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Helping You Secure Your Future™

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Winter 2014 Newsletter:

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Yes, It's (a) Bull, But to Prevent Tears, Please Proceed with Extreme Caution!

In our Spring, 2013 Newsletter, we discussed how US large cap stocks (S&P 500®) were posting new highs during the month of May. Based upon our ***CastlingFP*** Valuation Model, we were in a range of fair value, but no bargains. We were not predicting a correction, but being open to the possibility of one during the rest of 2013 or 2014. Well, 2013 ended not only without a correction, but with a late surge.

We continue to dislike event level prediction and take what event level predictors (ELPers) say, with a huge grain of salt. But we also think it prudent to point out that our valuation model is now reaching a point crossing over from our "fairly valued range" into an "over valued range".

Does this mean red lights start blinking and sirens blast? Not exactly. Stocks can stay overvalued (or undervalued) for years. But if you are a long term investor, buying most of your shares during periods of under/fair valuation has shown itself to lead to higher returns with less volatility.

We have not been advising our clients to exit the stock market. However, we always provide the standard advice to:

1. Stick with a predefined asset allocation (this is what we specialize in developing for each client).
2. Dollar cost average (DCA) small amounts (1%-4%) periodically, to reach that allocation, if you are starting out (we show you exactly how, step by step, customized for each client).
3. Re-balance annually back to that allocation, unless the DCA process already takes care of this for you (we recommend the end of the year as the best time for this and provide detailed support for those needing it).
4. DCA out of the allocation for distributions (unless they have targeted other funds/amounts for this purpose; this procedure is also customized).

But now, we are somewhat more cautious. Let's review why. Investors are rewarded for the risk that they take. However, this does not mean that one should take foolish risks. Risks that can be minimized through diversification, must be minimized. It is easy to buy stocks and equity mutual funds/ETFs when the news media and market gurus are positively radiant and singing in unison. Perhaps this is not currently the case, but we have very recently been surprised by the amount of positive reports we are hearing on a daily basis. This no longer makes us feel as positive. Have you heard the age old refrain

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"markets like to climb a wall of worry"? There's not enough worrying going around, in our opinion.

We do not depend solely on our ***CastlingFP*** Valuation Model. So let's consider other sources and see where this leads us next.

We went to the Wall Street Journal and looked over three dates in August 2011, August 2012 and the end of December, 2013. We looked at published S&P 500® index values and the actual (trailing) P/E ratios.

"P/E" stands for Price-to-Earnings ratio and represents the amount that investors are willing to pay for one dollar of earnings. Historically, buying stocks when the P/E ratio has been low (around 14 or under) has proven to be profitable over the long term. Conversely, when the P/E ratio is considered to be relatively high (20 and above), stocks may not return as much in the following time period. The former is considered under valued while the latter is seen as overvalued.

But things are not quite as simple as this. Stock prices can be high and still go higher for quite some time. The reverse is also true. We need to consider longer time frames and that is why we use our proprietary asset allocation database utilizing rolling period analysis.

On August 15th 2011, the index closed at 1,204.49 with a P/E of 14.08. Fast forward slightly more than a year to August 24th 2012, we were at 1,411.13 and 16.25, respectively. Most recently, December 27th 2013 saw the index close at 1,841.40 and the P/E at 18.98[1].

We have not seen a correction, defined as a drop of between 10-20% in the index value, since the third quarter of 2011, just before the first reading above. This would have kept it moderately valued. Had we moved only gradually higher or even sideways for a while, we would now be somewhat happier. Why? Time helps to soften higher valuations.

But this is not what happened. After 2012, we saw the index up 17%, while the P/E was up about 15%. Okay, we were still fairly valued back then.

2013 came and went, exhibiting actually lower market volatility, but no correction. Instead, we saw a 31% increase in the index, along with a 17% higher P/E. Overall, we have seen a 53% increase in stock prices in less than two and a half years, accompanied by a P/E expansion of about 35%. Fast and furious. Why?

