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Helping You Secure Your Future ™

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Summer, 2010 Newsletter:
Introducing The Castling Defensive Portfolio

How Would Your Financial Adviser Feel About You Reading This?

Does your current financial adviser want you to expand your knowledge or does he or she want to keep you in the dark? In his classic 1940 book, "Where are the Customers' Yachts?", author Fred Schwed exposed in a rather lighthearted way, how Wall Street is not your friend[1]. But change around a few terms and one could say that not much has changed in seventy years.

In fact, the level of financial complexity has certainly grown, but the level of financial literacy (exhibited by the general public), has barely budged. The relationship between these two is critical. We feel it underlies most personal financial problems today and also played a part in the recent financial crisis.

We think there is abundant evidence that not only is Wall Street not your friend, but neither is a large part of the Financial Services Industry.

The financial and investment advice industry is essentially broken, as far as objectivity is concerned. This is due primarily to conflicts of interest.

While it has been well documented that commission based financial advisers have conflicts of interest, it may be a surprise to you that (percentage of) asset based advisers also have major conflicts of interest. In fact, about 99% of financial adviser businesses are conflicted in one way or another, because of no other reason than their business model. This prevents them from putting their clients first, doing what they openly state to be doing and delivering it in a way that is affordable to middle class Americans.

The only business model without these conflicts operates in a way that is very familiar to you. Your accountant, dentist, lawyer and family doctor most probably all operate in the same way: hourly or fixed fees.

So why don't more than 1% of financial advisers operate in this way? Because most people have been deceived into accepting the status quo.

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What of the 1% of financial advisers who do operate on an hourly basis? Almost all of them have set their hourly rates to stratospheric levels, beyond the reach of hardworking, middle class Americans. It has gotten to the point where the news media, generally very favorable to hourly financial planners, nonetheless conditions the public into thinking that perhaps all they can afford is a couple hours with a planner. To be sure, three hours at $200 per hour results in a hefty $600 bill.

Once you consider that all financial planning includes data gathering and analysis, it it easy to see that three hours is not going to go that far in generating a detailed or customized solution.

A a result, the vast majority of middle class Americans either do without any professional financial planning or settle for “free advice” from a commission based product salesperson. Often, this is not much more than a sales presentation.

Castling Financial Planning, Ltd. was created as a unique, hourly, fee-only, non-product selling and non-AUM (assets under management) investment adviser and financial planning firm, that is still very affordable for middle America.

How are we different? By being truly independent and adopting a decidedly unpopular business model, we eliminated conflicts of interest from day one. We also learned how to use statistical methods and information technology to your benefit. For example, if you are paying more than 0.5% in TOTAL mutual fund and financial planner fees on an annual basis, we feel you are paying too much!

In fact, our unique style earns us the wrath of some when we post blogs on professional adviser Websites. We know we must be doing something right when we call for a 100% fiduciary standard and then find ourselves being ridiculed for writing “...such nonsense.”

Actually, we're not pressing for new regulation. It may surprise you to learn that the financial services industry is already one of the most heavily regulated in the nation. However, most of that regulation serves mainly the industry itself (not the general public), by obscuring disclosure, promoting ambiguity and erecting barriers to competition.

What is really needed is quite simple:

1. Prominent Disclosure
2. More Competition

We do not hold our breath waiting for the first. But we humbly submit Castling Financial Planning, Ltd. as part of the second. Even if you never contact us, please read this newsletter and begin to think more critically about your relationship with ANY adviser.

Does the relationship exist for your benefit or for his?

Have you been told what “fiduciary” really means? If you have had an adviser for a while, but he has never used this term to describe himself, why not? We will dive more deeply into this topic in a future issue.

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Why a Castling Defensive Portfolio?

We took this opportunity to create a model portfolio that is free of charge or obligation, as an example of our affordable, analytical methods. It is meant to be educational in nature and directed to conservative investors. Using it, we show how advisers charging a percentage of your assets are maximizing THEIR returns, while also maximizing YOUR risk.

How did you do in 2008? Perhaps if you are like many in middle America, your adviser appeared to let you down. Maybe you have already switched advisers. Does it seem plausible now that advisers charging a percentage of assets did not necessarily work X number of hours on your behalf, or navigate the bear market any more nimbly? Did you come to the conclusion that you were taking far too much risk in your investments to begin with, but this was clearly a path your old adviser had recommended you take in the first place?

Could you be ready for a *21st century approach where you only pay for actual work done on your behalf and not a percentage of your hard earned assets*?

Castling Financial Planning, Ltd. does not believe that the percentage of assets under management approach has ever been in the best interests of clients. %AUM advisers are supposed to be “continuously monitoring and supervising a securities portfolio” for their clients, according to the SEC's definition. If “continuous” has any meaning at all, it means at least daily. So was your % AUM adviser checking your portfolio every single day the market was open? Was he comparing it to your written Investment Policy Statement? He did give you one, right? Did he analyze daily whether to make a change or recommend a change? While we weren't there watching him, we're not holding out much hope.

Rather, we think he was chasing for more AUM. Gathering assets, not growing assets, is the primary means that % AUM advisory businesses prosper. By contrast, the typical middle class American with a 401K over multiple decades, following a consistent asset allocation strategy, has instead, seen growth (not contributions) as the dominant source of her account balance.

Now isn't that ironic? If AUM based advisers were really in the business of growing clients' assets, wouldn't they take on all clients who needed to grow their assets? Why would they impose account minimums, especially minimums that dwarf most middle Americans nest eggs? Because “grabbing” AUM, not growing AUM, is the fastest way for a AUM advisory business to prosper.

Please read on to see how Castling Financial Planning, Ltd., is different.

