: competent in his trade and subsequently able and permitted to make a living in his village, or most any other.

Was our young apprentice going to commit years of his life in pursuit of learning subjects that did not translate into immediate value in making a living? Of course not.

Was our young apprentice going to accept sinking into debt in order to learn those skills? Are you kidding? Of course not.

These are the basic, time tested lessons that the poor young boy from a humble village can teach us all about higher education and how to fund it.

Back in the reality of our world, Federal student loan debt has now surpassed $1.1 trillion, up a whopping 53% from just 2007[2]. By contrast, private student loans total less than $200 billion. Since virtually everyone can get Federal student loans, this form of debt is increasing much faster, regardless of its practicality.

It is our view that demand created by the Federal government student loan program has been the single biggest driver causing price inflation in higher education. Making loans more "available" or more "affordable" is, paradoxically, like pouring gasoline on a fire that you're trying to extinguish.

Evidence supporting this view is easily found by looking at price changes in individual categories over a long period of time. For example, the price increase for college tuition and fees since January, 2000 is a whopping 130%, compared with overall inflation (as measured by the CPI) of only 47.4%[3].

How can college costs be increasing at roughly three times the rate of inflation?

If we dig further into the component expenditure categories that make up the CPI, we see that various personal services, reading materials, fees for lessons, Internet access and club memberships all either rose by a rate less than overall inflation, or actually dropped in price. Nothing is inherently "built into" the cost of college tuition and fees that would justify their level of price increases, solely based on the cost of their "component parts". If there was, why don't we see similar price increases in other areas that are involved with imparting information or performing services for another group of people (just like in our case: college students)?

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The difference with college costs is that there is inflated demand, due to the wide accessibility of student loans. We do not feel that anyone who is truly serious about going to school and getting a degree, should be thwarted. But neither should they be given an unlimited credit card that later becomes a boat anchor around their necks, or a burden to taxpayers in the future, while politicians keep seeking votes in exchange for bailouts.

Having attended several schools and having completed undergraduate, two graduate and a continuing education program over the last several decades, I have observed that the following points come up repeatedly as options, alternatives and solutions. But they are often ignored. Why? The following items should be discussed with the college and high school students in your families.

1. We have seen bright students actually graduate high school in only three years or at least take advanced placement courses during their senior year in high school. Getting a jump on college helps to save time and money. Why? Please read on.
2. Changing a major field of study continues to be one of the major impediments to finishing a four year degree in four years. How about delaying the choice until you are sure, but taking the most flexible core curriculum and then supplementing it with a few courses (especially from a local community college) chosen specifically to help you decide (i.e. those that are more job focused)? "Flexible" in this context, definitely does not mean "easiest". I am amazed at how many students insist that they received an "education", but never took calculus.
3. On a tight budget? Combine (1) and (2) into trying to begin a community college program as early as possible. Pick one that will transfer to a four year school of your choice, assuming you complete the entire core curriculum. Then add electives on top of this, which will highlight other potential careers and industries, even if those jobs appear to be "beneath you". For example, we have seen how the better mechanical engineering students also liked to work on automobiles. Computer Science majors taking extra programming courses will not be wasting their time. Also, consider taking summer classes, unless you have secured a top notch internship. Don't waste the time!
4. Community college programs cost about $3,000-$4,000 per year. The motivated student should be able to move on to their junior year by age 20 (at the latest). This spartan level of expense should more easily be covered by a savings program, such as a 529 plan, prior to enrolling.
5. Sorry to break the bad news. But your choice of school will probably not have a major impact on your financial well being, later in life, unless of course, you have the ability to make the superior networking connections at a top tier school. But only a small fraction of students actually accomplish this while attending those elite schools. Others are just stuck with an elite bill.

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6. Be firm and decisive by the start of your junior year. You should now have an understanding of the major field of study you have selected and the reason why you selected it. This decision should primarily be grounded in the economics of finding an entry level job.
7. Your professors may not have practical, real world experience, to offer you. Their life stories may be more about getting a doctorate than an entry level job. So why depend so much on their advice, unless you intend to follow their academic path?
8. There may be rivalries between the various colleges at your university. For example, the business school may not get along very well with the engineering school. This may prevent an engineering student from taking a few business courses that would prepare him or her for a real world job.
9. Be more general as an undergraduate. Don't over specialize your way into a practically non-existent job market. The purpose of the undergraduate degree is to get a decent entry level job, especially with a company that can provide varying experiences and future tuition reimbursement. Consider specializing later, not now.
10. Given your chosen major, think about the judicious use of free electives that could potentially qualify you for two additional types of jobs or industries. This is how we apply the ***Castling*** principle to education. For example, the information technology major who also takes Accounting courses, has opened up forensic accounting as a possible new job target. The industrial/operations engineer who takes information technology classes, could now become a good fit for working on a large scale Oracle ERP implementation. You do not need to focus on being a double major. But do focus on being doubly creative.