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We believe that the 800 pound gorilla in the room is the Federal Reserve's current Quantitative Easing (QE) program. (Money printing almost to infinity and beyond.) The recent "taper" announcement by outgoing chairman Ben Bernanke was no longer seen as cause for alarm, since incoming chairwoman Janet Yellen is expected to be even more accommodating to easy money policies.

We would like to see the economy grow on its own and not be helped along (i.e. distorted), as with a still growing, four point something trillion dollar Fed balance sheet. While they assure us that they will know how to unwind this when the time is "right" and without harming the economy, we won't be holding our breath.

Mounting and later adjusting the training wheels on junior's bicycle was certainly called for (during the recession). But if junior is now 18 years old, at some point, shouldn't the training wheels have already come off (ending QE altogether)?

The same with our economy. Federal Reserve action in 2008 and 2009 was necessary (we can argue the specifics). But to continue artificially goosing the economy into 2014?

Secondly, investors have been willing to pay more for stocks, as we have shown with the expanding P/E ratio. But this is considered the speculative part of the return, because it is based on sentiment. No three alarm blaze just yet, but please proceed with caution.

Thirdly, corporate earnings will probably grow more slowly now, unless there is sustained growth in the economy. While the third quarter GDP increase of 4.1% we recently heard about looks solid, we will need to see this unfold into a 3% plus year in 2014. However, we do not expect this to happen, as much as we would like to see it.

Can this continue? What about market winning streaks? We studied market data for consecutive positive calendar years. We have just witnessed five straight years of gains, totaling about 126%, including dividends. So does the party end here? Looking at past history from 1926 onward, there have been three other longer winning streaks:

1. 1947 through 1952 (six years) and over 150%.
2. 1982 through 1989 (eight years) and almost 300%.
3. 1991 through 1999 (nine years) and almost 450%[2].

That was the good news. Now for the reality.

The first period corresponds to the beginning of the post war economic boom in the US. There was tremendous pent up demand, huge manufacturing capacity, decreased government spending and a yearning for recovery from the Great Depression.

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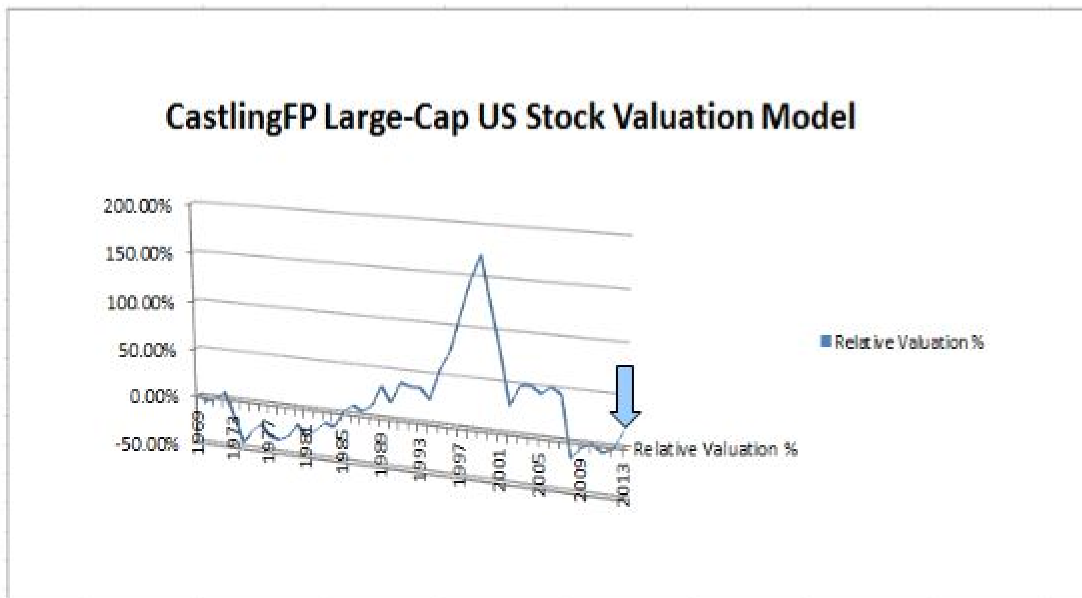
The second period also occurred during a time of great economic growth, right after the 1982 recession ended. Large tax cuts and overall tax reform helped to reshape the economy in this decade. Defense spending saw big increases, while the size of the US debt was still quite small by relative comparison.