Background for the Castling Defensive Portfolio

Some time ago, we were asked about what kind of asset allocation would be required for a conservative investor to have a reasonably high probability of doubling his or her portfolio in a ten year time period. The question was asked irrespective of current conditions in the stock and bond markets, or the economy. This might be considered a rather modest goal. But it means achieving a net of expenses, pretax, annualized return of 7.2%.

This got us thinking along the lines of Target-Return investing, as opposed to Target-Date investing or other such methodologies.

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During the so-called “Lost Decade” of 2000-2009, a mutual fund invested in the S&P 500® index of large cap U.S stocks lost money, even if you had reinvested all dividends. Moreover, many investors failed to achieve a net 7.2% annualized return over the last fifteen and even twenty years. Some of them even acted on the recommendations of various financial advisers, who were selling the latest high cost investment fad. And some people felt secure in insurance based products, like annuities, that often returned a “whopping” 4% annually.

Over the past few years, we have been working on creating our own proprietary asset allocation database. While we know that a lot of very good research has been done in both industry and academia, we wanted to focus our interests in quantitative and statistical methods, along with information technology, to search for answers beyond the conventional wisdom we were taught in financial planning courses years ago.

The goals in creating our database were to look for:

Differences in the performance of various investment portfolios at the asset class level. This eliminates the “survivorship bias” of specific funds, many of which wind up getting merged out of existence if they perform poorly, or touted based on short term track records, if they do well. We have eliminated the marketing hype associated with chasing performance.

Consistency in performance over many time periods. Instead of looking at one very long holding period or a recent, but shorter one, we did rolling period analysis that covered 140 unique calendar year periods, from 1970 through 2008. 2009 will soon be added, but was nowhere near as interesting or vital, as looking at data in the brutal bear market of 2008. We found that as more rolling periods get added, the conclusions reached change little. Why? Because consistency dictates that the same asset allocation perform well (or well enough to achieve a given required rate of return) across many different market and economic conditions.

Robustness in any shorter time period and calendar year. It is amusing to see how many advisers try to time the market by constantly shifting their clients' investments from one fund or asset class into another. We think this is closer to the ridiculous than the sublime. If they were so sure about a given fund recommendation a few months ago, why think they are correct now when they advise you to pull out and go with their new “top pick”? We call this trying to “predict at the event level”. There's only one problem with this notion. It doesn't work. If it did, they would rapidly become so wealthy timing their own portfolios, that grabbing assets under management for a percentage would be the last thing on their minds.

Methodology for the Castling Defensive Portfolio

Without boring you to tears, we took the performance of different asset classes that resulted in about 135 million different investment portfolios and studied them across 140 rolling periods of five and multiples of five years. This resulted in over 16 billion portfolio calculations. Oracle, Linux and the Perl programming language all helped power our custom software on the separate computers we devoted to this task.

Our methodology for this type of analysis is to always begin with asset class returns, since this eliminates the bias inherent in looking at specific mutual funds that may have survived a certain time period, while others performed terribly and were quietly put out of their misery.

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But asset classes do not carry management expenses, as real mutual funds do. We accounted for this by assuming a 0.5% in total expenses allowed, by increasing the required rate of return from the target 7.2% to 7.7% annualized. A portfolio of asset classes whose annualized return was at least 7.7%, was considered to have met its objective of delivering a 7.2% net pretax annualized return. In other words, on a path to doubling over a ten year period.

Our database stretches across a long time period that we consider to be the modern history of the financial markets, starting back in 1970. Why didn't we go back further? In order to make an apples to apples comparison among asset classes, we need data for each asset class in every year. Some asset classes, such as real estate investment trusts, have not been around as long as large cap U.S. stocks. Others such as foreign developed markets, have been around, but have changed significantly over the last eighty years. Indexes tracking international markets have, likewise, only been around for a more limited time.

From 1970-2008, we can define 140 five year and multiple of five year, calendar “rolling periods”.

Why bother? Because many in the financial services industry only use data that supports their objective. One of the most common investing mistakes is to consider only the recent past, such as the previous few years or even a single market cycle. Yet the industry awards itself “trophies” for such fleeting distinctions, as “the best performing fund family for the twelve months ending in December 31st, 20XX”.

A somewhat less common mistake is to take a single, very long time period and make generalizations about market performance for a future, shorter time frame. The average annual return of large cap U.S. stocks is indeed about 10%. But did you realize that the standard deviation of those returns is about 20%[2]? This means that a devastating year such as 2008 is not as rare as one might imagine. We will take up this topic in greater detail in future newsletters.

By employing statistical methods and information technology, we searched for underlying consistency.

There is no single investment portfolio that will deliver your required rate of return, year in and year out. Expecting this result means that uncertainty has been eliminated. Investing is inherently uncertain and will always remain so, in our opinion.

What is possible is to seek and find consistency on a rolling period basis. We believe rolling periods are key, since “we live there”. Looking at investing as a sequence of individual years, trying to time the market or pick the “right” stock, will always lead you back to the same fundamental question. Now what?

Instead, we view investing as a marathon without a traditional finish line. It's not a series of sprints. Instead, there are various checkpoints along the way. Perform consistently well enough during these checkpoints (i.e. various stretches) and you stand an excellent chance at reaching your goal.

