Castling Financial Planning, Ltd.

Helping You Secure Your Future™

henry@YourIndependentAdviser.com

Fall 2018 Newsletter:

Come on Baby, Don't Fear the Correction...or Two

We are not Event Level Predictors (ELPers), although we are pretty critical of anyone who claims to be. Trying to call both the timing and the direction of market moves is something that we have never seen anyone pull off consistently. What we do, is to write about the general conditions of markets and the economy, along with our views on long term implications. We do the same in guiding our clients.

Last year in our Fall, 2017 Newsletter, we wrote the following:

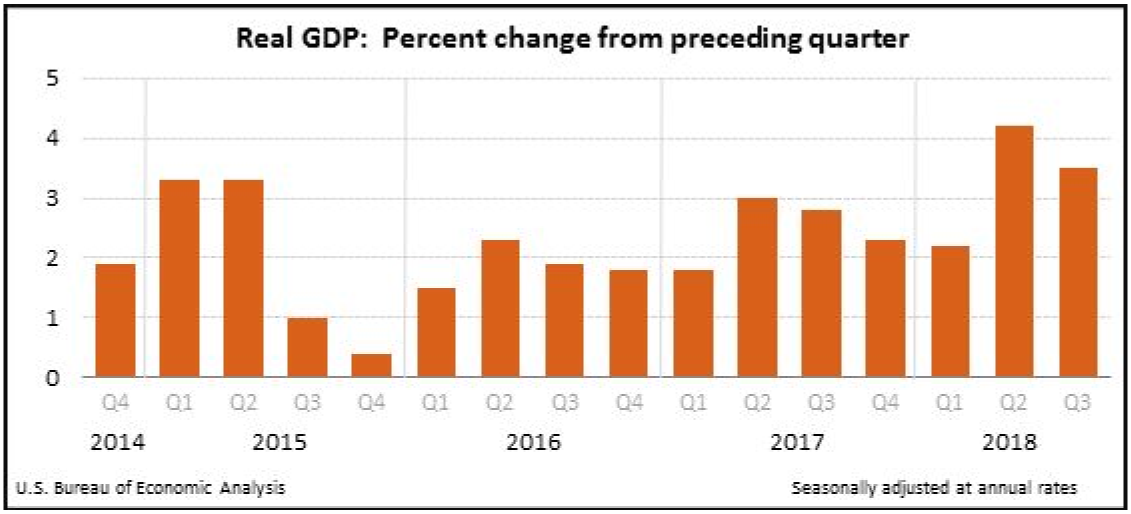
"Getting a market correction within the next calendar year may turn into a blessing in disguise. If markets consolidate the gains of the past several years and turn in a slightly positive or slightly negative 2018 calendar year performance, do not be afraid. Look at those GDP growth numbers and see if they continue to point upward." [1]

Depending upon the way you may look at it, 2018 has delivered perhaps two minor corrections, a huge increase in volatility over last year and some better (though not spectacular) numbers on economic growth. Uncertainty regarding the midterm elections is now over. Divided government has usually been viewed by the markets as being perfectly acceptable, at least from the standpoint of restraining unchecked government spending that may be engaged in by either party, acting on its own.

Nonetheless, nervousness seems to be the order of the day. This includes a lot of financial professionals who, we would otherwise assume, would remain unfazed by it. After all, 2017 was a "Goldilocks" year of very low volatility, coupled with high double digit returns (**S&P500®** at 21.8%).

Our thesis has been that since the stock market has made major gains since the end of 2015, it was time for the US economy to "put up or shut up". This recent chart (below) from the **Bureau of Economic Analysis** includes an "advance estimate" of third quarter GDP[2]. While not spectacular, there is unarguably, a significant improvement in 2017-2018 over 2015-2016. Simply look at the difference in "white space" under the 3% (long term trend line growth) line and the bars, in comparing the two time periods. The big question is, how long does this last? By July of 2019, assuming no recession were to begin by then (and current economic leading indicators are not sensing one), the present economic expansion would become the longest in US history.

Two rather unique features of this expansion are that it never produced a true recovery (thus far) from the preceding recession and that it mostly exhibited a rather feeble growth rate of around 2% or less. We believe that <u>this low growth rate has allowed the expansion to continue for this long</u>. Had sustained, robust growth occurred early on in this cycle, the Federal Reserve would probably have started their quantitative tightening much sooner.



Instead, we saw only two Fed Funds rate hikes from the end of the recession to the beginning of 2017 (in December of 2015 and again in December of 2016). But since then, the Fed has raised six more times, to 2.25%. We should keep in mind that the Fed has direct control over short term rates, but can exert only indirect influence over long term rates, since the bond market controls them. The Fed Funds rate directly affects the "prime rate" (which is usually the Fed Funds rate plus 3 percentage points) that is used for setting bank loan rates to highly credit worthy customers, as well as rates on adjustable mortgages.

Much of the negative (bearish) sentiment in the stock market recently has been because of the view that the Federal Reserve is steadily removing the "punch bowl", just as the party is getting going. Without getting into overly technical discussions of stock valuation models, it is relatively easy to see that if the risk free rate of return (such as on a three month Treasury Bill) was close to zero, growing stock valuations are easier to obtain and sustain. Corporations who could have borrowed freely (i.e. easily getting financing), might have borrowed almost for free, while us "little people" didn't have many alternatives for savings, since fixed income instruments keyed off of the Fed Funds rate were yielding almost nothing (not that long ago). This has now changed.

At increasingly higher risk free rates, the intrinsic value of stocks can be viewed as being consistently lower. Corporate tax cuts enacted recently have helped offset this, since the resulting earnings reports have come in consistently better than last year.

A perceived danger exists if short term interest rates were to keep rising and eventually surpass longer term rates, such as the yield on the 10 year US Treasury Note. This condition is called an "inverted yield curve" and usually signals that a recession will begin within the following twelve months or so. We would like to stress that this has not been the case and currently is not the case, thus far in this economic cycle. But markets like to worry, anyway.

Early this year, we appeared to have a stock market correction of the barely 10% variety on the S&P500®. Now let's take a closer look at what has happened since October. Keep in mind that any 10% or greater decrease from a recent high in a stock market index, is considered a correction. A fall of 20% or more is considered a bear market. Since any stock or the index it's in could fall during a trading session and still close above its 10% low, it becomes a point of contention among market gurus whether corrections measured based on such intra-day numbers, should qualify. Markets move based upon facts, but they also move due to sentiment and fear. So while we respect all of these numbers, we don't want to obsess over them. The question is, what major messages are they sending to us and how should we be interpreting them, in our role as long term investors?

Let us review a few facts[3]. All major categories of stocks are represented by their own index.

For large cap stocks (i.e. large and well established, publicly traded companies), this means the S&P500®. It closed 2017 at just under 2,674 (we will round all of the following numbers to make them a bit easier to work with). Then on September 21st, we reached a high (intra-day) of almost 2,941. We need at least a 10% pullback from this number to qualify as a correction, or about 2,646. On October 29th, we went as low as just under 2,604, before closing around 2,641. So yes, we did have a minor correction.

Moving on to the technology heavy **NASDAQ** stock exchange, the **NASDAQ Composite** is the index we looked at. It ended 2017 at around 6,903. Now it gets a little more interesting. On August 30th, an intra-day high of about 8,133 was reached. A 10% pullback from this number would be 7,319. Tech stocks then started getting hammered. The so-called "***FAANGs***" (Facebook, Apple, Amazon, Netflix and Google/Alphabet) all looked as though they lost their mojo. The NASDAQ Composite hit a low of around 6,923 on October 29th, thus easily surpassing the basic requirement for a correction. In fact, a bear market could be called if this index were to reach 6,506.

Next, let's take a look at the stocks of smaller firms, as represented by the **Russell 2000** index. It is important to note this small cap stock index usually moves in a somewhat different cycle as compared to large cap stocks. Owning multiple asset classes that show this weaker correlation to each other, is very useful for diversification of your portfolio. However, small cap stocks can be just as volatile as (and even more so), than large caps. The Russell 2000 closed 2017 at just under 1,536. On August 31st, it reached 1,742 briefly. A 10% pullback would be at 1,567 and a 20% bear would begin at 1,393. A low of close to 1,459 was reached on October 26th. Once again, we easily reached and surpassed the requirement for a correction and we were within five percentage points of bear market territory.

So should we panic? No, never. *(Well, almost never. If the asteroid with Earth's name on it is headed our way, all bets are off.)* Should we be concerned? Only in so far as to take the temperature of the economy and see if we can spot a recession on the horizon. Major market drops can signal a recession, but can also be caused by all sorts of other things.

Our economic research of choice comes from **AIER**. Their October, 2018 readings show that most all leading indicators are still expanding (83%), while almost all coincidental indicators (92%) are also expanding. Lagging indicators, which can be used to confirm the other two, held steady at a high level (83%). The housing market appears to be one of the weakest areas of the economy, based upon their data. Stated in plain English, they see a very low probability of a recession in the next six months and a low probability when looking out one year[4]. Based on our experience, no one has a way to accurately forecast macroeconomic conditions more than a year into the future. Those who insist that they can, may be smoking some of their “cannabis stocks”.