The third era (1990's) was, in our view, influenced by Y2K induced artificial growth. This fueled a wild increase in stock market valuations that helped set the stage for many of our current problems. We do give credit for capital gains tax cuts in 1997 and some government budget restraint (some).

Unfortunately, none of the above causal factors seem present in the current economic and political environments. Instead, we have a US total debt to GDP ratio above 100%, tens of trillions of dollars of unfunded liabilities in major entitlement programs, new entitlements such as the ACA (aka Obamacare), and a complete inability to cut anything from the size of government (the budget sequester, the only real cutting that was going on, itself got "sequestered"). There is no major tax reform on the near horizon that will help to bring us above trend line (3%+) GDP growth. If only there could be.

While we can hope for these things in the future, we do not see any evidence of progress in these areas likely to occur in 2014. So given our valuation model and the analysis shown above, but with our natural reluctance to do ELPing, we essentially begin 2014 with a hope, not a prediction. <u>A short lived correction that helps restore valuations, is desirable. It could set the stage for another leg of a long bull market cycle. But the longer we go without any correction, the more caution we would advise</u>.



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Add To Your Life by Subtracting Something From It

This is the time for New Years resolutions. We try to set the bar high and see what grand thing we can attempt to accomplish in 2014. Unfortunately for most of us, we come up very short of the lofty goals we have set. This may even make us feel worse during the depths of winter, if we realize we are not going to accomplish what we first resolved.

But what if we could really accomplish something by essentially going in reverse? Adding to our lives by subtracting something from it, instead of committing to always adding something new.

How could this work and what does it have to do with financial planning?

In his 2012 book **Antifragile**, one of our favorite authors, Nassim Nicholas Taleb, makes the case for moving from simple "robustness", to something more. Antifragile is defined as that which gains from volatility. This book is deep into some original thinking that we have not seen anywhere else. While we are not able to cover much of it here, we did want to touch one concept Taleb mentions: "*via negativa*". In one of its manifestations, a person's health can be improved by subtracting things from their life[3].

We can expand this into financial planning, by considering any major area of spending that a person or family engages in over the course of a year. Taken together, does every single "thing" provide a level of benefit that is greater than its associated cost? If the answer is truly yes, then let's move on to something else. But if not, then it's time to consider removing it and actually adding to your life in the process.

At the end of each year, my wife and I like to discuss the ten best things of the year and the ten worst things, that impacted our lives. For the worst things, we can consider what actions could now be taken to remove them from our lives, or at least mitigate their negative consequences.

These could represent big or small costs. For example, a subscription to a service or publication that is not being used much or at all, is practically a dead weight cost that can be eliminated. By removing it, could you also prevent the clutter it was causing and save the time that it was taking out of your busy life, in addition to what it was costing you? Please keep in mind that we are not asking you to clean out your closets and drawers (though you might find this useful, as well). This is about ongoing costs of money and time, not things buried in your past.

By focusing on your financial goals, through your budget, could the money saved by not spending in these areas, now be better used by adding to your real priorities?

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Let's say that a particular area can not be cut entirely. Does this mean that no savings are possible? In reviewing your cable TV or telephone plan usage, you may find that you are not using some services at all, or not in the way you originally envisioned. The end or beginning of a year is an excellent time to be making these changes.

It may also be the case that you are interested in increasing your charitable giving with your savings from subtracting from your life. Are you already aware of the electronic and other planned giving options that these charities offer you? This may save you valuable time in not mailing in checks, but performing all giving in electronic form online.