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Does Your Financial Adviser Work for You or for a Commission?

We need to preface this article with a clarification that ***Castling Financial Planning, Ltd.*** has never and will never work for any commissions, of any sort. Period. (This is the type of "period" that sticks.) So our essay is directed at those readers who are not currently clients of ***CastlingFP***, but who have another financial adviser.

Our curious observation has sometimes been that new clients or prospective clients who have had other advisers, insist that their previous adviser "worked for free". They did not pay him or her a dime. And they are sure of it! Were these advisers working pro-bono? We don't think so.

In fact, this is our first major criticism of the financial advice industry. Every member of the general public should walk away from any encounter with a financial professional and have a clear understanding of how the financial adviser is compensated. There is absolutely no excuse or justification for it to be otherwise. This is evidence that whatever regulatory disclosures may exist, they obviously do not constitute what we would call "prominent disclosure".

Moving on from this point, let us assume the case where the client understands that her adviser is compensated through commissions received on the purchase or sale of various financial products. Can the client assume that because he calls himself a "financial advisor" and appears to have all the requisite licenses and certifications, that he must necessarily be acting in her best interests? Sadly, nothing could be further from the truth.

This reminds us of one of our original sayings:

We are not what we call ourselves. We are what we are paid to do.

Next, we move on to a much older principle:

No man can serve two masters.

This ancient aphorism has Biblical roots as well as general usage in English Common Law. It is also the fundamental idea underlying the fiduciary principle. Jack Bogle, the founder of The Vanguard Group, wrote an excellent essay a few years ago, about the breakdown of the fiduciary principle and how this has happened at various times in our history[4].

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Perhaps it would be best to first define what we mean by "fiduciary principle". It grew out of the English Common Law of agency and the law of trusts. This imposes special duties upon those who hold a position of trust and confidence with their clients. Some of the specific requirements are to act solely in the best interests of their clients, treat their clients fairly and to disclose all material facts concerning the relationship with their clients, especially any conflicts of interest[5].

Now let's back up to the general notion of a commission based product salesperson acting in the role of a "financial advisor". Here's the big problem. Isn't there already some relationship between the product seller and the salesperson? Definitely. Typically, it is some type of agency or representative relationship (e.g. that's why a stock broker is often called a registered rep). If we delve further into this relationship, we would clearly see it is meant to be a fiduciary one.

As a result, how could the commission based product salesperson have a fiduciary relationship with you, the client, if he already has a fiduciary relationship with the product seller (insurance company, broker/dealer, bank, mutual fund company, etc.)?

Remember, "no man can serve two masters".

You may be asking yourself at this point, "If this is so obvious, what am I missing?". Don't worry. You are not alone. In 2010, President Obama signed into law the Dodd-Frank financial reform bill. This was a huge piece of legislation which increased the level of regulation and compliance requirements in the financial services industry. Unfortunately, we do not see that it did much to improve our level of prominent disclosure, or decrease systemic risk.

One of the many provisions of the new law gave the Securities and Exchange Commission the authority to write a regulation that would require all financial advisers to adopt the fiduciary standard of care. Currently, this standard only applies to investment advisers. Well, it has now been four years and no such regulation has been written[6].

Who knows when or even if, it will ever be written. In fact, the real danger to the general public would be if a watered down version were to be written, that applied only to commission based product salespersons. This would give the impression that client's best interests were being looked after, when nothing could be further from the truth.

Our view is that a much stricter version of the fiduciary standard, such as the one that applies to employer based retirement plans (e.g. "qualified" plans, those falling under the purview of the ERISA law), should be defined. Advisers should then be able to sign on

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to adhering to this stricter standard, or not. In either case, there should be prominent disclosure. Either a given adviser adheres to the stricter principle or does not.

Furthermore, let's have prominent disclosure that means something. If an adviser does not adhere to this stricter fiduciary standard, we'll assume that the only standard remaining is “caveat emptor” (let the buyer beware).