So where does this leave us? Corrections are a natural part of the cycle. Since no one rings a bell at the tops and bottoms of markets, long term investors need to continue to make sure that the asset allocation in their portfolio represents their three dimensions of risk tolerance:

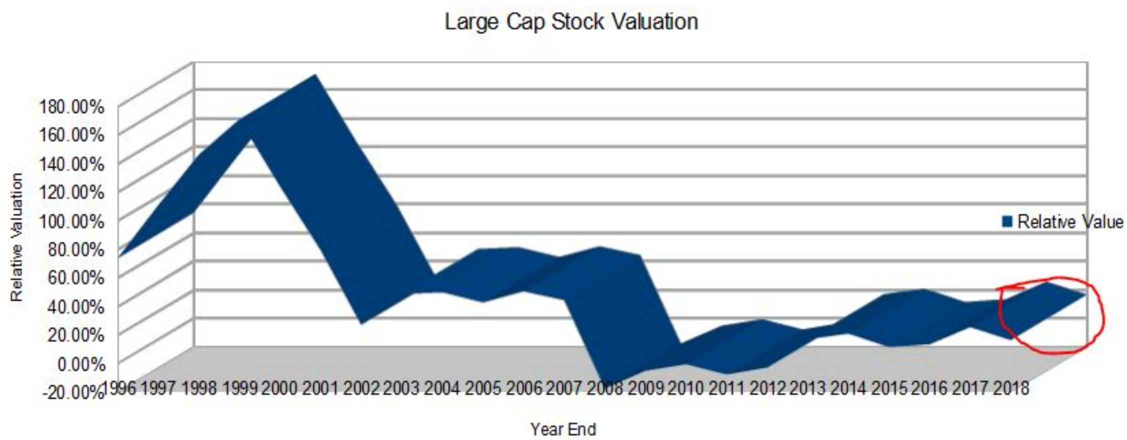
1. Your ***willingness*** to take risk (subjective; the sleep well at night aspect)
2. Your ***ability*** to take risk (objective; looking at your own income/net worth)
3. Your ***need*** to take risk (objective; the goals you want to accomplish)

These dimensions of risk tolerance are different for everyone and a one size fits all approach definitely does not fit us all very well. If you are not comfortable figuring this out on your own, of course we are here to help, with as much or as little assistance as you require.

For now, here are our final thoughts. 2017 was the anomaly. Do not expect years where markets go relatively straight up while exhibiting very little volatility. Repeat those years often enough and you will then have severe bear markets and crashes, as a consequence.

Instead, 2018 has given us a dose of reality, just like taking some bitter medicine. We actually find it useful, since it lessens the probability of a more severe move. We go back to our beginning quote and reiterate that a basically flat year, as long as the GDP numbers continue to come in at or above 3%, is a plus.

Here is our own model of large cap stock valuations, assuming that the S&P500® index is flat for 2018, but with a +2% total return, due to dividends.



This would put us below our +20% overvaluation threshold. While our database goes back to 1970, here we show data beginning with 1996 and the Y2K inspired lunacy that helped bring us where we are today. We are certainly NOT undervalued and future returns may be relatively weak. But no none knows if we will enter a period of low returns, or have a small bear of 20% and then rebound, or have a huge bear, etc.

But the long term investor with a well organized financial suite that may include multiple portfolios for different purposes, should continue to survive the bad times and really thrive during the good times. You may also like to read our separate article on organizing your finances.

RETURN

Could Financial Wellness Actually be Your Step Zero?

A long time ago a family member related a story about a computer class she had been taking. It was meant to teach the student the basics of logic, through writing what is called "pseudo-code" (e.g. a very precise set of English language instructions that were once used as an initial step before writing actual software code in a real computer language). The instructor asked her what was the very first thing that she needed to do, in order to accomplish some task (which has long since been forgotten). The answer she gave, although generally accepted by the others, was dismissed immediately by the teacher. "So what is the very first thing I should do?" she asked, somewhat perplexed. "You would get your hands out of your pockets!", was the response.

Imagine a second scenario where a homeowner, in trying to perform what should be a very simple replacement of an under sink water filter, instead struggles for an hour in trying to get the old one removed. Exasperated, he looks around at why this task is so arduous. His spouse walks by and calmly asks if he is using the right tool. "I'm following the *'¡#$%&¡'* instructions!", he bellows. But then he looks at them again and sees that perhaps an initial step might be missing along with a mention of another tool: a right angled, ratcheting screw driver. With it, he would be able to loosen the screws that he is currently unable to access. For some reason, whoever wrote those instructions did not anticipate an under sink layout such as the one our homeowner had to deal with. Later, he acquires the right tool and voila! Fifteen minutes later, the entire job is done.

Do we see any similarity in the two stories? We may be convinced we need to hurry up and get on with "step one" in whatever it is we are doing. But what about "***step zero***"? Are we even prepared to begin at the beginning?

Life may not be easy. But for some, their particular circumstances make even simple financial planning seem nearly impossible. Just getting to the end of their month, before the end of their money, is enough of a struggle.

Some forward looking employers who already sponsor (physical) wellness programs, have recognized the financial stress that some of their employees are under. They have developed a program to deal with this problem, called "**Financial Wellness**"[5].

Here we even go a step further and postulate that for some of us, financial wellness may be that necessary step zero. Perhaps this is the remedial course you need to take before you commit yourself to the more advanced learning objectives that your "classmates" have already embarked on. If so, then don't feel embarrassed that you need to focus on the basics first. But what if you skip this step zero and pretend that you can just dive into the more advanced material of financial planning? Well, just as with skipping that remedial course in school, if you get lost or lose motivation, do you then risk failing or dropping out?

Financial wellness programs are about educating and supporting participants in the foundational financial areas such as budgeting and debt management, as well as promoting retirement planning (especially for those who have not yet started) and saving for other long term goals, such as college for their children. The underlying issue is that stress caused by basic financial problems or a lack of financial literacy, can rob employee productivity[6].

But what if you are not lucky enough to have such a program through your employer? Many financial advisers are not all that prepared to take clients who need this kind of help, mostly because it does not fit their commission or asset based business model. For those of us who practice financial planning hourly, many clients in need of financial wellness do not feel that they can afford these kinds of services. (We would suggest that they reassess that last point.)

If you or someone you know and care about happens to be in this predicament, do not give up. <u>Recognize that there is a problem, but keep in mind that financial wellness is both the goal, as well as the treatment</u>. <u>There is a solution to lower your stress and this is your step zero, before advancing to more sophisticated financial planning</u>. This is no different than watching someone recover from an illness. They should focus on getting healthy first, before training to run the next marathon.

While I see that financial wellness is trending in corporate employee benefit circles, the aftermath of the Great Recession has caused many people to retain significant difficulties. But it has also resulted in some folks rationalizing away their current situation. Here are a few example statements:

"You know, everyone else is only one or two missed paychecks away from their own financial catastrophe!"

"We're savvy people. We did everything right and it still didn't work out."

"We put all of our money with Bernie Madoff because the government approved of him."

"They loaned us the money. Doesn't that mean that they were sure we could afford the loan?"

"How did we go bankrupt? Two ways. Slowly and then all of a sudden."[7]

With respect, we simply reply to each of these: "No, no way and no how". Recognizing your problem is the start of your Step Zero/Financial Wellness program. Take responsibility for the current situation and you will soon be able to give yourself most of the credit for fixing it. At the end of our discussion, we'll come back to these statements and I'll provide my own reasoning for why I feel strongly about them.

After taking responsibility, there is an urgent need to take immediate action. Most financial stress is sourced to problems with cash flow. There is not enough money coming in to cover what is going out. There may also be the realization of a huge debt lingering on the horizon, or one that requires hefty monthly payments, resulting in the present shortfall.

There is an ancient principle related to this. It is as old as our **Castling Principle**. We can summarize it simply as:

Live beneath your means.

At this point, there is no choice other than creating a realistic budget. Resist no longer. While we have covered this elsewhere, it takes on an urgency in this case, that must be acknowledged. Don't resist because you don't have much of a choice and the alternative will probably be to pull the plug on one or more of your priorities.

"Can I really afford this?" "Do I really need this, while I am struggling so badly?"

Every expense item needs to be tallied into a line on a budget worksheet. This does not mean buying paper clips qualifies as a line item. But you need to know how much you spend on each utility, especially mobile and land line telephones, TV packages, Internet, gas, electric and water. Fixed expenses for rent or mortgage, all kinds of insurance, any car payments, etc. All food purchased at grocery and department super stores versus dining out should be listed as well. I think you may get the picture at this point. *(Please see our other articles which discuss budgets in other contexts, if you would like more background in this area. Please contact us if you need a copy of them.)*

Our real purpose in bringing up the "B-word" is to help provide clarity once you have it all down on paper or logged in a spreadsheet.

One of the financially most depressing things we have heard in the past few years, even though we are far removed from the last recession, is that some folks are not able to deal with an unexpected expense of as low as $400 - $1,000, without going into further debt. This means that they have no emergency fund. This is part of Step Zero/Financial Wellness. It is not simply some nice thing to have when you get around to saving for it.

An emergency fund (EF), composed of enough cash/liquid cash equivalents to cover three to six months of after tax expenses, is an outright and urgent necessity!

How much louder do we need to say it?

So when going through the items on your expense list that form your budget, you need to wind up with enough income surplus each month, so that this excess can be squirreled away in a savings account (a separate account is usually best), in order to build up your emergency fund. How long should it take to accumulate? Well, you needed it yesterday but we know it's impossible for you to have it by tomorrow or next month. Going through this process should make it clear how quickly it can be built up. Sacrifices will be made in an attempt to get you the EF you need (or at least modestly so), sometime within the next twelve months.

This does mean some temporary sacrifice. We have seen people (none of our clients, of course), rationalize their need for multiple phone plans and cable TV packages, all while not saving anything toward their EF. While I do think that a fast Internet connection is important and should be retained, monthly phone and TV packages should be drastically scaled back, if not eliminated entirely.

Your Wired and Wireless: The Low Hanging Fruit in Cutting Your Spending

Consider the following:

1. Prepaid cellular phones eliminate the monthly bill, which would otherwise be layered with access fees and taxes. While **Tracphone** is one of the leaders in this market, there are others. A $50 monthly invoice could be squeezed down to the equivalent of $10, while still being able to use a smart phone with most of the features included in the latest top of the line **Apple iPhone** or **Samsung Galaxy**.
2. Home phone substitutes, such as **MagicJack**, use voice over the Internet protocol (VOIP). While this is also being used by digital telephony providers such as **Comcast**, their cost is only a small fraction of Comcast's, although quality can be spotty at times. Compare these, as well as with any current home provider, such as **AT&T** or **Verizon**. Again, look at the cost of fees and taxes added to your monthly bill. If your cell phone can double as your home phone, getting rid of this charge would be even better. At least replacing Ma Bell's $40 charge with the equivalent of $4 from someone like MagicJack, makes sense when you do not have the cash flow to fund your EF.
3. Cable or satellite TV is great, when you can easily afford it. If you do not have the money in your EF today, you may not be able to afford your grandiose TV package. If you are stuck with months remaining in your contract, then you

probably should wait it out. If not, one simple approach would be to call your provider and ask to speak with a "customer retention rep". Politely threaten to take your business elsewhere, unless you can get an immediate and significant discount (i.e. pricing along the lines of what a new customer would receive). While this may or may not work, we have seen it result in $60 a month savings.