Some of us will need to take more chances (risk) in order to reach our individual goals. Others need take less risk. This distinction (the relative need to take risk) can only be arrived at if we can quantify an investor's required rate of return. This is not a trivial matter. We feel it is probably one of the most overlooked areas in financial planning, simply because of the amount of effort involved in calculating it. Keep in mind that this means knowing all other aspects of a financial goal, such as the initial amount and periodic contribution. But since market returns are uncertain

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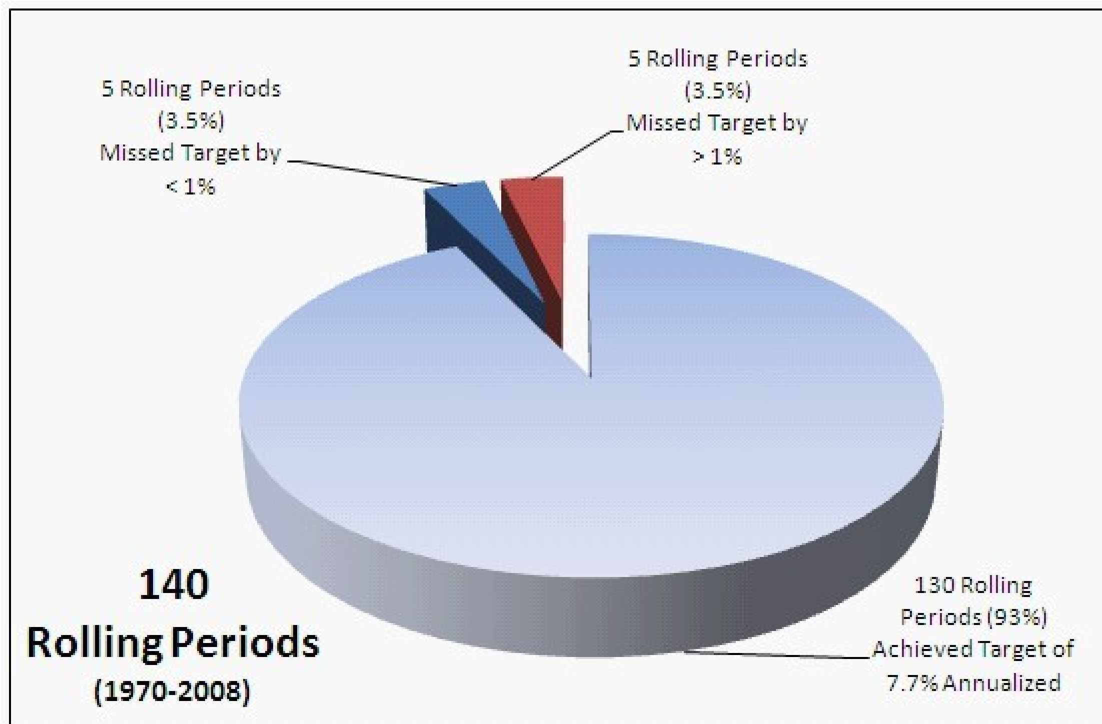
and contribution amounts are not, this value itself requires building a budget and spending plan and understanding one's own cash flows. Guessing or estimating a contribution amount has led many investors down a path fraught with higher risk.

Warren Buffet is fond of saying that history does not repeat itself, but rhymes. Our use of rolling periods helps us capture time frames containing multiple market cycles, those with a single cycle, portions of a cycle and even overlapping cycles. We don't play favorites with the data and calculations. We try to capture both the rhythm and the rhyme of market cycles.

Of the many contenders, we settled on one asset allocation that achieved our objective of a 7.7% gross pretax annualized return (netting out to 7.2%) or better. It accomplished this a relatively astounding 130 times out of 140 (Figure 1).

Figure 1



Most everyone would agree that "consistently" does not mean "always". We did find 5 rolling periods in which the portfolio missed our target by less than a single percentage point (gross). We defined this as being a near miss. You may or may not share this opinion. Changing the asset allocation caused results to improve in these five periods, but performance in some of the other 130 dipped.

This fact is the very essence of "constrained optimization". <u>The good can not be made the enemy of the perfect, since perfection does not exist in investing</u>.

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Finally, there were five rolling periods in which our chosen portfolio missed the mark by more than 1%. We consider these to be clear misses (Table 1). We take comfort in the fact that none of these returns was actually negative and that each of them compare favorably with both stock market indexes as well as the classical "balanced" 60% large cap U.S. stock/40% aggregate bond portfolio. In fact, we have compared our back tested asset class results (net of a hypothetical 0.5% expense ratio) against the Vanguard Wellington fund (VWELX). Wellington is a superb example of a balanced fund and we have also recommended it for certain clients. It must be kept in mind, however, that no mutual fund or investment adviser can guarantee a gain or avoidance of a loss. All investing involves at least some risk, including loss of principal.

Table 1

Beginning	Ending	Back Tested Net Return	VWELX
1970	1974	2.8%	4.5%
1971	1975	4.9%	4.3%
1998	2002	5.4%	4.6%
1999	2008	5.5%	4.5%
2004	2008	3.5%	2.8%

Some may ask at this point, why not use the investment portfolio that performed well in the 130 rolling periods and then switch to another portfolio that worked better in other ten? If we knew what kind of market and economic conditions we would be faced with in any future time period, we would naturally orient our investment portfolio to take advantage of the opportunities and avoid the dangers.

Guess what? That is simply not possible. Any financial adviser professing to "know" what lies around the corner is lying to somebody, perhaps even himself. The financial advisory industry has not been known to be in short supply of hubris. If arrogance could make you money, every advisor's clients would already be rich.

Event level prediction is nothing more than an educated guess. If you do not believe our assessment, step back and imagine how many PhD educated economists fail to make accurate predictions about the business cycle. Or imagine that mutual fund managers, as a group, fail to beat their market benchmark, even though many of them have attained the coveted CFA designation. Since many retail advisers have essentially 8th grade math skills, does anyone seriously believe that the financial adviser community can achieve what our much better educated and skilled colleagues can not?

Castling Financial Planning, Ltd. humbly admits to not being able to predict at the event level. But since we already know that no one else is truly successful at it, we do not waste our time and our client's money trying to do the impossible. We focus, instead, on the practical.