Currently, a registered investment adviser, such as ***CastlingFP***, must adhere to the fiduciary standard at all times. However, an investment adviser is permitted to be dually registered as also a broker dealer, thus creating one giant conflict of interest. Under a stricter fiduciary rule, this would no longer be the case. ***CastlingFP*** maintains no such affiliations or dual registrations and as a result, does not have these conflicts.

While we don't really like so-called rules of thumb, one thing to keep in mind is that most non-fiduciary financial professionals refer to themselves as “advisors” and not “advisers”. We believe that this further distances themselves from the fiduciary standard necessitated by the legally defined term “investment adviser”. By contrast, “financial advisor” has no legal definition and no specific licensing requirement. Licensing is determined based upon the products each person sells.

Speaking of selling products, what if we apply a thought experiment here? Let's lift the same situation out of a financial context that we may find unfamiliar or confusing and then set it back down again into another context that we are readily comfortable with. We then run the thought experiment to its logical conclusion and examine the results.

Instead of financial planning, imagine something you may already know about, such as automobiles. So you head out to do car shopping. Upon arriving at a car dealer's lot, you begin randomly looking over the stock and trying to identify something you like. You check the sticker and look for the features you want on the make and model you had your eye on. But you are not sure if this is the right time to buy a car, how much you can afford, whether you will get a good enough deal and whether the car will be reliable. In summary, you could really use some objective advice right about now.

Does this sound at all familiar? Not long after you and your spouse have looked over a couple vehicles, a guy with a big smile and loud suit strolls over to you. “Hi there, my name is Duke, Duke Nukem and I'm your automobile consultant”.

“Oh really?”, you reply. “So, like, you're our transportation advisor, correct? You could advise us on our transportation needs?”

“Of course”, he responds smoothly.

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"Well, as a transportation advisor, what do you think? Should we buy a car today?"

Alert! Thought experiment over. Baloney warning threshold reached!

So why don't you actually react like these customers on the car dealer's lot? You might say that you know better. Or that this example is not relevant. But why was it so obvious that you were not dealing with an actual "transportation advisor"? Could it be that you understand the context (i.e. car buying) so well, that there is no way you would mistake a car salesman for a transportation advisor?

So let's then turn back to financial advisers who sell financial products. Might you feel that your comparatively weaker knowledge in financial products and planning, put you at a disadvantage?

Here's a simple answer. The first step is to determine what you are looking for. If what you need help with is advice, analysis or a second opinion on your own ideas and not to simply be sold products, there is absolutely no substitute to finding out if a given "advisor" operates according to a fiduciary standard of care. Ask them! But also add that you need something in writing that reflects their answer. If they truly are fiduciaries, they should have no problem with this question and should display plenty of desire to demonstrate it. For example, ***CastlingFP*** is and always has been, a fiduciary in all dealings with all clients.

Second, keep in mind that everything less than a strict fiduciary relationship is really "caveat emptor", to one degree or another. There is simply no ascertainable standard for when the sales presentation ends and when the analysis begins.

What if all you need is for someone to execute a transaction for you, such as a stock or fund trade? A fiduciary standard may not be important in those cases, but this scenario misses one point. If the investor is knowledgeable enough in determining what to buy or sell, then why would they need a person to execute this transaction for them in the first place? It could be performed more inexpensively on-line, without human intervention. The person would probably be able to do it on their own, using the Web.

Even something like buying term life insurance can be applied for on the Web. No salesperson needs to visit you, although you may have some interaction over the phone. But this typically would be with someone who is not hard selling you something you didn't ask for.

So what should you do? Choose wisely, my friends.

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The Dirty Little Secret About Taxes & Social Security (And What You Can Do About It!)

OK, perhaps the following is not on a par with the NSA snooping on innocent Americans. But if you are not aware that your Social Security benefits are being taxed, or how they may be taxed, or what you can do about it, you may wind up feeling taken advantage of once you finally learn the facts.

The reason for our negative sounding title stems from the fact that for most of its lifespan, Social Security had been described as being a social insurance program that prevented poverty in old age, by providing a primary insurance amount (PIA) free of Federal income tax, starting at age 65.

Changes to tax law in the 1980s began to tax up to 50% of Social Security benefits. Further changes in 1993 raised the maximum portion subject to taxation, to 85%. Other changes gradually raised the retirement age for full benefits from 65 to 67, depending on year of birth[7].