4. This next one may hurt a little, until you wean yourself from the inertia that is keeping you from Financial Wellness. <u>Consider temporarily getting rid of your TV package entirely (i.e. become a "cord-cutter")</u>. The modern day equivalent of a rabbit ears antenna will pull in the high definition TV broadcasts from all of your local, over the air channels, for free. I realize that this may not be enough for most people. However, a Smart TV or current standard "dumb" TV with a streaming player, such as the ones from **Roku** or **Amazon**, can bring in a large number of free channels. One of the more interesting ones is called **Pluto TV**. It is an app that is really a platform for the reception of a large number of live, streaming television networks. While these probably will not comprise all the ones you had before, but when combined with your local over the air channels, it may be sufficient. But it would result in 12 or 24 months of drastic savings to help you build your EF.
5. While specific TV/movie services such as **Netflix** are still relatively cheap, consider that your local library may give you free access to a streaming app called **Kanopy**. This will allow you to watch some movies as well as documentaries and other programming.

Saving at least 50%, or perhaps $100-200 a month on wired and wireless, should be a priority.

Our Obsession with Automobiles: Your Next Area to Cut

We are a population that is obsessed with our vehicles. Full disclosure: I am a member of the **Volvo Club of America**, so that makes me a bit of a car lover as well. Our passion for cars, trucks and SUVs does not make us bad people. It's when we cannot afford them and then let our ownership or "loaner-ship" (i.e. loans and leases), create the obstacles to our Financial Wellness.

We do not have the space here to cover all aspects of selection, purchase or lease, financing, insurance, maintenance, repair and ultimately, retirement (of the vehicle). But it has been my experience that <u>there is a significant correlation between people with deep financial problems and the ownership and payment of autos</u>.

One of our favorite analogies compares financial advisers with car salesmen. Since when would the latter be called "transportation advisers"? The general public instinctively understands that they are not advisers. And yet, many of the same people with financial problems accept the notion that if a dealer is willing to work out a financing arrangement for you, that it necessarily is something that you can afford.

Anyone working to sell a product is trying to figure out a way that you can legitimately buy it from them. This may include painting a rosy scenario regarding financing. But do you believe that they understand your financial details and situation? If you already do not believe that what they are selling you is necessarily in your best interests, why believe that you can afford the vehicle, under almost any circumstances?

Car payments on a brand new vehicle of any type, for a person seeking Financial Wellness who does not yet have an EF, is a big mistake. A late model used car with some portion of its warranty unexpired, is still usually a superior purchase.

Maintaining and holding on to a vehicle for a year or two longer, in order to allow you to build your EF up, is something to consider. While repairs can escalate for older vehicles, insurance costs should come down. The point is that those without an adequate EF, but who still feel the need to spend $500 a month on a car payment, are creating their own financial stress.

We realize that if you already are making these payments and cannot simply get rid of the vehicle without paying a dealer to take it off your hands, you may be stuck. But don't do this again. And don't do it with a spouse's vehicle, either.

Even an older car costing you $2,000 a year for repairs, would still allow you to put money away monthly into your EF, over payments and insurance on a brand new, comparable car (in most cases). We are not asking you to sacrifice safety. But achieving financial wellness quickly should be the priority for you now, not maintaining your old level of comfort or luxury.

Leasing is not always a bad deal. However, it makes more sense when used in business transactions. Most often in personal situations, it is used as a convenient way to acquire use of a vehicle that we could not otherwise afford to buy (a bad move). Once again, we prioritize financial wellness over the lease. Simply focus on getting your transportation needs solved safely and reliably, but with a low, long term cost. This usually translates into getting your monthly bill down as well.

Personal Items, Clothing, Household Goods and Furniture: Out with the New?

One of the classics in personal finance was written by two people who did not follow a conventional path in financial services: Joe Dominguez and Vicki Robin. Their book,

Your Money or Your Life, was considered to be inspirational for both the "FI" (Financial Independence) movement, as well as the Voluntary Simplicity movement. In the past decade, FI has been recast as "FIRE" (Financial Independence; Retire Early).

While this book has a wealth of practical information, worksheets and tables, here we simply are interested in discussing two methods (there are many more mentioned) for decreasing spending, targeted to the folks who need to cut in order to jump start their Financial Wellness: 1) Wear it Out, 2) Buy it Used[8].

I picked these two because they are the kind of "ancient principles" that have always existed and have always worked, just like the concept of ***Castling***.

People used to say *"Use it up or wear it out"*, especially when financial resources were very limited. This was mostly before the era of easy credit. Today, a lot of clothing is discarded or donated long before it is actually worn out, simply due to a change in fashion or tastes.

I am the last person to be recommending anything based upon fashion or style, to anyone else. But this discussion is not about me. Regardless of what may be trendy, there are certain "classic" colors, styles and combinations that seem to last longer, in a fashion sense. Getting even one extra season of wear from your wardrobe, compared to what you have done in the past, seems like a small sacrifice when your Financial Wellness is at stake.

This concept is even more true with household goods and furniture. We may be more forgiving of a stain on the carpet or slight tear in the fabric of a sofa, when those items are not presented to the outside world as regularly as our daily dress. In the corporate world, the concept is called "cost avoidance". If we can simply avoid having to replace a capital investment (for example, a computer system), for another year or two, we delay the costs involved until our finances are improved.

The second principle, buying used, seems to have been completely forgotten by large segments of the population, while a much smaller group appears to apply the idea almost religiously. The rest of us fall somewhere in between. But for people who are seeking Financial Wellness, yet do not have an emergency fund, how do you justify buying thousands of dollars of furniture on credit, when comparable (used) items are available for 10%-25% of their cost as brand new?

Garage sales often get a bad rap as places where junk is purveyed by folks with too much free time on their hands. But just go to garage or estate sales in upscale neighborhoods only. Yes, 90% of the "stuff" you find may still be considered "junk" and another 90% of what's left, you will not be able to use. This still leaves the 1%. Either get in early for the best selection, or come near the close to haggle down the price. Where else can you ask for a 50% discount and stand a good chance of getting it?

Goodwill Industries stores (or similar stores run by other charities), offer a wide assortment of goods for your home, including furniture, as well as clothing. Some items are incredible bargains, while others are merely OK. The issue is whether you can satisfy your needs by buying quality items in used condition, that you can afford, as opposed to racking up more debt.

The Next Step to Financial Wellness: Review Your Credit and Fix It Yourself

Many companies exist with the stated purpose of helping you repair your credit or to do credit counseling with you. If your situation has not yet deteriorated to the extent that you feel you must go to one of these firms, take action yourself. Most of them do not work for free and to the best of my knowledge, none perform real financial planning.

Here is another approach. First of all, anyone committing to reach Financial Wellness should consider calling a "time out" for a while and refrain from opening any additional credit lines of any kind. Why? Simply think of an athlete recovering from surgery. Should she go back out onto the training ground as soon as possible to "save time"? Or would it be prudent to give herself some time to heal?

Time heals all wounds, right? Not only that but time, when used wisely, also heals credit scores and credit reports.

While you need to have at least one credit line open to build some sort of credit history, continually adding accounts and putting balances on them, while you are trying to achieve Financial Wellness, is not a good idea. Instead, focus on making at least the minimum payment on every single account, every single month, by the due date, without fail. You may say that it's too late; the cow has already left the barn. Remember how time heals? There is little excuse for not fulfilling this task, even if it means selling some personal items.

Your mother still loves you, but does J.P. Morgan Chase still "love" you?

Have you ever loaned money because a friend or family member really needed it and then faced a difficult time getting paid back? How did that make you feel? Sure, banks do not have feelings. But they have the next best thing: ***algorithms***. If you are not already that dependable person that credit card issuers "love" and are looking for, there is no reason that you cannot become that person, slowly, over time.

While I like and respect financial guru Dave Ramsey, his attitude toward credit is akin to someone running Alcoholics Anonymous (maybe more extreme). There are those who have messed up their credit to such an extent in the past, that they probably should stay away from it in the future, just like a reformed alcoholic avoids taking even a single drink. But I believe that learning the mature and disciplined use of credit is far more beneficial for most everyone, than to simply stay away from it entirely.

One of the more recent innovations in the financial services industry is individual banks/credit card issuers reporting **FICO®** credit scores to their individual customers at no cost. While this can be very useful, keep in mind that it represents one specific bank performing their credit calculations using a version of the **Fair Isaac Corporation** score (owner of the FICO® formulas and trademarks; for more information, we have provided a link to their Website[9]). This may differ somewhat from another bank's score and therefore, explains why your score may vary among each of your card issuers. Monitoring these (when available without cost) is a good start, but you need to do the following as well.

While many people know that they can get one free credit report each year from each of the big three credit reporting bureaus: **Equifax**, **Experian** and **TransUnion**[10] only a fraction actually bothers to do so. However, if you are trying to achieve Financial Wellness, you need to make sure your credit file is cleaned up.

The resulting reports should be saved to a PDF file for later viewing and analysis. Your credit scores will not be included in these reports, but each will have detailed information on every one of your credit card accounts, along with home and auto loans, other types of debt and even outstanding medical bills and landlord reports, among other things.

It is up to each person to review the report and follow the defined process that the credit report agency describes, in terms of notifying them to correct faulty information. This also holds true if you find an account(s) listed on the report that you did not open. Also, perhaps you settled a dispute with a creditor amicably and closed the account, but your credit report shows a big negative mark against you for that one. You need to take action, document, communicate and seek resolution with the credit reporting agency. They may allow you to add comments to your credit file to explain the situation. Follow their defined process for resolving the matter first, before escalating.