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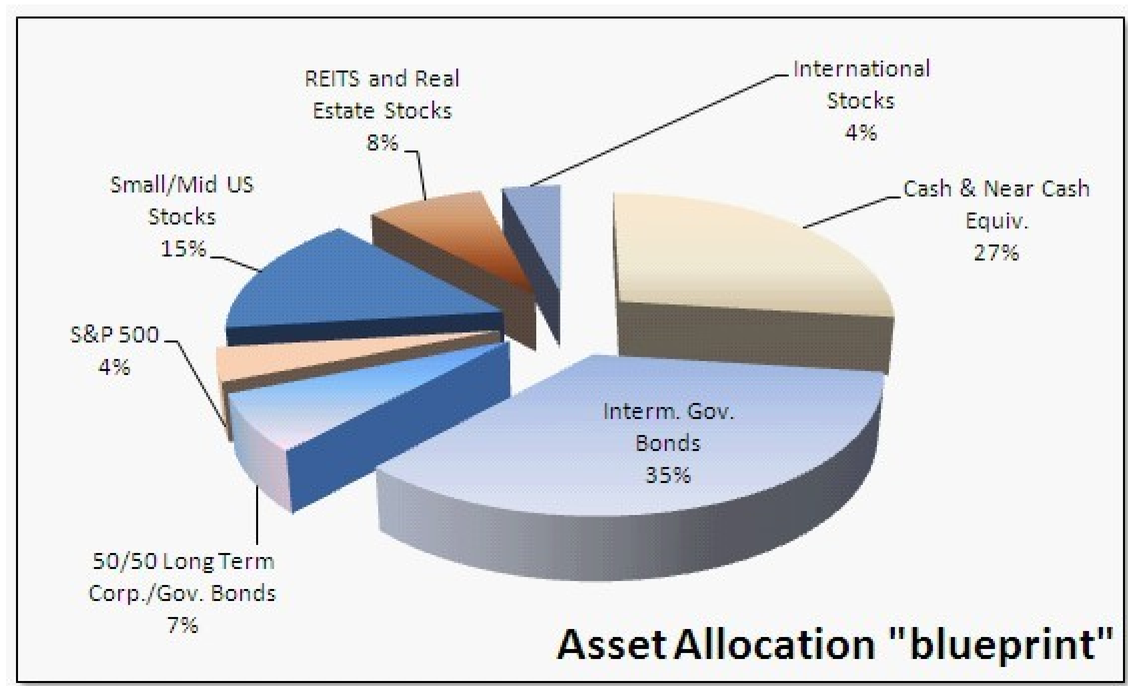
The Castling Defensive Portfolio at an Asset Class Level

Everyone recognizes the difference between a house and a blueprint for a house. A blueprint is not a house and a house is not a blueprint. But we use a blueprint to actually build a house.

So it is the same with investment portfolios. As we have mentioned earlier, by analyzing at an asset class level, we arrived at one combination that achieved its required rate of return more consistently and with less risk.

Here it is (Figure 2).

Figure 2



We show seven distinct pieces in this pie chart. Let's explain what each one means. The percentage given represents the relative weighting we give to each asset class in our model portfolio. This determination was arrived at solely by Castling Financial Planning, Ltd.

1. Cash and near cash equivalents. This includes FDIC insured bank certificates of deposit of six and twelve month maturities (not longer), U.S. Treasury issued bills (T-Bills) and very high quality short term bond funds (both Treasury and Corporate) whose average maturities and duration are less than three years. This expressly excludes any fund with significant holdings in any exotic or new investment vehicle, such as Action Rate Securities. Familiarity breeds not contempt, but fosters stability. The chosen allocation of 27% was definitely a surprise for us. But the data support this.

2. Intermediate term Treasury bonds make up a whopping 35% of our model portfolio, also something of a surprise when we first saw the results. This includes bond mutual funds

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whose average maturity and duration are under about six years. Enough evidence suggests that intermediate term U.S. Government bonds exhibit a much better risk versus return trade off than long term Treasuries. The addition of Treasury Inflation Protected Securities (TIPS) gives this asset class some relative safety if future inflation is greater than expected.

3. Long term bonds were grouped into a 50%/50% split between U.S. Treasuries and investment grade corporate bonds. An aggregate bond index fund and some income type funds can help provide the proper mix. No below investment grade ("junk") bonds need apply. Our small 7% allocation is justified by the relative under performance of long term bonds in many time periods. But our analysis did show that this is still a valuable asset class to be represented.

4. Large cap U.S. equity is represented by the stocks of the Standard and Poors 500 (S&P 500®). While this can most easily be implemented by purchasing a simple index mutual fund, some balanced funds also work quite well. An emphasis on dividend paying stocks is recommended, if an index fund will not be used. The tiny 4% allocation is simply based on the lack of evidence supporting large cap stocks as being consistent performers.

5. In what may be the biggest shock of the Castling Defensive Portfolio, we recommend a 15% allocation to small and mid sized U.S stocks. While being more volatile than their large cap cousins, smaller companies exhibit a growth potential that even conservative, income oriented investors, should not completely turn away from. The 15% allocation was arrived at by many iterations and not by accident. We also think that small cap U.S. equity represents one of the few places where active management can be valuable. In addition, academic research on small cap value stocks indicates a performance premium which is significant over large cap. Please keep in mind that this is a volatile asset class and we are not recommending any allocation above 15% for very conservative investors.

6. Real Estate Investment Trusts (REITS) are a relatively newer asset class. They are public companies that own and operate commercial real estate. We realize that real estate has been at the center of the recent financial crisis. But the historical evidence is very favorable for REITS, across many time periods. In addition, REITS and real estate stocks are not as well correlated to the rest of the U.S stock market, especially large caps. REITS by law, must distribute at least 90% of their net earnings, usually resulting in high dividend payouts, a desirable attribute of an income oriented portfolio such as ours. The healthy 8% allocation recognizes the contribution that can be made by REITS. We prefer a mutual fund or ETF specializing in REITS, compared to picking individual REIT stocks. This is also a volatile asset class and we do not recommend any allocation above 8% for very conservative investors.