Subtraction is possible strictly in the time dimension as well. Do you have recurring monthly and quarterly bills automated, such that you do not need to write as many hard copy checks each month? The mortgage payment, insurance premiums, monthly utility bills, credit card payments, etc. can and should be fully automated, so that they are paid on time every time, using bank to bank (automated clearing house – ACH) payments, commonly referred to as EFT (electronic funds transfer).

Our rationale is simple. Either we can define and defend the reason for spending in each of these categories, or we should look for cheaper alternatives, even going so far as to dropping an item from our budget.

Couples may argue over items where they feel that their partner is wasting money. The main thing is to communicate each others honest feelings and to keep your eyes on the big picture. “Cigar of the Month Club” may have been a whim and not a serious choice, way back when. Or for a given charity, did you ever examine them using Charity Navigator[4]. Upon closer inspection, you may find that your hard earned charitable dollars would be better off going elsewhere.

Pity the New Year's resolution. It is oftentimes violated, simply because of the ongoing commitment it requires from the person making it. By contrast, our “subtraction” methodology is much easier to implement. Some folks achieve a less cluttered state by donating items to charity or holding a garage sale. We advocate that each person review their ongoing spending and identify one recurring item that is not providing commensurate value, or that is taking up too much of their time. Simply cut it out or significantly diminish its cost or time commitment, in the new year.

On behalf of Castling Financial Planning, Ltd.
We wish you and your family
a peaceful and prosperous 2014!

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Better Than a Free Lunch Seminar? So Why Exactly Should I Dollar Cost Average?

We try to give practical, nuts and bolts financial planning information to our readers, whether they be clients or not. But for clients, we do provide individually customized support around each person's unique requirements. As a result, what may be necessary in one case is complete overkill for someone else. Tailoring the delivery of services by client also means that no one is paying for what they do not need.

In selecting topics for these articles, we look for recurring themes from client engagements, as well as our review of the financial planning literature.

You may have heard the often repeated phrase that “there's no such thing as a free lunch”. In other words, some easy money, excess profit, or reward without taking risk is not to be found. Whether exactly true or not, this generalization has stood the test of time. We have seen many so called “financial advisers” offer free lunch or dinner seminars, to tout their latest product or service.

Perhaps receiving dubious advice is more palatable on a full stomach?

Instead, being careful to stay well away from investment fads and get rich quick schemes, some simple concepts have been shown to work consistently. We present one of them here. Please keep in mind that the definition of “consistently” does not mean “always”.

In our first article, we called for caution in the wake of a rapid rise in the stock market. This is not at all meant to imply that you should stop investing. In fact, holding an investment portfolio which follows a predefined asset allocation, is one of the best methods for achieving your long term financial goals.

But what if you are still trying to reach some defined asset allocation? In other words, you may have some steps to take to get from where you currently are to where you should be. This may be the result of not previously considering what asset allocation you need. Or perhaps you may be downshifting in risk from another allocation or moving from an adviser who envisioned your risk tolerance as being dramatically different. What if he got it wrong and overstated your true risk tolerance?

Is getting from where you are now to your target asset allocation and investment portfolio, something you should consider doing in one step? Just like dental work on multiple teeth? Let's get all of the pain out of the way in one day, right?

We do not recommend this approach and strongly caution everyone against it.

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As an example, consider the person with a $100K portfolio, but no money invested in the stock market. After meeting with us a couple times, we determine that our model portfolio for very conservative investors, called the Castling Defensive Portfolio (CDP, reviewed in the last article), would be the best fit. The CDP has a 31% allocation to stocks, quite low by conventional standards.

So should this person take action the very next day, which results in 31% of her money now being invested in stocks? Absolutely not.

Why? Price discovery in the market. Every day that the markets are open, prices are changing. Some are going up, while others are coming down. OK, some move around and then end flat on the day when the closing bell rings.