Once you have reviewed all three credit reports and worked out any negative issues that were mistakenly added, use your existing credit card issuers' Websites to monitor your credit scores (if they offer this feature for free). But most of all, you need to review every single transaction on every single card, every single month. This is the only way that you are going to know that these purchases are not fraudulent and that your data is still "safe" (which is a relative term). There is no shortcut to making sure transactions are legitimate. You need to report any fraud as soon as possible. So a monthly review of transactions, such as after a statement cycle closes, would be a good opportunity.

After a year has passed, if you have not opened up new lines of credit and have dutifully paid at least the minimum amount on every outstanding card, on time, each month, you should begin to see your credit score increase.

Think you have more lines of credit opened than you actually need? Think twice about closing them, unless you truly have no need for a particular credit card and the account has only been open for a short time. It is usually a bad idea to close credit accounts that have been opened for a longer time, such as more than a year. These represent a big part of your credit history. It is far better to "patch them up" by dutifully paying on time (every month) and paying the balances down to zero, so that these payments will then "proudly be on display" in your credit file. Also, having a larger total credit line available with a smaller total debt balance, will lower your overall credit utilization ratio, which makes you more "lovable" to the credit card companies algorithms.

At this point, a useful tip is to request your annual credit report from only one of the credit reporting agencies, but do this every four months with another and then repeat. This will still be free for you, but you will have fresher data every four months.

Credit cards provide remarkable convenience and can practically eliminate the need to carry cash. But they are not a replacement for your budget. Someone trying to sell you something on attractive credit terms does not automatically mean that you can afford whatever it is, or that the transaction is in your best interests. Always keep in mind that the person on the other side of the table is just trying to make their own sales goals, not provide you advice.

Rounding Out Financial Wellness: Start/Increase Contributions to Your Retirement Plans

We have written about specific uses for borrowing from your 401(k) plan. But for people trying to achieve Financial Wellness, this is less of a good idea and should be avoided. You need to address the spending and budget issues that we described above and robbing from your retirement is not a good place to start.

But for some, Financial Wellness can be put back on track when they can start making contributions to their retirement plans, simply based on the fact that their cash flow and budget problems are now under control or at least getting better.

The following move is a "no-brainer" for anyone who previously did not participate in their 401(k), due to cash flow problems. If this is you, simply follow the above guidelines and review the sources I listed. Improve your cash flow situation using all this information and it should allow an immediate increase from 0% to something closer to your employer's match percentage. This is **free** money that you would otherwise be leaving on the table. If you are unsure how to invest since you may never have done this before, look for a target date retirement fund whose year most closely matches your long term retirement date (or year when you qualify for Social Security's full retirement benefit).

However, you may still be uneasy about investing. In that case, simply look to invest in a stable value fund. This is not meant as a long term strategy, but as a way for you to get started and to see your account balance steadily grow, month by month. Seeing month to month growth in your balances over the next several years may be the motivation you need, to get going with your financial planning in other areas.

To end this discussion, let's review some of the rationalizations made earlier and dispel some myths.

"You know, everyone else is only one or two missed paychecks away from their own financial catastrophe!"
No, not really and probably not ever. If you read and act on the above discussion regarding an emergency fund (EF), you will eventually have the equivalent of 3-6 months of after-tax expenses available. This is just the beginning of Financial Wellness. We have previously written about many other things, such as the benefits of Health Savings Accounts (HSAs) in funding unexpected medical expenses (i.e. deductibles and other out of pocket costs). The best time to act in building the EF is NOW! The second best time is when times are good and you feel that you can meet all your expenses. But the fact that you live without an EF now indicates that you are still living on the edge.

"We're savvy people. We did everything right and it still didn't work out."
The problem here is that if something did not work as expected, you could not have done "everything right", by definition. Everyone makes mistakes. I have certainly made my share. For example, an investment did not turn out as expected and lost money. But we try to learn from these experiences and then not repeat the same mistakes going forward. In the future, being able to look back and talk calmly about the experience and pinpoint the causes like a football analyst reviews a play, shows a level of maturity. Finally, we all keep learning for as long as we are living.

"We put all of our money with Bernie Madoff because the government approved of him."

Of course, we can remove the name, insert a blank line and ask you to fill it in. The problem with this statement is that NO governmental agency APPROVES of any investment adviser or broker, or of any investment product or security. Instead, the various advisers, reps, products and securities are supposed to be REGISTERED with the appropriate regulatory bodies. In addition, the fact that any investment appears to be working for you and generating the expected returns, is not an indication that you should put more and more of your money into it, culminating with all of your golden eggs inside the now overflowing and flimsy basket. This will not work from a diversification standpoint. But also keep in mind that the more that investors pack into any product or asset class, the lower its expected returns will be. The more that any asset class rises in value, the lower its expected future returns will be.

"They loaned us the money. Doesn't that mean that they were sure we could afford the loan?"
The person or institution loaning you money is not doing so because the action is in YOUR best interests. But that does not make them bad people. What if you sold your home to a couple who were later foreclosed on and ultimately became homeless? Feel any pangs of guilt? I didn't think so. People selling "stuff", including mortgage loans, are focused on making their numbers. Many years ago, a loan officer was baffled as to why we were not purchasing a home for $100,000 more than we were. To him, it was obvious that "we could afford it". I had done my homework and my interest in financial planning was already sky high, although this was a decade before I was to start doing it professionally. He found my reasoning somewhat "odd". No matter. I knew he was a Commission Based Product Salesperson (CBPS) who would benefit from a larger loan amount. The home we were purchasing and the amount of the loan were previously very well analyzed. It all fit our long term financial plan.

"How did we go bankrupt? Two ways. Slowly and then all of a sudden."
Compound interest and compound investment gains grow wealth over time. But multiple, poor financial decisions can be like compounding in reverse: a vicious cycle that can lead to financial ruin. Financial Wellness is about achieving an objective state of being that maintains your overall fiscal health. We think this is merely the starting point for achieving your bigger goals. But Financial Wellness is also about achieving the healthy state of mind that emanates from knowing that all is well with your financial numbers.

RETURN

[Don't Let Your Financial Plan Become a Casualty of Your Property Casualty Insurance...Practicing Risk Management]

No, I am not an insurance agent and no, this is not insurance advice. As an aside, it would be interesting if the next time your insurance agent wanted to talk to you about a general topic such as retirement, you asked him or her about whether they were actual investment advisers? This is not meant to complain about insurance agents (yes, you need them), but to get you thinking more broadly, in the hope of improving your financial decision making.

Our approach to various insurance matters is very similar to that for estate planning, which we have covered in the past. While we recommend attorneys for the drafting of your estate planning documents, we do not recommend their use without you first understanding:

1. How does this fit into our overall financial plan?
2. What can we realistically budget for and afford, given our other financial goals?
3. What are our objectives when speaking with this professional, in the context of our own financial planning, so that we don't get sidetracked into focusing on what this professional wants (such as selling you mortgage life insurance when you need property coverage), to the exclusion of what we are looking for?
4. Do we have the knowledge to clearly articulate our objectives in plain English?
5. Do we know enough of the technical jargon in this area so that we can communicate with this professional effectively and not pay extra to overcome our supposed ignorance?

All of this can apply to handling insurance issues as well. While our discussion will focus on property and casualty matters, it can be used for other insurance areas as well.

Where do we begin? Where else? Our overall financial plan. Even if you do not have a comprehensive financial plan (guess what, the vast majority of people do not have one and never will) this will not usually be a problem as long as the major topic areas have been reviewed and analyzed. The related general area of financial planning is **risk management**. Before you fully consider risk management, you may get sidetracked by going straight into an insurance discussion with an agent. At best, you may not be prepared with the answers to some of his questions. This may result in you not getting covered adequately and at the right cost.

Here is what we mean. Risk management is really about the identification of the risks in our lives, along with some quantification as to their probability, size, scope and cost to handle, resolve, replace or repair. Once this has been done, we can then usually apply the four techniques of risk management:

1. Risk **Retention**
2. Risk **Avoidance**
3. Risk **Mitigation**
4. Risk **Transfer**

Only the last one involves the use of insurance products. How do we know what risks to transfer? Shouldn't we transfer all risks and “stay safe”? Obviously, if you begin every conversation with a person selling insurance about whether you should buy more insurance, the answer will most likely be “yes, of course”. Instead, this is why risk transfer is listed as the last alternative. We should evaluate the others first to see if there is a different and better way to handle the situation.

Why should we do this? Insuring every potential risk is not only prohibitively expensive, but it can be downright illogical. The insurance principle is based upon the concept that in a risk pool of a large number of “*homogeneous exposure units*”, an insurance company can predict the number and severity of particular losses sustained by the group over a given time period (say, one year), with relative ease. However, they cannot predict which specific individual within that risk pool will be the unfortunate chump to have a deer run out in front of his car (that would have been me, back in 2008) and cause thousands of dollars of damage.

Risk transfer works when the probability of the risk becoming a reality is very low, but the severity (cost to recover or make yourself whole) is very high. Risk also involves not just the loss of our property if, for example, our home was to burn down, but the liability we may be exposed to if we inadvertently harm others. *(Did my karma just run over your dogma? Oh, so sorry about that.)*

It's Not Only About Insurance – Extended Warranties

But costs still matter and such things as extended warranties, while not real insurance policies, still represent a contract between yourself and the other party. Much of the time, these contracts cover little and their deductibles act as reverse insurance policies (you wind up protecting the warranty provider to the extent of the deductible). Instead, it may help to first understand the manufacturer's warranty and how to make optimal use of it. In fact, how many people check out the warranty BEFORE purchasing the product? How many check the actual warranty information, including location of authorized service centers, in order to know whether they can easily drive over there? Knowing what your recourse will be ahead of time and then “milking” the original manufacturer's warranty until its expiration date, is a tried and true methodology. Quite few of us do it well, rationalizing instead that we cannot be bothered to have a small issue dealt with, while there still is time.

Also, remember that nothing lasts forever. At some point, a replacement is worthwhile to pay for. Therefore, the useful life for such things as appliances, needs to be understood before committing to extended warranties on old systems/appliances. These warranties may come with a deductible. Read third party online reviews and you may be in for a shock. Even if their service is good, if the extent of that service is only to patch up your old dying dinosaur, it may not be worth the monthly cost.