7. International stocks are represented by large companies headquartered outside the U.S., but mostly in developed countries. The major stock index tracking these companies is the Morgan Stanley EAFE (Europe Australasia and the Far East). Our relatively small allocation of 4% was just indicative of the lack of evidence suggesting a larger portion of investor assets is warranted. We think this asset class is vital or else we would not have included it. But additional risks are involved, such as foreign currency, political instability and lack of accounting transparency. All of these risks are magnified when we speak about emerging markets. While we think that emerging markets will only grow in relative importance in the coming decades, we are not able to recommend anything other than a tiny amount in our model portfolio. There is a fundamental lack of data that prevents us from comparing emerging markets with the others across all time periods studied.

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Overall, our model portfolio has only a 31% allocation to stocks, yet has achieved its objective of a 7.2% net pretax annualized return in 93% of 140 rolling periods.

By comparison, the classical portfolio often associated with a long term expected return of 8%, requires a 60% allocation to stocks.

It is easy to see that if a 0% stock portfolio results in 0% stock market risk and a 100% stock portfolio results in 100% stock market risk, then a 31% stock portfolio will have considerably less risk than a 60% allocation. The expected return is lower, but by a smaller amount.

We do not consider this to be anything like the proverbial "free lunch". We just think it is the additional efficiency of our Castling Financial Planning, Ltd. approach to evidence based investing, using statistical methods and information technology.

While we do not know for sure, we are guessing that perhaps you may not have seen this kind of information elsewhere. If this is true, please let us know what you think and whether this is the kind of analysis that could "***Help You Secure Your Future***".

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Building the Castling Defensive Portfolio from the Blueprint

Some readers will be able to apply our model portfolio at the "blueprint" level, to the choices and constraints uniquely facing them. Since we do not know what these constraints may be without analyzing them, we can only offer this report as educational material.

However, Castling Financial Planning, Ltd. is able to help prospective clients with their unique choices, including their 401k, 403b, IRAs and other types of plans and accounts. Our non-selling and non-AUM based approach means we can help you on your terms.

As an example of building a house from a blueprint, we have created a hypothetical portfolio of actual investments and have measured it across a time period as wide as the investment choices allowed: 2000-2009. This was the so-called "Lost Decade" of dashed dreams and ruined fortunes where 401k's were said to have become "201k's".

Or was it? Not for our portfolio.

We took our model asset allocation and simply searched for excellent, no-load mutual funds to represent each asset class. Seven major asset classes were implemented with ten funds and their overall portfolio performance was measured over the 2000-2009 period (Table 2). We would have measured performance across a longer time period, but not all of these funds have been in existence for more than ten years.

Table 2

	The Castling Defensive Portfolio:	Ticker Symbol	% Allocation
1	FDIC Insured Certificates of Deposit (Avg. of High Yielding)	Bank CD's	9%
2	Vanguard Short-Term Treasury Investor Shares	VFISX	9%
3	Vanguard Short-Term Investment-Grade Investor Shares	VFSTX	9%
4	Vanguard Intermediate-Term Treasury Investor Shares	VFITX	12%
5	Vanguard Inflation-Protected Securities Investor Shares	VIPSX	12%
6	Vanguard GNMA Investor Shares	VFIIX	11%
7	Vanguard Wellesley Income Investor Shares	VWINX	11%
8	Royce Special Equity Investment Class Shares	RYSEX	15%
9	Vanguard REIT Index Investor Shares	VGSIX	8%
10	Vanguard Total International Stock Index	VGTSX	4%
	Totals		**100%**

As evidenced by the following pie chart (Figure 3), no single fund allocation dominates. Having ten specific investments does not need to be costly or complicated. None of these funds is sold with a front or back end sales load. None levy a 12b-1 marketing fee. The weighted average expense ratio is a very low 0.37%, staying within our 0.5% target.

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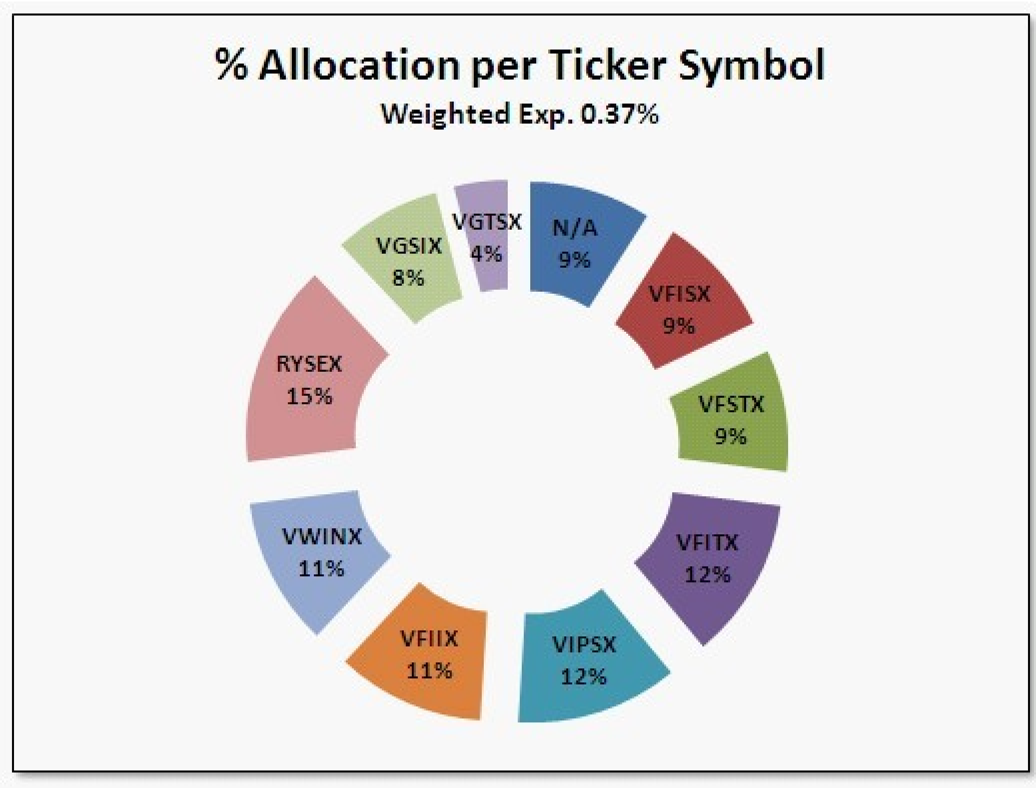
Figure 3