We certainly realize that changes needed to be made over time. Otherwise, the solvency of the system would have been in jeopardy. But we cannot defend everything that has been done. The system promised a lot of benefits to a lot of people, assuming it could provide those benefits at reasonable cost. This has become increasingly more difficult, as the number of workers supporting each retiree has gradually diminished.

Over the decades, the maximum wage base subject to Social Security payroll taxes has been steadily increasing. The payroll tax percentage of 12.4% (employee and employer combined) has been in place for almost 25 years, with only a temporary two percentage point "holiday" a few years back.

The "average Joe" in 1972 earned about $10,000 and already saw his Social Security tax max'ed out at the $9,000 level. So he didn't pay Social Security tax on his Christmas bonus. Today, a roughly median income worker earning about $50,000 will have every dollar subjected to FICA tax. This will most likely continue throughout their entire career. The Social Security tax wage limit is more than double this amount.

But this is not even our main gripe. Our real issue is with including Social Security benefits into adjusted gross income (AGI) on your Federal income tax return.
Simply stated, the dirty little secret is that the income thresholds, beyond which more and more Social Security benefits are taxable, are not indexed for inflation. This is "stealth" means-testing for the program, since it results in ever more Social Security benefits being

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taxed away from middle class folks over time. Specifically, there are two income "hurdles" to consider[8]:

	Single	Married Filing Jointly
Hurdle One	$25,000	$32,000
Hurdle Two	$34,000	$44,000

Hurdle One limits Federal income taxation on Social Security, to 50% of benefits, while the second hurdle increases this to 85%. No more than 85% of a recipient's Social Security benefits are subject to income tax, under current law. The actual calculation is a little more involved and includes adjusted gross income (AGI) and some additional items such as tax exempt interest, which are added to 50% of Social Security benefits.

If the result exceeds the first hurdle, you begin paying income tax on your benefits. If it exceeds the second hurdle, you pay even more. But the real issue is that the hurdles, such as $32,000 and $44,000, are not annually adjusted for inflation and have not been, for the past twenty years.

By contrast, most every part of the Internal Revenue Code dealing with tax brackets is indexed to inflation. For instance, the cut-off for the 15% marginal tax bracket for joint filer status in 2014, is set to $73,800. But back in 1994, it was only $38,000[9].

Had the first hurdle amount been adjusted for inflation since its inception, it would now be around $62,000. The net effect is to steadily increase the amount of benefits subjected to tax, especially among people who are not very affluent. This acts as a means test for the Social Security program.

This would be a good point to remind everyone that ***CastlingFP*** does not give tax advice. But we do tax planning. What's the difference? You consult your CPA to get your income tax returns completed, questions answered and to have representation in front of the IRS. We do simulations (not actual returns) with data supplied by clients or their tax advisers, in order to provide financial plans and recommendations regarding how clients can best meet their future goals. This process usually involves budgets, investments and savings.

So what can be done? Like an ostrich, burying our heads in the sand by ignoring the issue, will not make it go away. In fact, most people may not even realize the increasing amount of their Social Security benefits that have been subjected to tax, unless they study

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their annual income tax returns over a number of years. For most retired folks, the decision to take a periodic distribution from a traditional IRA or employer sponsored 401(k), is driven by the need to pay bills and maintain one's lifestyle.

Rest assured, ***CastlingFP*** wants you to maintain your desired standard of living! This isn't about scrimping. It's about advance planning and then controlling the various "buckets" that determine how much of your Social Security benefits are eventually taxed.

In order to demonstrate this, we have put together some realistic examples in an Excel spreadsheet model, both for married couples filing jointly, as well as for single filers. We are happy to send the full Excel file to anyone who requests it, at no cost or obligation.

The next two pages show some of the many calculations involved. The first is labeled "Married Filing Jointly" and depicts seven columns of different annual budget amounts that a hypothetical couple may need to maintain their standard of living, ranging from $46,000 to $76,000. This is where many retired, middle class Americans find themselves in. We picked this range in order to demonstrate how relatively small increases in your budget translate into proportionally higher income needs. Not surprising, right? But let's look at the resulting percentage of Social Security benefits being taxed and the final tax paid on those benefits, assuming the low marginal income tax rate of 15%.