Buying higher reliability brands in the first place, such as Consumer Reports recommendations, coupled with positive review ratios on shopping Websites (4+5 star reviews divided by 1+2 star reviews, assuming a large number of reviews) has been a successful strategy for some.

It's Not Only About Insurance – The Printer Example

Here is a quirky example that demonstrates the point but does not touch on insurance or warranties. I buy a well regarded color laser printer and it works well. I gradually replace the black toner cartridge but not the others, since I use color only sparingly. At some point though, all four toner cartridges need replacement at the same time. The printer is not functioning at all until I get this done. I then check to see that my local retailer who sold me the printer, will charge me $85-$90 per cartridge, for a total cost of well over $300. Checking Amazon, I see that the lowest price for a set of cartridges (OEM – from the manufacturer) will cost me $235. Now here's the ironic part. The printer originally cost under $200! That was three years ago.

Even though I had a bad experience with another printer using after market cartridges some years ago, I search for a third party (not OEM) ink and toner supplier, online. I see a cartridge set that it is supposed to fit my printer for under $57! This is far less than the cost of only the black OEM toner cartridge. The ratio of 4+5 star reviews over 1+2 is high. The reviews indicate that these cartridges have worked for most people. One reviewer was even critical of the OEM product because it did not work for him. Yet, we were always told to buy OEM replacement parts, to maintain the warranty and as a sort of “insurance policy” against potential problems.

Please keep in mind that while the cartridges are precision built and specific to the particular printer, toner is very, very cheap.

Here is the risk management I employed. I foresaw only four possible outcomes if I was to purchase the low cost set of cartridges:

1. They all worked as intended (I thought this was not such a high probability even after reading the reviews).
2. One or more of them did not work while the others did (I thought this was more likely since the third party seller was reusing and refilling cartridges themselves).
3. None of them worked (also a relatively high probability in my mind, so I would simply use the return policy of the seller).
4. None of them worked and actually damaged my printer (the worst case I could think of, since I had one such bad experience with another printer).

<u>Retaining the risk</u> and buying the cheaper cartridges would be a great deal if they worked. If the worst that could happen is that my already used printer costing under $200 when new, would be ruined, I would purchase its replacement for the same or even less money. In other words, the worst case scenario was having to recycle my existing printer and getting a refund for the faulty cartridges, but STILL NOT SPENDING the $235 to $300+ for the OEM cartridges. I would just buy another printer for even less, perhaps this time focusing on one which was more economical with toner/ink.

So what really happened? All the cartridges worked and I wound up saving $200 to $300. Sure, this was a calculated risk, but one worth taking. The issue is what are we protecting and how much are we paying for that protection. <u>At some point, it is no longer worth the cost of protection.</u> <u>To be convinced otherwise is like drinking the Kool-Aid</u>.

Now, let's consider something more valuable: your home.

<u>Risk Management, Your Financial Plan and Your Home</u>

For many folks, their home represents their most valuable asset, a roof over their heads, the place to raise their children and part of their nest egg going into retirement. Surely, protecting it must be their first priority, should it not?

<u>Protecting it as part of our overall financial plan means that we do not sacrifice all of our other goals and become house (insurance) rich and cash (flow) poor</u>.

Another Quirky Example – Replacement Windows:

Here's another example that is housing related. You determine that you would like to buy replacement windows for some rooms of your home. You do you homework reading Consumer Reports and then interview contractors. You are then completely shocked that your quotes for a few window and door replacements are over $20,000 and the entire home may be $80,000! Is your first reaction to say, “Well Junior, I guess we need to tap into your college fund, OK? You wouldn't want us to live in a house with old, drafty windows, right?” No, I didn't think this would be your reaction, either.

Just because someone wants to sell you something under the guise of it being good for your home, you still need to be realistic about how much value it will actually provide, in addition to the purely “consumption based features” you may desire. Let's say that the current fair market value (FMV) of your home is $365,000. Let's further assume you can negotiate your window contractor down to $65,000 to replace all the windows in your home in one project. Will your home now be worth $430,000? Very unlikely.

Your home's value is going to be influenced mostly by the value of comparable homes sold in your neighborhood. While prospective buyers will most likely want a well maintained house and will also ask about the age of various components and systems, the premium for newness and quality will only go so far. If your home is otherwise average and the average value in your sub-division is $370,000, the addition of all new high-end windows will not make it a $430,000 home. It will probably not even make it a $400,000 home.

Yet, you may need to deal with the replacement issue at some point. You probably need to buy something that has reasonable quality, for a much more affordable price. You may not recoup dollar-for-dollar in expenses, but you will be seen as having properly maintained your home. To do otherwise, may mean that your $365,000 house may not even fetch that amount, if it had to be sold at the present time.

If overspending on feature laden replacements or upgrades is not such a good idea, based on a comparison with local property values, could this same thing happen when buying or reviewing insurance protection?

<u>Protecting Your Home – Doing as much as is needed but no more?</u>

The general concept of insurance is to indemnify the individual policyholder (make them whole after a loss), in exchange for collecting periodic payments called premiums. The policyholder can retain some of the risk, thereby saving on premiums, by offering to pay for a larger amount of the first dollars of covered losses. This is called a deductible.

One fundamental problem is that the filing of a claim after a loss, can result in an increase in future premiums. The filing of two relatively small claims (compared to the value of the asset being protected) within a relatively short period of time, such as three years, can lead to the insurance company refusing to renew the policy.

Yes, their *algorithms* may not play you the right *rhythm*. <u>A case can be made that insurance is most useful when you use it sparingly, to cover the really significant losses</u> (or else you should develop a back-up strategy to move to another insurer in case you get dropped, which is kind of a tricky plan). Therefore, setting a high deductible, such as

$2,500 or even $5,000 can act as a deterrent to filing small claims, while saving you some money in the meantime.

Another basic concept is to insure based upon replacement cost and not current market value. In other words, if you purchased your home way back in 1997 for $316,000 and the cost of rebuilding it has certainly increased in the interim, an inflation cost factor should be built into the annual process of renewing the policy.

However, another basic concept is that land should not be insured. Well, at least not through property/casualty coverage. Your lot and the house standing on it were probably covered by an owner's title insurance policy when you bought it. Or should have been, although this may be called something else depending upon the jurisdiction. When you buy an existing single family home or new construction from a developer, the purchase price already includes the land.

What do you think that land value may be? One way to find out would be to speak with a real estate agent. However, you may also get a valid estimate by looking at your real estate tax assessment. Properties are assigned a valuation for tax purposes that is then input to a series of calculations which are highly dependent on the local county. Usually, the assessed value is available online from the county assessor's office. The total assessed value consists of the house (building value) plus the land value. If you then perform the following simple calculation:

Land Assessed Value
DIVIDED BY
Total Assessed Value
MULTIPLIED BY
Fair Market Value of Your Home/Lot (FMV)
EQUALS
Estimated Land Value

Furthermore, you can take this land value and subtract it from the FMV of the overall home and compare that result to the actual cash value (ACV) that an insurance company may estimate for your property.

The reason why we should be concerned about this is that we should keep some balance in terms of insuring what we need to, while understanding that over time and with housing market cycles, we may be under or over insuring our home. And based on particular requirements, we may be missing valuable coverage while “insuring air”. Here are some important points and examples of what I mean.

1. In case of a major or total loss, the responsibility of the insurance company is to "make you whole", within the limits of your policy. This is the essence of indemnification. But this does not mean that they will make you "better than whole". If I have builder grade kitchen *counters* and my house is destroyed, can I *count* on quartz *counter* replacements, just because I *count* up that there is enough to rebuild within policy limits? Sorry, I don't *count* so well. <u>The insurance company is paying to rebuild to the quality and level of what was destroyed and not any better</u> than that.
2. Over longer periods of time, inflation adjustments may no longer reflect actual replacement costs. We have seen how a home with a $316,000 original cost may wind up being insured with $500,000 as the replacement cost. Is this realistic if the land value is in the $60K-$80K range and the FMV is only $365,000? Maybe or maybe not. In the event of a total loss, will the insurance company spend $500,000 to rebuild a home that will then have a market value of only $365,000 plus some "newness premium" (maybe $400,000)? Perhaps they will wind up spending far less.
3. Depending upon the nature of the loss, the foundation may still be usable, thus further decreasing the cost of rebuilding. But could the insurance company insist upon reusing the foundation in a situation where you feel that it should be rebuilt from scratch? This can be a technical question where you need a structural engineer's opinion. It can also be a future market sales question. You will need to disclose the fact that the house was rebuilt after a loss and that the old foundation was reused. Will future buyers accept this answer? Would you pay out of pocket to re-pour the foundation if the insurance company wants to reuse the old one?
4. <u>Inflation protection is necessary, but just as important, is building code or ordinance protection</u>. As previously mentioned, your insurance will rebuild what you lost. But if your village or town has updated building codes that mandate certain features on all new construction that you did not previously have, you will need to pay extra unless you have this coverage. For example, an indoor (fire) sprinkler system is present in many new homes that are built alongside existing houses that do not have this feature. Your huge replacement cost limits will be of little value to you, when you are shelling out $10,000 to get the sprinkler added in.
5. Don't have any "***other structures***"? Then why does your policy declarations page show a significant amount for something which is "empty air"? This value may just have been a percentage of the dwelling protection amount. If you build a shed or gazebo, it would be sensible to make sure they are covered. <u>Otherwise, this amount could be closer to zero and it would not make any difference, other than in saving you money</u>.
6. You need to analyze your particular risk exposures and ask questions about whether each one will be covered appropriately. Check over the policy document and see what exclusions there are. This is a broad area which we cannot cover in

detail here. But some examples are: a) Finished Basement? - Do you have coverage for sump or sewer overflow?; b) Jewelry, watches and furs are usually covered separately, so the built-in coverage limits are quite low; c) The same with musical instruments and sports equipment; d) Gardens and yards are usually not included; e) business data and equipment may have little or no coverage outside of a business policy.