These desirable attributes were not found by accident. Since Castling Financial Planning, Ltd. Is truly independent, does not sell financial products and does not gather AUM, we are free to search for the best low cost, high quality investment recommendations.

The minimum initial investment for each of the Vanguard funds for this share class, is $3,000. The Royce fund has a $2,000 minimum. FDIC insured certificates of deposit can be purchased at various minimums, usually for under $1,000.

In order to meet all share class minimums and stay exactly at the proportions given in our model portfolio, a total starting investment of about $75,000 would be required.

Let's review each of the components of our model portfolio with a brief description and reasoning behind our decision to add it.

The first three exhibit a range from pure cash to very short term, high quality bonds.

1. The highest yielding but still FDIC insured certificates of deposit from local, regional or nationwide banks. This would easily qualify as our most boring pick. But cash is definitely not trash. Our analysis indicates that striving for the highest insured yields can offset volatility elsewhere in the portfolio and boost overall return. When we analyzed CD yields, we looked at the highest rates we could find on a monthly basis, over the entire ten

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year period. We considered the average yield of a 6 month and 12 month CD. We avoided longer maturities, due to inflation and interest rate risk. Depending upon the amount invested and its timing over multiple months, a type of “laddering” effect can be achieved using only the two maturities. Every month, two or three, another CD would mature and then be replaced with a new one for 6 or 12 months in length. Various personal finance magazines and Web sites report on the highest yielding certificates. Yields can change daily. While typically available for individual retirement accounts, a few banks do not offer them for IRAs[3].

2. Vanguard Short-Term Treasury Investor Shares[4]. This fund invests primarily in short term debt obligations backed by the full faith and credit of the U.S. Government. We looked for something with a higher yield than money market funds, while still being very conservative.

3. Vanguard Short-Term Investment-Grade Investor Shares. This fund invests in investment grade and government short term bonds. It is actively managed, yet has an expense ratio which is essentially at or near the low point for its peer group.

The next three investments represent a range of intermediate term government bond funds.

4. Vanguard Intermediate-Term Treasury Investor Shares. This fund invests primarily in bonds backed by the full faith and credit of the U.S Government, with a weighted maturity in the range of 5 to 10 years. This was a very easy choice since the expenses were so low and the performance has been close to the asset class we have been analyzing (even after expenses).

5. Vanguard Inflation-Protected Securities Investor Shares. This fund invest in inflation indexed bonds issued by the U.S. Treasury, Government agencies and some corporations. Principal and interest payments are adjusted in response to changes in inflation. We think this may be a more important fund than the previous one, if and when inflation exceeds expectations.

6. Vanguard GNMA Investor Shares. This fund invests primarily in Government National Mortgage Association (”Ginnie Mae”) securities, which are explicitly backed by the U.S. Government for the payment of principal and interest. Once again, super low expenses and a medium term makes us really like this fund. It is interesting to note that even with all the turmoil over Fannie Mae and Freddie Mac, this fund did not have a single losing year during the 2000-2009 period.

The next fund actually implements two of our asset classes at once.

7. Vanguard Wellesley Income Investor Shares. This is a balanced type of fund, holding about two thirds high quality bonds and one third large cap stocks. We find our long term bond allocation here, although not all the bonds are long dated. The equity portion focuses on dividend paying stocks, which has been a successful formula. We like the overall proportion of bonds to stocks, since it fits our targets. This is a superbly managed fund with a very low expense ratio.

Next up is our only non-Vanguard pick.

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8. Royce Special Equity Investment Class Shares. This is a disciplined, small cap value fund[5]. It is the only non Vanguard fund selected for our model portfolio, because we feel that the small cap market is less efficient than almost all others. This means that an active manager has the potential to add value by picking stocks that are not widely followed by Wall Street. All Royce funds focus on smaller companies. The risk versus return trade off of this fund has been excellent. Our own research, along with the academic research we have seen, leads us to the conclusion that a certain proportion of small cap stocks should exist in most investors' portfolios, even those who are risk averse. We must point out that small cap stocks are inherently more volatile than most other asset classes. In addition, the expense ratio of this fund is, by far, the highest in our model portfolio. The right mix makes all the difference. We are still able to keep overall portfolio expenses below our critical 0.5% level. Special Equity has performed extremely well relative to its peer group and index funds, over the last ten years.

We picked index funds for our last two asset classes.

9. Vanguard REIT Index Investor Shares. This is a very low cost index fund that seeks to track the performance of the overall equity real estate investment trust (REIT) market. REITs are investment companies that own and operate commercial real estate and are required, by law, to distribute at least 90% of their net earnings to shareholders. As a result, they usually have high dividend yields, although individual volatility is also quite high. We feel that it is best to own REITs through mutual funds. They have historically shown a relatively lower correlation to the overall U.S. stock market, than some other equity asset classes. This adds a diversification benefit. Along with rock bottom expenses, this Vanguard fund plays an important role in our model portfolio.