So what makes for a "good price"? We pretty much intuitively understand what makes for a good price in other aspects of our lives. If we bought the last item on the shelf while it was on sale (and had a coupon to boot), we may be very satisfied, saying to others "I got this at a good price". When buying, "good" means lower, before a price increase. When selling, "good" means higher, before a price drop.

Therefore, in any market, some knowledge of what will happen later gives us the critical understanding as to whether we received a "good" price or not.

Making a single large purchase (or sale) on one day, at a single price (or one set of prices, as with multiple investment products purchased together) makes us completely dependent on that one day's good fortune. Subsequent price history will then tell us if we guessed right or if we guessed wrong.

But could we eliminate this guessing? Yes, most assuredly so. This brings us to something that has sometimes been described as the closest thing to a free lunch: Dollar Cost Averaging (DCA).

DCA is a simple process. It dictates that the investor, already having a predefined asset allocation and the specific investment products picked out, performs periodic, very small purchases of these investments. The relative amounts of each investment depend upon the asset allocation being adhered to and perhaps the minimum amounts required by fund companies, for initial and subsequent investments.

The intervals can be weekly, monthly, quarterly, etc. An annual purchase is probably much too long a time period, relative to the time horizon of the average investor. Daily purchases could work, but the level of price change over one day periods may be too

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slight to be worthwhile. Remember that we mentioned price discovery as our reasoning. Knowing what a good price is, is something we learn after the fact. Sampling a variety of prices over a variety of dates is, therefore, very beneficial.

Based upon our past experience, we have found that individual purchases somewhere in the range of 1%-4% of total assets, is prudent. Use a value lower than 1% and we may need years to reach our asset allocation goals. More than 4% risks being stuck with the outcome of fewer purchases and therefore, more dependence on each price point.

We should also stress that this means purchases are a constant dollar amount, based upon this percent.

So in the example of the investor with a $100K portfolio trying to dollar cost average into our CDP model, she may like to purchase $3,000 of this allocation each week. Since only 31% of this is invested in equity mutual finds, only about $930 would actually be going into the stock market each week.

If this seems somewhat familiar to periodic payroll deductions into 401(k) and other retirement plans, it is exactly the same concept. The same dollar amount gets invested at the same recurring time period in the same allocation as before.

Are we totally bored yet? Well, some of this can be automated, but even when it can not be, the repetitive nature helps us to claim better prices.

While it is by no means a guarantee, there is ample evidence of markets increasing in value over long time periods, with significant variation along the way.

We have three real life examples to demonstrate this. Consider the person who desires to invest $27,000 into the Vanguard REIT Index fund (VGSIX). This fund invests in Real Estate Investment Trusts and is included in our CDP. It can be somewhat volatile and should only be used as part of an asset allocation. However, it exhibits reduced correlation with the returns of large company US stocks. This is another way of saying that it helps diversify your investments, which actually reduces overall risk.

We examined real share prices for this fund during three distinct time periods:

1. July through December, 2008.
2. July through December, 2009.
3. July through December, 2011.

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What difference does a year make? In the first case, we saw a full flung bear market and global financial crisis. In the second, a new bull market was underway. The last instance is an example of a mixed market going sideways.

In our tables shown below, we examine the results of making constant $1,000 purchases for these six months, ending in a total investment of $27,000. Please note that the number of shares purchased each time varied, because of different prices.

The central idea is to be able to purchase more of something when the price is lower, with the expectation that over long enough periods of time, the price will move higher.

Another important concept to keep in mind is that the average cost per share using DCA is lower than the average price per share. This is because more shares are being purchased when the price is lower and fewer shares are being purchased when the price is higher.

This single point may be more valuable than all the free lunch seminars you attend during your life!

We also calculated the rate of return during these six month time periods. In both 2008 and 2011 (bear and mixed markets), there was significant improvement in the return using DCA, compared to simply buying all $27,000 worth of the investment at the start and holding on to it until the end.