7. The personal property coverage may look like a huge number, if it is generated as a percentage of the dwelling protection. Having a video inventory, with written documentation of receipts would be ideal, but is seldom practiced. Increasingly, a lot of our "stuff" depreciates rapidly, is built for obsolescence and has a lower shelf life, in addition to the notion that technology lowers costs over time. This is not an area we worry about much, assuming you have a simple inventory made.
8. Family heirlooms, mementos, keepsakes and my personal favorite, data, form a special category. The market value of these may be difficult to judge or may be close to nil. But for us, these items are irreplaceable. Data should be backed up with multiple copies, preferably off-site. So this is an example of using <u>risk mitigation</u>, since insurance may be inappropriate or costly for this. Bank safe deposit boxes remain a very cost effective solution. This is an example of <u>risk avoidance</u>, since we try to keep a precious item away from the location subjected to <u>hazards (risks insured against)</u> that lead to a <u>covered peril (an actual loss)</u>.
9. Consider what would you do in the event of a total loss, if you live in an area where property values have not recovered from the housing crash? Are you absolutely sure that you would want to rebuild? This is where understanding actual cash value (ACV) comes in handy. If you are not tied down to the neighborhood, you may like to consider that if you are offered a choice of rebuilding or receiving the ACV, it may not always be best to rebuild. For example, if the FMV of our property is $365,000, the value of the land is conservatively estimated at $60,000 and the insurance company calculates an ACV of $310,000 and a rebuilt home is worth $390,000, it becomes an "interesting dilemma". Rebuilding takes time. Your policy should cover your housing expenses in the interim. Pocketing the ACV of $310,000 plus $50,000 on the sale of the land very quickly, is one alternative. But if you loved the house, you may want to see it rebuilt. This will take some time, during which you will need temporary accommodations. If you have a mortgage balance, the loan will need to continue to be paid and this may certainly affect your decision.

<u>A Few Words on the Care and Feeding of Your Insurance Agent</u>

In this discussion, we have tried to get you thinking more broadly in terms of risk management and to focus on a few items of the jargon involved with property coverage.

Now we turn to the insurance agent.

A so-called "captive" or "exclusive" agent works with a single insurer only, hence the name. He may be very knowledgeable in the details of his company's policies, but is very limited in what he sells. Our main issue is what if he already was (or wanted to be) your trusted financial adviser? You would then be loathe to switch insurers, even if his company's policies were much more expensive.

This is yet another reason why we DO NOT think that commission based product sales and general financial planning go together.

An insurance broker can shop for your policies at different companies and perhaps get you a better price. But which companies? How many of them? This could still be very limited.

Some agents ask their clients about doing an annual insurance review, around the time of the renewal of their policies. This looks like a great idea as there is a chance to see what may have changed. <u>However, do you really think that you are going to get through the ordeal with lower premiums on your existing policies and without the agent trying to sell you more insurance</u>? Maybe you do need changes. Maybe you do need some more coverage somewhere. If you can end up where you need to be, without spending more, consider it a great win.

Sometimes, policyholders will sacrifice something in order to get something else, such as holding the cost down to a certain level. Please keep in mind that many insurance companies seem to treat new customers with more consideration than loyal, existing policyholders. In other words, <u>some first year policies seem to start out quite low and then mysteriously grow well beyond inflation, over time, without any claims being filed and without other major losses being incurred by the insurer in the local area</u>. It is not uncommon to see a homeowner policy go up by 50% or more over the course of five years. I think this is rather unreasonable unless there were claims filed, or major losses occurred locally. These events point to increasing risk.

So what is our approach to this? Two things. <u>First, do not assume that any relationship with an agent or insurer will last for the very long term</u>. Maybe yes. Maybe not. <u>Second, use an RFQ (request for quote) every few years</u>. You can send out this request by email to a number of agents and include a spreadsheet which lists all of your policies and the features contained in each, along with their costs. If you are comfortable attaching your present policy's declaration page to this spreadsheet, that would be optimal.

Ask each agent to provide a quote for the exact same coverage that you currently have, even if he or she spots gaps. You need to be able to compare apples with apples. If you decide to make a switch, you can always add those missing coverages later on. Be clear with each agent that you will not consider making a switch unless there would be significant savings. The best pricing usually occurs with a single insurer covering home, auto, umbrella liability, rentals, etc., although there can be exceptions. If a specific agent does not reply to your email, move on. If another asks you to fill out meaningless forms instead of using your spreadsheet, this is an example of someone who does not really want to put forth the required effort on your behalf. There are plenty of agents hungry enough for your business and so the RFQ process can be valuable. You need to be able to shop around every couple years if your premiums are headed up, yet you are without claims and your agent has no better answer.

Keep in mind that all of this needs to be in the context of risk management. Insurance is not always the best answer. But when it is, you need the right coverages and in the right amounts, not simply more coverage of just any kind. Always keep your financial plan and goals in mind, this will usually guide you to a better decision.

Lastly – A Couple Resources You Should Know About

It was not our intention to create a primer on insurance. However, the **National Association of Insurance Commissioners (NAIC)** has already done that for you, with free resources you can download from their Website[11]. NAIC is the standards setting and regulatory support organization for the state level insurance regulators. Their information is not insurer specific and is unbiased. Their ***Consumer's Guide to Home Insurance*** explains much of the jargon used and goes beyond what we have touched on here[12].

Finally, in order to evaluate an unknown insurance company, or to look up the ratings on an insurer you know well from their advertising or perhaps from being a customer, where do you turn? *The best place I know is Best*. **A.M. Best Rating Services, Inc.**, that is. You will need to sign up on their Website to get access, but it's free[13]. Look for "A" rated or higher (such as A+ or A++) insurers showing "*Stable*" for the outlook.

RETURN

"Organization is what you do before you do something, so that when you do it, it's not all mixed up"...Like With My Finances, Perhaps?

The quotation in our title supposedly came from author **A.A. Milne**, famous for creating ***Winnie-the-Pooh***[14]. We find it particularly well suited to the area of personal finance. In fact, lack of organization is probably one of the most serious, yet seldom discussed, problems in financial planning. Now before you pooh-pooh the premise of our idea, please consider the following.

Were many investors nearing retirement over allocated to stocks back in 2007? They watched helplessly as the markets tanked with the Great Recession and bear market that followed. Then they sold everything (what they had left) at or near the bottom and remained in cash or low yielding instruments, for quite a long time afterward. Some moved back into stocks and at least caught some of the long bull market that followed. They may once again be out in front of where they were in 2007. Others never made it back to their previous account balances and remain behind (perhaps permanently so), as well as being psychologically scarred by all the events.

Did it have to be that way? Well, "No" and "Yes". This article presents a simple idea for trying to deal with the uncertainty of market cycles and the economy. Embracing it, we can say emphatically, "*No, you don't have to live like a refugee...from financial markets*". However, we are realists. Many people will not adopt those behaviors that are in their long-term best interests. As a result, they will continue to be motivated more by greed and fear.

Organizing one's personal finances is the equivalent of adding the boring elements of analysis, reason, efficiency and effectiveness to a person's financial life. Unexciting and un-sexy, so it's probably time to stop reading this, right?

For those who continue beyond this point, we promise to make it simple and to get to the point.

The basic concept of organizing is to bring together various things, such that the whole (whatever bigger thing we are talking about, be it your closet, entire household or your finances) functions more productively (or *synergistic-ally*, if that word seems more exciting to use) than it did before, according to your goals and objectives.

Let's begin by understanding that the basic concept of financial markets and the economy is that uncertainty will always exist. It may play a larger or smaller role in any decision making we undertake. But we realize that we cannot eliminate it entirely. No one can predict what will happen tomorrow with consistent and unfailing accuracy. In fact, we often see "conventional wisdom" turned on its head. Yet we somehow struggle through a thousand tomorrows and make it to the other side, not terribly scared of our own shadows.

Next, while time is said to heal all wounds, it has many interesting properties. While we cannot possibly go through all of them, consider the following:

1. Whether rich or poor, or somewhere in between, a 35 year old has the exact same 30 year period to make it to age 65, as any other person of the same age has, assuming they both live that long.
2. We do not have a "longevity shortage", even among the poorer among us, although there is some evidence of wealthy people living a bit longer.
3. Due to the wonderful statistical concept of the **Central Limit Theorem**, we can see multi-year (i.e. 10 years or longer) rolling period returns on investment portfolios perform in more predictable ways than we can forecast for how that portfolio or single investment vehicle will do tomorrow, this month, or next year, for instance.
4. We typically feel the most acute stress when something is currently happening or is imminent. The fear of a root canal ten years away somehow pails in comparison to a simple dental filling happening right now.
5. The average human may procrastinate more than animals wandering the Serengeti Plain. But we can also prioritize among the multiple tasks that we must finish. Given the following: *a) a completed report due to your boss by 5 PM today; b) an anniversary gift you need to get for your spouse by tomorrow or c) going to pay a property tax bill due next week*, which do you focus on when coming back from lunch? We thought so. If you could just apply the same thinking to your investment portfolio and other finances.

A most basic form of organization for one's finances is to allocate income and separate money needed to pay for expenses, based upon priority and time, such as from the famous film, "**I Remember Mama**"[15]. Updating this concept for the modern era, budget, cash flow and time horizon diversification principles are used. Since we have already covered budgets and cash flows in detail in other articles, let's instead focus on the various time horizons used.

1. A month is the basic building block of time. Most of our bill payments are monthly in nature, for example, including rent, mortgage, utilities and credit card statements. We may be paid monthly, semi-monthly, bi-weekly, etc. but we easily can convert to monthly values. In the past, we may have allocated weekly income to weekly expenses, as in "I Remember Mama". Today, always having enough

cash to pay what is due this month, has become the bedrock principle for preventing your finances from spiraling out of control. However, as good a start as this may be, it isn't nearly enough by itself.