$46,000 (the far left column) of income is achieved by Social Security ($24,000), an employer pension ($12,000), some muni-bond interest ($2,000) and a distribution from a traditional IRA ($8,000). The resulting amount of Social Security being taxed is only $1,000, or 4%. No big deal. But let's say you need somewhat more to maintain your lifestyle. How about $76,000? <u>In this case, $20,400 will be taxed, or a whopping 85%</u>.

Our ***CastlingFP*** solution to this is two fold. <u>First, plan on having multiple buckets in the "post tax" and "tax free" categories, even if you cannot afford to fund them to any large extent. These could include liquid savings accounts, taxable brokerage and mutual fund accounts and especially, Roth accounts, such as Roth IRAs (even a HELOC/HECM)</u>. An after tax account means that you only pay taxes on capital gains and interest, not on the principal. <u>Second, source your annual income needs among these buckets, so as to minimize the amount distributed from your traditional IRAs (as long as you watch out for your IRA's required minimum distribution requirement, if applicable, based on your age)</u>.

<u>In our second spreadsheet example, rather small amounts were sourced from our various buckets, resulting in only $8,550 of Social Security benefits getting taxed. At a 15% marginal rate, the savings over the prior example is $1,778</u>. Best of all, this required no sacrifice on the part of the taxpayer. Let us know if we can help you try to achieve similar savings. The secret is out!

Married Filing Jointly

Various Budget and Income Scenarios

Item Description							
Filing Status:	Married/Joint	Married/Joint	Married/Joint	Married/Joint	Married/Joint	Married/Joint	Married/Joint
Required Annual Budget Amount in Retirement	$46,000	$51,000	$56,000	$61,000	$66,000	$71,000	$76,000
Annual Budget Amount To Be Sourced From:							
1. Post-Tax and Tax Free Sources:							
Taxable Liquid Savings							
Taxable Brokerage Account							
Taxable Mutual Fund Account							
Tax Free Bond Interest	$2,000	$2,000	$2,000	$2,000	$2,000	$2,000	$2,000
Roth IRAs							
Employer Qualified Roth Plans							
2. Pre-Tax and Taxable Sources:							
Traditional IRAs *(But make sure you take your RMDs, if necessary!)*	$8,000	$13,000	$18,000	$23,000	$28,000	$33,000	$38,000
Traditional Employer Qualified Plans							
Annuities							
Employer Pensions	$12,000	$12,000	$12,000	$12,000	$12,000	$12,000	$12,000
3. Social Security Benefits	$24,000	$24,000	$24,000	$24,000	$24,000	$24,000	$24,000
Adjusted Gross Income (AGI) Excluding Social Security Benefits	$20,000	$25,000	$30,000	$35,000	$40,000	$45,000	$50,000
Modified Adjust Gross Income (MAGI)	$22,000	$27,000	$32,000	$37,000	$42,000	$47,000	$52,000
MAGI + 50% of Social Security (MAGI+50%SSB)	$34,000	$39,000	$44,000	$49,000	$54,000	$59,000	$64,000
First Income Tax Hurdle Amount (Base Amount)	$32,000	$32,000	$32,000	$32,000	$32,000	$32,000	$32,000
Second Income Tax Hurdle Amount	$44,000	$44,000	$44,000	$44,000	$44,000	$44,000	$44,000
Hurdle Reached:	FIRST	FIRST	FIRST	SECOND	SECOND	SECOND	SECOND
Amount of Social Security Benefits Taxed	$1,000	$3,500	$6,000	$10,250	$14,500	$18,750	$20,400
Percentage of Social Security Benefits Taxed	4%	15%	25%	43%	60%	78%	85%
Federal Income Tax Due on Social Security (assuming 15% marginal rate)	$150	$525	$900	$1,538	$2,175	$2,813	$3,060

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Married Filing Jointly - Improved