How about the bull market? Only in the case of a raging bull (July – December, 2009), did the buy in bulk strategy beat dollar cost averaging. In other words, if you have a high expectation that markets will be only going up in the near future, making a large purchase today will result in a higher return. But when is it ever reasonable to have this expectation? Looking backwards, it will always be easy to tell, but investing needs to be a forward looking process and it will never be as easy to predict.

Of course, the investor could buy even more based upon the investment's valuation being lower. This gets us into a related concept called value averaging, which we will need to discuss in a future Newsletter.

Lastly, DCA also works in reverse, when you are trying to pull money out of investments. Some people would rather take withdrawals only from the cash or bond portions of their portfolios. But this assumes a large enough allocation to make it feasible. In any case, repeated withdrawals from the same asset classes will change the overall allocation. Eventually, you will be forced to take withdrawals disproportionally from the equity side of your portfolio. When that happens, what will the overall valuation of stocks be? Who

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knows? For that reason, taking withdrawals from only one asset class is a form of market timing and we would caution against it in most cases.

Instead, consider taking from each of your asset classes in the same proportion as your predefined allocation, or even using this as an opportunity to re-balance back to your allocation, as a result of doing the withdrawal. This would naturally emphasize selling just a bit extra from the assets that had appreciated more and less from the assets that had underperformed.

Our major alternative to DCA on withdrawals is based on what we call the ***Castling Principle***. We described it fully in our Fall 2013 Newsletter. Please let us know if you would like a copy. Using this methodology, some or all of the withdrawal would come from a separate savings portfolio, but only when the investment portfolio is being stressed, such as during and right after a bear market or correction.

Another consideration is whether selling certain assets would trigger income tax consequences that you would rather avoid. This would be a valid argument against DCA during withdrawal. In the reverse situation, you may like to "harvest losses" near the end of the year. In that case, we actually identify and weed out assets that can be sold at a loss, to balance out against our gainers. All of this is done in order to minimize income taxes. This discussion implies that the investments have not been held in a retirement account. For traditional IRAs, 401(k)s and the like, there are no capital gains or losses to deal with, anyway. Withdrawals from these accounts will be taxed as ordinary income.

In the tables below, we show weekly purchases using actual share prices[5] for each date and then total up at the end of the six month period. In the interests of brevity, we have not shown every single purchase. Please let us know if you have any questions on how to make Dollar Cost Averaging part of your investing regimen.

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Bear Market Jul-Dec, 2008

Dollar Cost Averaging Example with Vanguard REIT Index Fund Investor Shares (VGSIX)

Date	Share Price	Weekly Purchase?	Amount Invested	# Shares Recvd.	Price Paid
07/01/08	$19.42	Yes	$1,000	51.493	$19.42
07/02/08	$19.05				
07/03/08	$18.96				
07/07/08	$18.55				
07/08/08	$19.78	Yes	$1,000	50.556	$19.78
07/09/08	$18.42				
07/10/08	$18.82				
07/11/08	$18.80				
07/14/08	$18.12				
07/15/08	$18.01	Yes	$1,000	55.525	$18.01
07/16/08	$19.17				
07/17/08	$19.53				
07/18/08	$19.53				
07/21/08	$19.66				
07/22/08	$20.25	Yes	$1,000	49.383	$20.25
07/23/08	$20.71				
07/24/08	$19.35				
07/25/08	$19.76				
07/28/08	$19.26				
07/29/08	$20.33	Yes	$1,000	49.188	$20.33
07/30/08	$20.25				
07/31/08	$19.97				
08/01/08	$19.98				
08/04/08	$19.67				
08/05/08	$20.62	Yes	$1,000	48.497	$20.62
12/23/08	$11.46	Yes	$1,000	87.260	$11.46
12/24/08	$11.56				
12/26/08	$11.68				
12/29/08	$11.06				
12/30/08	$11.57	Yes	$1,000	86.430	$11.57
12/31/08	$12.13				