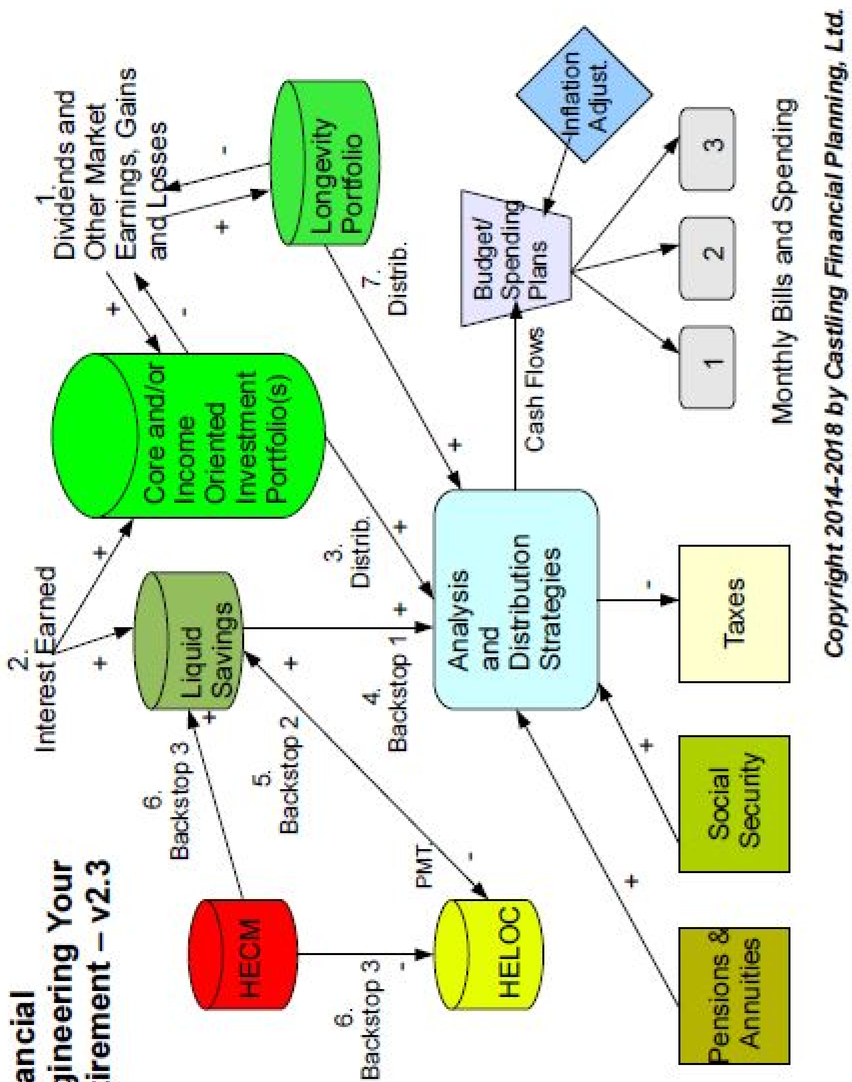
2. A year is a planning horizon for some and includes larger or more specialized payments, such as property taxes, some insurance premiums, holiday gifts, etc. If we can meet the timetable for paying off a lump sum due later in the year, all will be good. Miss it and all hell may break loose. While we cannot predict markets with accuracy for a one year period, we seem to know how much we will need, apart from emergencies that may occur.
3. The next five years is a longer time horizon, where things start to get a little fuzzy. For instance, your boss may ask you where you expect to see yourself in five years time. Financially, we may have goals for reaching retirement, funding a child's college fund or paying off a long term debt. The fact that the future is hazy may not be so bad after all. If we fail to exactly fulfill a stated goal from five years earlier, will we get depressed? Life is not so binary. Retiring in six years when the plan called for five, will mostly not upset anyone. The key is planning to make sure progress is being made, however slow it may be from the start.
4. The next ten or fifteen years is a much longer time horizon, with many of the same ideas applying, as with the five year period. But from the statistical concept of the central limit theorem, beginning with ten year periods, we have a much better understanding of the range of investment portfolio returns that are likely to occur.
5. The next twenty five years ,or longer, is truly long term. While we need to continue to live in the short term, part of our actions are to apply to the long term. <u>Lack of consistency in action toward the long term is often the problem</u>. Just like the person who fails to take the first step on a long journey fails to get to his destination, sticking to a well reasoned plan for all the individual days that together, make up that long term period, is vital.

Here are the key questions to ask to unlock **Time Horizon Diversification** (THD):

Do you know what you will need this month(of course), this year (pretty certain), the next five years (kinda) and the next twenty five years (working on it)?

If so, why can't you separate and allocate based on these time horizons and then match your assets and income to the need or liability, based on time frame? Furthermore, why not have an asset allocation that reflects the portions of your wealth you won't be needing for a long time and then not worry so much about volatility in its short run?

To bring this to life, let's bring in our **CastlingFP Retirement Model** (shown below), since it naturally incorporates all the time horizons we mentioned above.


Financial Engineering Your Retirement – v2.3
1. Dividends and Other Market Earnings, Gains and Losses
2. Interest Earned
Core and/or Income Oriented Investment Portfolio(s)
Longevity Portfolio
Liquid Savings
3. Distrib.
4. Backstop 1
5. Backstop 2
6. Backstop 3
7. Distrib.
HECM
HELOC
PMT
6. Backstop 3
Analysis and Distribution Strategies
Cash Flows
Budget/ Spending Plans
Inflation Adjust.
1
2
3
Monthly Bills and Spending
Taxes
Social Security
Pensions & Annuities
Copyright 2014-2018 by Castling Financial Planning, Ltd.

In order to achieve time horizon diversification, you not only need to: Avoid having all your eggs in one basket, but you need to maintain various different baskets (each with its own level of asset diversification) that are optimized for the time period of their main use.

In its simplest case, one family's portfolio can be split between investments and savings. This is the most basic application of 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 just the other.

A Short Aside to Discuss Savings

Savings is comprised of liquid savings and home equity. For those with cash value whole life insurance, the cash value is usually thought of as long term savings as well and can be part of your savings portfolio. The central attribute of a savings portfolio is that it is not exposed to market risk, although it may incur other risks, such as inflation. Even though your home is an asset with a market value that fluctuates, at least a portion of that equity is available in some "fixed" form , such as through a home equity line of credit (HELOC) or a home equity conversion mortgage (HECM aka reverse mortgage). This discussion in retirement assumes a paid off first mortgage, so that the HELOC or HECM is the first and only lien against the property. It should, therefore, not be frozen or impaired in times of recession or falling housing values.

So How Many Investment Portfolios Do You Need?

The underlying problem we laid out at the beginning of our discussion was that the investor, upon seeing significant drops in her investment portfolio (especially nearing or during retirement), becomes concerned and cashes out.

Our view is that this action is highly influenced by not having her finances organized around THD, resulting in too much overall market risk in one big, overall portfolio. So why not split it apart into several, to take advantage of THD?

Let's look at our diagram and explain these in action.

1. **Core Investment Portfolio** – Everyone has or should have one of these. While it may be sufficient alongside a savings portfolio (discussed above) for some, it will not be enough to achieve the optimal THD. In a core portfolio, total return is key and whether it should come from earnings or capital appreciation, is not a concern. The fact that the next distribution may require the sale of shares is also not much of a concern. Some distribution from the savings portfolio can step in to substitute for some, most or all of the distribution from the core portfolio, when its performance is down or otherwise sub-par (this is ***Castling***).

2. **Income Oriented Investment Portfolio** – Not everyone can or will want to have one of these, but its inclusion for those who do, will usually be a big plus. An income investment portfolio still holds investment vehicles, just those that emphasize income generation and not long term capital appreciation (though the latter may still occur). This is not the same as a fixed annuity, since market risk still exists. A case can be made for a variable annuity being a part of this, since some income guarantee riders can be purchased for additional cost from the insurance company. The typical income portfolio assets include dividend paying stocks, bonds and bond funds, income oriented mutual funds (such as our perennial favorite, **Vanguard Wellesley Income®**), active participation real estate, real estate investment trusts (REITs and REIT funds) and equity option trading for income (covered call writing). While there are others, these are some of the major categories. <u>One of the main points we would like to make is that ownership of the asset entitles you to the income it generates</u>. In other words, you own the tree and are entitled to the fruit that it bears, though there is no guarantee as to the amount of fruit or the future health of the tree. <u>Upon your death, however, you can pass the asset on, which is not the case with an annuity, when the last surviving annuitant passes away</u>. In addition, <u>the assets within the income portfolio can be less diversified</u>, such as income producing real estate. <u>They may also be less liquid</u> (i.e. you have less ability to quickly transform them into cash without principle loss). <u>Their principal value will still fluctuate</u>. These are all viewed as general negatives for these assets. However, when we plan the time period for income generation, it is the emphasis on earning a more predictable income stream that is viewed as being most desirable. For instance, if a relatively stable stock pays a 5.5% dividend yield that we find very attractive and the plan is to hold on to it for the next 20 years, a 15% price drop during year two is nothing to get worked up about. It is the stability of the dividend that is important. The same is true for income producing real estate. Each year, are we generating the rents we expected and is the net operating income (NOI) near our expectations? The value of the properties on a Website such as **Zillow** are nice to know, but largely irrelevant if we plan on holding for years or decades.
3. **Longevity Investment Portfolio** – The assumption is that a retired investor must be more conservative than in his youth, since his time horizon is now much shorter. This is certainly true when we speak of the core investment portfolio. This is also why some folks freaked out in 2007-2009, when they saw the value of their sole portfolio plummet. Had they used the concept of THD (or if their adviser at the time had done this), their core portfolio may have looked vastly different. The longevity portfolio takes into account the notion that human lifespans are growing. One in an age 65 couple now has a good chance of living to 90 or beyond. Recognizing this, we can create a much smaller and more aggressive investment portfolio that is not to be touched until some time in late

retirement. For example, our age 65 couple may devote a portion of their funds into another account, with the intention of not touching it until age 80. This means that they have the same 15 year time horizon as a 50 year old couple who are still working in their careers. All of sudden, this opens up the possibility for some mid cap and small cap stock funds that perform well, but need a longer time horizon to realize their performance premium. Roth IRAs are well suited for longevity portfolios, since these accounts do not have Required Minimum Distributions after age 70 ½. In the absence of a Roth, a traditional IRA with a standard brokerage account will also do. Just be sure to take your RMDs, pay the taxes and then continue investing in the same asset classes in the brokerage account (with the aforementioned taxes having already been taken out or paid for separately). Volatility in the longevity portfolio, while you are far away from needing those funds (based on time), should not be stress inducing. It should roll off you like rain on a duck. While the longevity portfolio will need some re-balancing as the late retirement time horizon approaches, this should be included in your other re-balancing activities, carried out between yourself and/or your adviser. However, another even cheaper approach would be to use a target date fund whose year matches your late retirement horizon. For our 65 year old couple in 2018 with an age 80 goal to use those funds, perhaps this would mean using either a 2030 or 2035 target date fund.