Various Budget and Income Scenarios

Item Description							
Filing Status:	Married/Joint	Married/Joint	Married/Joint	Married/Joint	Married/Joint	Married/Joint	Married/Joint
Required Annual Budget Amount in Retirement	$46,000	$51,000	$56,000	$61,000	$66,000	$71,000	$76,000
Annual Budget Amount To Be Sourced From:							
1. Post-Tax and Tax Free Sources:							
Taxable Liquid Savings	$2,000	$2,000	$2,000	$4,000	$4,000	$4,000	$4,000
Taxable Brokerage Account	$2,000	$3,000	$2,000	$4,000	$4,000	$4,000	$4,000
Taxable Mutual Fund Account	$2,000	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000
Tax Free Bond Interest	$2,000	$2,000	$2,000	$2,000	$2,000	$2,000	$2,000
Roth IRAs	$2,000	$5,000	$5,000	$6,000	$6,000	$6,000	$6,000
Employer Qualified Roth Plans							
2. Pre-Tax and Taxable Sources:							
Traditional IRAs *(But make sure you take your RMDs, if necessary!)*			$6,000	$6,000	$11,000	$16,000	$21,000
Traditional Employer Qualified Plans							
Annuities							
Employer Pensions	$12,000	$12,000	$12,000	$12,000	$12,000	$12,000	$12,000
3. Social Security Benefits	$24,000	$24,000	$24,000	$24,000	$24,000	$24,000	$24,000
Adjusted Gross Income (AGI) Excluding Social Security Benefits	$12,000	$12,000	$18,000	$18,000	$23,000	$28,000	$33,000
Modified Adjust Gross Income (MAGI)	$14,000	$14,000	$20,000	$20,000	$25,000	$30,000	$35,000
MAGI + 50% of Social Security (MAGI+50%SSB)	$26,000	$26,000	$32,000	$32,000	$37,000	$42,000	$47,000
First Income Tax Hurdle Amount (Base Amount)	$32,000	$32,000	$32,000	$32,000	$32,000	$32,000	$32,000
Second Income Tax Hurdle Amount	$44,000	$44,000	$44,000	$44,000	$44,000	$44,000	$44,000
Hurdle Reached:	NONE	NONE	NONE	NONE	FIRST	FIRST	SECOND
Amount of Social Security Benefits Taxed	$0	$0	$0	$0	$2,500	$5,000	$8,550
Percentage of Social Security Benefits Taxed	0%	0%	0%	0%	10%	21%	36%
Federal Income Tax Due on Social Security (assuming 15% marginal rate)	$0	$0	$0	$0	$375	$750	$1,283
Tax Savings Over Previous (Unimproved) Scenario	$150	$525	$900	$1,538	$1,800	$2,063	$1,778

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Economic Reports and the Stock Market: Is it Really "Good to be Bad"?

The recent Ad campaign by automaker Jaguar emphasizes British villains in movies and extols the point "It's good to be bad". Getting a positive result from something which, on first appearance, is less than desired or is downright awful, seems counter-intuitive.

But could this be happening more often than we are led to believe? For instance, a severe storm hits a section of the nation. Both state and federal officials declare it a disaster area. Emergency relief supplies are flown in. Lives are saved. The damage is minimized. We support these emergency actions. But what also happens? Bills are passed in Congress which add tax deductions or credits, to be used by residents of these hard hit areas. What could go wrong with that? How about the potential for moral hazard?

Insurance companies subsequently leave the state or gradually pull back and not write additional insurance in the area. But residents continue to rebuild in the same locations that seem prone to the same kinds of storms, simply because state and federal responses appear to give them protections (real or imagined) that are more based on the political process, than on sound risk management.

Consider how a family purposefully locates their home miles inland, dramatically decreasing the probability of damage from such a bad event, but still accepting the need to pay for wind damage out of their own pocket, for fear of submitting too many small claims against their homeowner's insurance. Regardless, what happens? Their premiums still rise significantly.

This article is really about stock market psychology, the impact of economic news reports and the resulting likelihood of actions by the Federal Reserve.

Let's suppose we have a slight economic or market storm, take a hit, pick our portfolios back up and continue marching on. Bad news is bad news, but what the heck, we'll survive.

Or consider when the news looks worse, causing the Federal Reserve to issue very cautious forecasts and downward revisions to prior estimates. The stock market then rises on these reports. Wait a minute! Bad news just turned out to be good news? How can this be?

To try and answer this (at least to the best of our abilities), let's take a step back. The stock market, itself, is considered one of a group of leading indicators of the economy.

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For instance the S&P500® bottomed out in early March, 2009 and then started moving back up. The recession was later declared to have ended by June of that year. By contrast, the previous peak of the cycle was recorded in October, 2007 and the market headed downward throughout the remainder of that year. The recession was later declared to have begun in December of 2007.

To generalize, a significant overall market movement from a cyclical bottom seems to indicate a near term improvement in the economy (e.g. out of recession in 2009). A significant movement off of a cyclical top (e.g. late 2007) seems to indicate a potential recession.