10. Vanguard Total International Stock Index. This is another very low cost index fund. It seeks to track the performance of the MSCI EAFE ® plus the MSCI Emerging Markets Index. Our allocation to this asset class, just like large cap U.S. Stocks, is quite small. One may ask, why bother? We definitely think that great investing ideas can come from the rest of the world and that emerging markets will be the source of much of world's growth in the coming years. However, we need to temper our general enthusiasm with the realization that ours is a very conservative portfolio and that our data analysis did not turn up very favorable results that would have argued for a larger allocation to this asset class. Our overall assessment is that large cap foreign stocks are generally in a very efficient market, so active management is less valuable. Emerging markets fund managers may add some value, but our allocation is too low to warrant breaking this out into another fund. In addition, we simply have not seen historical data that can pinpoint the nation or region that will deliver superior performance in the future. As a result, we are more than satisfied to go with an index approach here.

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Performance of the Castling Defensive Portfolio: 2000 - 2009

How well did the portfolio of actual funds perform, versus pure asset classes? Each was also selected since it has at least a ten year track record. The results over the "Lost Decade" were not a surprise. Our model portfolio actually beat its own benchmark of a net, pretax return of 7.2% annualized. Instead, it delivered a 7.5% return over this time period. We show the year by year returns in Figure 4.

Figure 4

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Year-by-Year Returns	11.50%	10.23%	8.73%	11.98%	8.55%	3.45%	9.37%	5.71%	-6.15%	13.15%

Please keep in mind that our objective was not trying to outperform this or any other benchmark. Instead, we focused on finding a portfolio that could achieve its objective consistently, not just in a single time period, as evidenced by the asset class returns shown earlier.

For a somewhat different view of the same data, we looked at the growth of $10,000 from the beginning of 2000 until the end of 2009 (Figure 5). To put this into perspective, let's compare our model portfolio to three high quality funds. Our total more than doubled the Vanguard 500 Index Fund (VFINX): $20,631 versus $9,016.

The Vanguard Wellington Fund (VWELX) fared much better ($18,161) and demonstrates how the classical portfolio is an improvement to an all large cap stock portfolio, during times of stock market stress.

Finally, the Vanguard Wellesley Income Fund (VWINX), having the lowest equity allocation of our comparable funds, did even better ($19,589).

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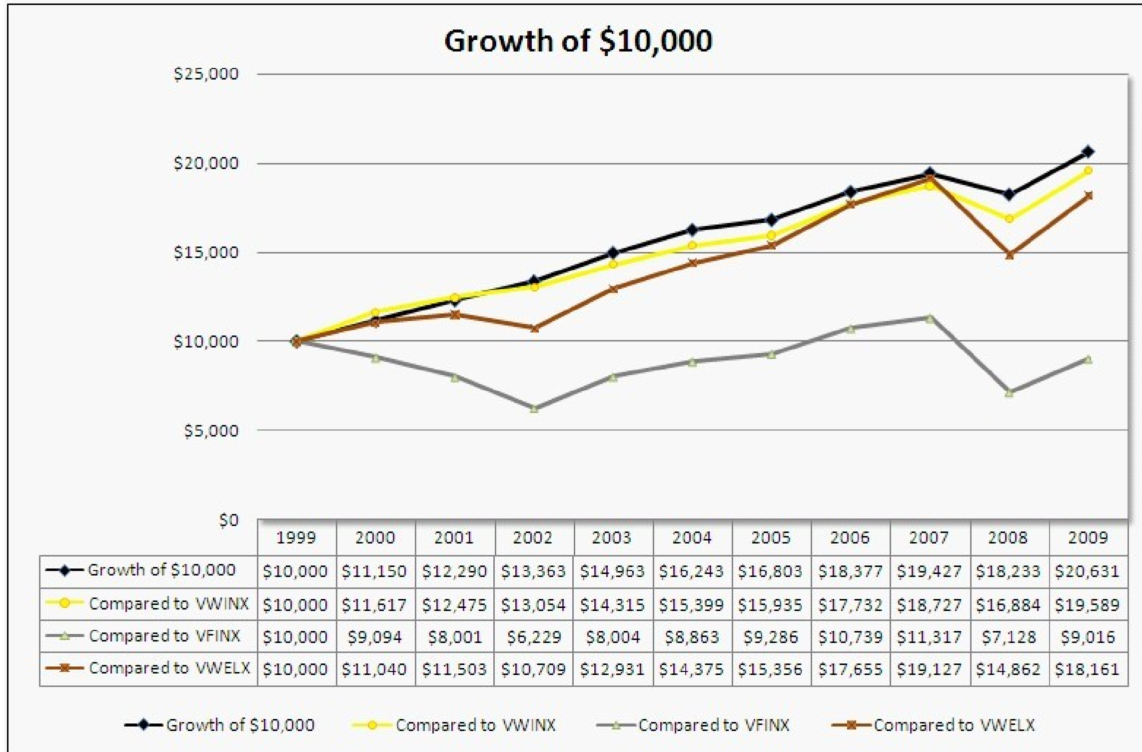
Figure 5



	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Growth of $10,000	$10,000	$11,150	$12,290	$13,363	$14,963	$16,243	$16,803	$18,377	$19,427	$18,233	$20,631
Compared to VWINX	$10,000	$11,617	$12,475	$13,054	$14,315	$15,399	$15,935	$17,732	$18,727	$16,884	$19,589
Compared to VFINX	$10,000	$9,094	$8,001	$6,229	$8,004	$8,863	$9,286	$10,739	$11,317	$7,128	$9,016
Compared to VWELX	$10,000	$11,040	$11,503	$10,709	$12,931	$14,375	$15,356	$17,655	$19,127	$14,862	$18,161

In our opinion, the Castling Defensive Portfolio achieved its objective of consistency. If all we wanted to do was back test to find a portfolio that performed well during the preceding ten years, we could have easily found a much more impressive mix. But what about the other 139 rolling periods? This is where a thorough analysis proves invaluable.