Could someone use the income portfolio without the core? Perhaps, but this would probably be more the exception. For instance, an investor who has been used to rental real estate providing most all of his income needs and plans to do this until age 70, then draw much fatter Social Security benefits. He may be growing his longevity portfolio during the interim.

On the other hand, many folks do not have that level of assets and will need to forgo a strictly income oriented portfolio. Even so, we highly recommend the concept of the longevity portfolio, in order to make a split between what you need now and the next few years, versus what is truly long term.

Go on and open more accounts and split apart assets when it can lessen your volatility and your stress level. You are not limited to the number of IRA accounts you can have. The IRS usually treats them all as one large IRA, for income tax purposes. The same is true for brokerage and mutual fund accounts. Different fund companies offer different groups of mutual funds and ETFs without transaction fees. We are certainly not recommending that your creation of a longevity portfolio should result in more fees. We will have more to say about organizing your finances in future articles.

RETURN

References

1. "Why This Economic Expansion (Still Not a Recovery) Can Continue (At Least for a While), But That Doesn't Mean There Won't Be Speed Bumps!", **Castling Financial Planning, Ltd.**, **Fall 2017 Newsletter**. It is not very often that we quote ourselves, but this may be a worthwhile read if you are interested in the markets and economy and how we arrived at our current state. Please contact us for a PDF copy emailed back to you, free of any cost or obligation.
RETURN

2. Bureau of Economic Analysis (BEA) Website, accessed via the following link:
https://www.bea.gov/data/gdp/gross-domestic-product
RETURN

3. All market data mentioned here was found using **Yahoo Finance**, via the following link:
https://finance.yahoo.com/
RETURN

4. "Business Conditions Monthly", November, 2018, **American Institute for Economic Research (AIER**). A valuable resource for education in economics, they are run as a 501(c)3 charitable organization. Full disclosure: This author is a contributor. The information quoted here can be accessed on their Website via the following link:
https://www.aier.org/research/november-business-conditions-monthly-0
RETURN

5. "PSNC 2018: A Shift in Educating Participants—What Is Financial Wellness?", **Plan Sponsor**, June 19, 2018. This article may be accessed via the following link:
https://www.plansponsor.com/psnc-2018-shift-educating-participants-financial-wellness/
RETURN

6. "Financial Finesse Think Tank Research – 2017 Year in Review", May, 2018. **Financial Finesse**. This research report may be accessed from their Website using the following link:
https://ffinesse.app.box.com/v/FWTrends2017YrInReviewReport
RETURN

7. We could not resist paraphrasing a quote attributed to Ernest Hemingway. Clearly, financial stress is nothing new. The original quote may be found at the following link:
https://www.goodreads.com/quotes/102579-how-did-you-go-bankrupt-two-ways-gradually-then-suddenly
RETURN

8. Joe Dominguez and Vicki Robin, Your Money or your Life – Transforming Your Relationship with Money and Achieving Financial Independence, Viking Penguin, New York, NY, 1992, pp. 173-181. This is one of the great books to read in personal finance, though some sections will appear to be dated. While there is much that we can take from it, for our present discussion we focus on ideas from Chapter 6: "The American Dream – on a Shoestring". Vicki Robin has since updated this book for 2018 and it can be reviewed and purchased on Amazon, via the following link:
https://www.amazon.com/Your-Money-Life-Transforming-Relationship/dp/0143115766/ref=sr_1_1?ie=UTF8&qid=1541544764&sr=8-1&keywords=Your+Money+or+your+Life+%E2%80%93+Transforming+Your+Relationship+with+Money+and+Achieving+Financial+Independence&dpID=51NnjdHlkqL&preST=_SY291_BO1,204,203,200_QL40_&dpSrc=srch
RETURN

9. The **FICO® Score** Website provides educational material about credit scoring and the different versions of this particular system. We are only able to scratch the surface in our discussion. You may access the Website via the following link:
https://ficoscore.com/
RETURN

10. Annual free credit reports can be accessed via the following link. Follow the prompts to input your data and submit a request, one credit reporting agency at a time.
https://www.annualcreditreport.com/index.action
RETURN

11. National Association of Insurance Commissioners . The consumer portion of their Website may be accessed via the following link:
https://www.naic.org/index_consumer.htm
RETURN

12. Ibid. Here is the specific link to use in order to download "A Consumer's Guide to Home Insurance":
https://www.naic.org/documents/prod_serv_consumer_guide_home.pdf?57
RETURN

13. A.M. Best Rating Services, Inc. Their Website may be accessed via the following link:
http://www.ambest.com/home/default.aspx
RETURN

14. Quote from A.A. Milne, along with many other famous quotes and other literary resources, can be found on the Goodreads Website, which is accessible via the following link:
https://www.goodreads.com/quotes/46807-organization-is-what-you-do-before-you-do-something-so
RETURN

15. "I Remember Mama" (1948), from a review on **AMC Filmsite**. The review to this film can be accessed via the following link:
https://www.filmsite.org/irem.html
RETURN

How to Contact Us

*Have a comment, suggestion, criticism or just plain feedback? We would like to hear from you. Please contact us by email, post, telephone or our **Facebook** page, as shown below.*

***Castling Financial Planning, Ltd.** was created as a unique, hourly, fee-only, non-product selling and non-AUM investment adviser and financial planning firm, that is still very affordable for middle America. We do not engage in conflicts of interest (and prove it), never set asset minimums and welcome all clients. Less than 1% of all financial advisers are both hourly and affordable for middle America.*

Do you currently have an adviser who says he offers you "free" advice? We are so confident that we can save you money over your current adviser (based on your total costs), that if we can't demonstrate how during our initial meeting with you, we will offer to perform your financial planning services in 2019 without charge, completely pro-bono.

*"Free" advice is worth exactly what you paid for it. How do you separate where the sales presentation ends and the analysis begins? **Castling Financial Planning, Ltd.** advises everyone to stop paying for the privilege of buying a financial product, such as through commissions and sales loads. We also disagree with the concept of paying asset management fees to a %AUM based adviser. Does he actually spend a great deal of time working on your finances? By definition, he has an obligation to provide "continuous and regular supervisory or management services" for your securities portfolio. Good luck finding a definition for "continuous", other than having this apply to the continuous fees YOU wind up paying.*

We believe financial planning services should be billed for in the same way as your accountant, dentist or lawyer. You pay each based on their time expended and for their professional expertise, not a percentage of some amount.

Registered Investment Adviser Principal:
Henry F. Glodny,
CRPS®, MBA, MS
Candidate for CFP® Certification as of November, 2016
Principal
Chartered Retirement Plans Specialist(SM)

Mailing Address and Office Location (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

How to Check Out Our Investment Adviser Registration

Point your Internet browser to the Securities and Exchange Commission (SEC) Website at:

http://www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_Search.aspx

(If this page has moved or changed, go to the SEC home page at: http://www.sec.gov/ and follow the links for information on Advisers.)

Choose “Firm” and then in the Firm Name search box, enter the word: “**Castling**” without quotes.

Click on the Start Search button.

On the Investment Adviser Search results page, click on the Investment Adviser Firm link. Our CRD (Central Registration Depository) number is **150844**.

Click on the “**Illinois**” link shown on the next page.

This should bring you to our complete Form ADV filing. Please take your time browsing it and comparing with your current financial adviser's filing. If they do not have their own Form ADV filing, they may be a stock broker, insurance agent or even be unregistered as an adviser. You may be somewhat surprised to compare Part 1A: Item 7 “Financial Industry Affiliations” with that of other advisers. Affiliation is really a euphemism for “conflict of interest”. A completely independent adviser will not have any box checked on this page.

Lastly, we encourage you to download our Form ADV Part 2 Brochure, from the SEC Website. It is important to note that many advisers do not make this important document available until after you contact them or just before you sign an advisory agreement with them. While this behavior is technically legal, we find it to be not in the best interests of clients.

Our brochure covers our advisory services, approach to clients and also our very affordable fee schedule.

Disclosures and Disclaimer

All investments involve risk, including risk of loss of principal.

The information provided in this report has been furnished completely free of charge and obligation, for educational purposes only. Information contained within this report should not be construed to constitute investment advice for any particular individual or group.

All calculations, analysis and assumptions used in this publication are the sole responsibility of Castling Financial Planning, Ltd. and were developed with great care. All background information used to create this report is believed to come from sources that are reliable. No warranty, whether express or implied, is given to any reader or user of this report. Castling Financial Planning, Ltd. expressly disclaims any liability resulting from the use of information contained within this publication, including incidental or consequential damages arising from the use of this publication.

Castling Financial Planning, Ltd. does not provide any investment or financial advice without performing analysis of a client's situation and goals. Anything less is, at best, a sales presentation.

Castling Financial Planning, Ltd. is an hourly, fee-only financial planning practice and investment adviser, registered in the State of Illinois.

Castling Financial Planning, Ltd. operates elsewhere, where permitted by state law, based upon the National Di Minimus provision to the Investment Advisers Act of 1940.

Castling Financial Planning, Ltd. believes strongly in the concept of independent, fact based advice, which is not tainted by conflicts of interest. As a result, we do not sell any financial products, nor seek affiliations with any broker/dealers or other financial product providers.

Castling Financial Planning, Ltd. is not in the business of providing legal or tax advice. Please consult with your attorney or qualified tax professional, for legal and tax advice specific to your personal situation.

Castling Financial Planning, Ltd. is not responsible for events beyond its control, such as wars, strikes, natural disasters, terrorist acts and market fluctuations.

This disclaimer does not seek to waive, limit or minimize any rights a client may have under applicable state or federal laws.