Of course, it works when it works and fails at other times! Every indicator carries the risk of giving false positive warnings.

Week to week and month to month, the release of a myriad of economic reports would seem to attempt the opposite: provoke some change in the stock market. At least many market observers read the tea leaves on a daily basis and try to discern the bigger picture of what the market will do next. We have avoided this methodology and have called its devotees “Event Level Predictors” or ELPers for short.

Let's add the Federal Reserve into the discussion. While our central bank has been affecting financial markets ever since its founding, it was profoundly involved during and after the 2008 financial crisis. Several rounds of quantitative easing (called QE1, 2 and 3) have seen the Fed purchase Treasury and mortgage-backed securities (MBS), pumping up demand for bonds, increasing their prices and decreasing their yields. Over the past year, the pace of QE bond buying has been slowing. But the total Fed balance sheet has still grown enormously, from around $900 billion in August, 2008 to currently $4.4 trillion[10].

The two most often asked questions regarding the Federal Reserve are when will it begin to tighten short term interest rate policy, thus increasing the Federal Funds rate and when (and how) will it reverse course to begin unwinding its massive balance sheet, thus reeling the dollars back in? In short, this means going from a “very loose” monetary policy to a “tighter” policy. Just how tight and exactly when and what this will mean for the markets, is anyone's guess.

Various predictions have been made, running the gamut from a major hit to the stock market, with a 20%+ correction into bear market territory, all the way to it being actually a good thing, as the markets learn to work on their own again, with less “free money” from the Fed.

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Our view is that QE3 has overstayed its welcome. Federal Reserve activity was needed during the financial crisis, although we can still debate the particular actions that were taken. But that was now five to six years ago. At some point, the "patient", as represented by the markets and economy, needs to heal and grow on its own, freed from the artificial stimulus it had been getting for so long. We may experience some hurt (volatility) during this transition. But prolonging QE while the economy is growing (though not fast enough to be a true recovery), is in our view, a mistake we may all live to regret.

Consider that savers have been crushed by interest rates that yield nothing (actually are negative after factoring in inflation). Investors have been pushed up the risk/return scale, chasing for yield, but increasingly beyond their comfort zone in many cases. Asset bubbles may be percolating in places we cannot predict, until its too late, due to near endless supplies of cheap money.

This brings us back to our headline. What if "bad" news from the real economy is interpreted by the stock market as being "good", for no other reason than the expectation that the Federal Reserve's Open Market Committee (FOMC) and Board of Governors chair Janet Yellen, will take this as a reason to proceed more slowly to tighten or continue with the current loose policy, even longer.

This may also explain to some why the market has a "bad" day after some good economic news is released. We recently saw Dallas Fed President Richard Fisher on CNBC's ***Squawk Box*** touch on this topic. Really good economic reports may cause the FOMC to bring the decision on raising short term rates forward, he mentioned[11]. Nervous investors, a few institutions and some traders may take this as a signal to dump some of their positions, thus causing a sell-off.

Even though the stock market is considered a leading indicator for the economy, the economy provides a whole host of what could be considered "coincidental" indicators that affect the market. For example, GDP is considered the broadest measure of the economy and is also a coincidental indicator. The first look at second quarter GDP was a more robust 4%, but was not exactly greeted by a stock market rally[12].

We have put together a little table (below), to depict the distinctions between economic news as reported and how it is interpreted by the stock market.

While veteran market watchers may look at this and insist it's nothing new, this does not mean that they are any better at predicting events than you are. Right now, good news may be interpreted as being somewhat "bad". We would advise you to continue your asset allocation, dollar cost averaging and re-balancing activities. But we are not

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advocating large purchases in the stock market in general and especially not at the present time. If this does turn out to be a correction, ***CastlingFP's*** asset allocation strategies include enough cash equivalents to allow you to make future purchases at lower prices.

As Reported:	As Interpreted by Markets:	
	Good News	**Bad News**
Good News is	Logical; commonsense; What "should" happen if there is no underlying distortion	Counter-intuitive; What may happen if there are underlying distortions in the market; "The Fed will take away our cheap money sooner!"
Bad News is	Counter-intuitive; What may happen if there are underlying distortions in the market; "The Fed will keep pumping cheap money!"	Logical; commonsense; Could trigger a sell-off

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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
Facebook:
http://www.facebook.com/CastlingFP
Twitter:
@CastlingFP

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