Our other objective is robustness. We think we have achieved it. Only one down year in the decade was recorded. The magnitude of loss was only a fraction of what the overall market and the vast majority of equity mutual funds made their investors endure in 2008.

Overall, Castling Financial Planning, Ltd. believes that this portfolio has as high a probability of achieving its stated objective in the future, as it has done in the past, because of our research in asset class performance across 140 different rolling periods.

We must caution readers that this performance can not be guaranteed and that our analysis is only concerned with rolling periods and not the day to day fluctuations in the market. We think that investors should be holding a broadly and deeply diversified portfolio for the long term. Also, annual re-balancing is as important as holding the asset classes in the first place. The robustness of the portfolio should temper the volatility during down markets, such that the investor can "ride out any storm". This is critical.

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We have seen some clients of other financial advisors who simply had too volatile a mix to begin with. They could not hold their portfolios and wound up selling, typically at or near the bottom of the market cycle. Their advisors, of course, still pocketed handsome commissions or asset management fees. So where are the customers' yachts?

More Information about the Castling Defensive Portfolio

We could have gone into much more detail about each of these investments, but in the interests of keeping our newsletter more readable, we have edited this down. Refer to the References section for Web links to these mutual fund companies. Please feel free to contact us, if we could be of further assistance in helping you take the next step of analyzing your financial objectives, or studying your current investments. Since Castling Financial Planning, Ltd. does not receive any compensation of any kind from third parties, we are in a truly independent position to guide you.

Please check us out (as you should any financial advisor) by looking up our Investment Adviser registration on the SEC Website. Complete details appear below.

Buy and Hold is Dead? Long Live Buy and Hold

The so-called “Lost Decade” as described by some, has been cited as proof of the inferiority of buy and hold as an investment philosophy. Actually, there is a kernel of truth in this statement. But mostly, we think it is seriously off the mark.

First of all, it is never a good idea to buy and hold lousy securities. How do we know something will be lousy or not? We usually don't. That is why holding a broadly and deeply diversified portfolio is always important.

Secondly, buy and hold was never a complete investing strategy, all by itself.

If asset allocation is to be valid, it must be set and reset periodically. In other words, your investment portfolio may start out with certain proportions, but then go “out of balance” with the passage of time and market fluctuations. Therefore, re-balancing is an activity that seeks to restore the asset allocation to its original state. We feel re-balancing is absolutely essential, but should not be overdone.

A once per year re-balance is sufficient for most investors, in our opinion. We think that the most advantageous time of the year to perform this activity, is at year's end. December is statistically a positive month in the equity markets. At the end of the year, we see that many market participants take the holidays off. Trading volume on the major stock exchanges is usually very low. This typically placid environment creates the best opportunity to re-balance and restore your portfolio to the proportions which have been recommended for you. This also means that you will begin the new year with asset class weightings at, or very near, the model or customized portfolio weightings we have computed for you. This helps achieve returns closer to those reported as calendar year returns in various publications, including this one.

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Because Castling Financial Planning, Ltd. never charges an asset management fee, middle America is able to afford our help in performing this activity. You are never under any pressure to purchase additional services, but we are always here to help you, on your terms.

Is the Castling Defensive Portfolio Right for Me?

Without doing some analysis of your particular financial situation and quantifying your goals, this is not possible to determine. Our model portfolio is presented for educational purposes, completely free of any charge or obligation. It is a full blown example of our analysis in action.

You may need a portfolio whose expected return is more or less than the Castling Defensive Portfolio's expected return.

You may not have these mutual fund choices available to you in your 401k, for instance. But other choices may exist. Since we do not sell financial products, take custody of client assets or seek discretion over client accounts, we are completely free to give independent investment advice about your 401k, 403b, IRA or taxable brokerage account.

You may also need to address other more pressing issues, such as getting out of debt or building an emergency fund. We perform general financial planning, not just investment advisory. We are able to focus on analyzing problems and getting to solutions, since we do not not push products or grab for AUM.

What really matters is that the financial advice you get be 100% independent and 100% customized for your situation. We strongly feel that anything less than this (such as any conflict of interest), renders the advice to be about as useful as a sales presentation.

We do customized analysis for each client to determine such parameters as your Required Rate of Return (which we somewhat affectionately refer to as “R-cubed”).

We can also unveil the mystery as to how much your investments are really costing you and how much so called “free financial advice” is really taking from your pocket. We also make use of independent tools from FINRA and Morningstar, to bolster our own research.

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References

1. Schwed, Fred (1940). Where are the customers' yachts?, or, A good hard look at Wall Street, New York: Simon and Schuster.

2. Ibbotson Stocks, Bonds, Bills and Inflation (SBBI) Classic Yearbook. (2010). Chicago: Morningstar. No chart, table, graph, picture, data series, datum or calculation have been reproduced from this work, in the creation of this report.

3. While Castling Financial Planning, Ltd. recommends Money Magazine and Kiplinger's Personal Finance for information about high yielding certificates of deposit, recent data can be obtained at: http://www.bankrate.com/.

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

5. Information about the Royce Special Equity Fund was obtained from Advisor Review, December 31, 2009, a publication of The Royce Funds. Much of the same information is available to investors at: http://www.roycefunds.com/.

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http://www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_OrgSearch.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.)

In the Firm Name search box, enter the word: “Castling” without quotes and make sure Type of firm Search is set to “Starts With”.

Click on the Go button.

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

Click on the “Illinois” link showed on the next page.

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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 contract 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.

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