Total Invested:	$27,000
Ending Share Price:	$12.13
Beginning Share Price:	$19.42
Total No. Shares Bought using DCA:	1,782.917
Market Value at End using DCA:	$21,627
Rate of Return using DCA:	-19.90%
Average Cost per Share using DCA:	*$15.14*
Average Price per Share using DCA:	*$16.28*
Total No. Shares Bought using Start/End:	1,390.319
Market Value using Start/End:	$16,865
Rate of Return using Start/End:	-37.54%
Gain by using DCA:	$4,762
% Improvement by using DCA:	28.24%

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Bull Market Jul-Dec, 2009

Dollar Cost Averaging Example with Vanguard REIT Index Fund Investor Shares (VGSIX)

Date	Share Price	Weekly Purchase?	Amount Invested	# Shares Recvd.	Price Paid
07/01/09	$10.47	Yes	$1,000	95.511	$10.47
07/02/09	$9.85				
07/06/09	$10.20				
07/07/09	$9.76				
07/08/09	$9.65	Yes	$1,000	103.627	$9.65
07/09/09	$9.50				
07/10/09	$9.48				
07/13/09	$9.91				
07/14/09	$10.00				
07/15/09	$10.38	Yes	$1,000	96.339	$10.38
07/16/09	$10.46				
07/17/09	$10.17				
07/20/09	$10.57				
07/21/09	$10.49				
07/22/09	$10.54	Yes	$1,000	94.877	$10.54
07/23/09	$10.95				
07/24/09	$11.02				
07/27/09	$11.18				
07/28/09	$11.17				
07/29/09	$11.03	Yes	$1,000	90.662	$11.03
07/30/09	$11.44				
07/31/09	$11.44				
08/03/09	$11.62				
08/04/09	$12.26				
08/05/09	$12.75	Yes	$1,000	78.431	$12.75
12/24/09	$15.27	Yes	$1,000	65.488	$15.27
12/28/09	$15.32				
12/29/09	$15.12				
12/30/09	$15.13				
12/31/09	$14.84	Yes	$1,000	67.385	$14.84

Total Invested:	$27,000
Ending Share Price:	$14.84
Beginning Share Price:	$10.47
Total No. Shares Bought using DCA:	2,097.105
Market Value at End using DCA:	$31,121
Rate of Return using DCA:	15.26%
Average Cost per Share using DCA:	*$12.87*
Average Price per Share using DCA:	*$13.05*
Total No. Shares Bought using Start/End:	2,578.797
Market Value using Start/End:	$38,269
Rate of Return using Start/End:	41.74%
Decrease Due to DCA:	-$7,148
% Decrease Due to DCA:	-18.68%

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Mixed Market Jul-Dec, 2011

Dollar Cost Averaging Example with Vanguard REIT Index Fund Investor Shares (VGSIX)

Date	Share Price	Weekly Purchase?	Amount Invested	# Shares Recvd.	Price Paid
07/01/11	$20.33	Yes	$1,000	49.188	$20.33
07/05/11	$20.48				
07/06/11	$20.63				
07/07/11	$20.89				
07/08/11	$20.83	Yes	$1,000	48.008	$20.83
07/11/11	$20.46				
07/12/11	$20.55				
07/13/11	$20.33				
07/14/11	$20.14				
07/15/11	$20.38	Yes	$1,000	49.068	$20.38
07/18/11	$20.22				
07/19/11	$20.58				
07/20/11	$20.73				
07/21/11	$20.90				
07/22/11	$21.00	Yes	$1,000	47.619	$21.00
07/25/11	$20.78				
07/26/11	$20.83				
07/27/11	$20.23				
07/28/11	$20.26				
07/29/11	$20.27	Yes	$1,000	49.334	$20.27
08/01/11	$19.95				
08/02/11	$19.31				
08/03/11	$19.18				
08/04/11	$18.21				
08/05/11	$17.77	Yes	$1,000	56.275	$17.77
12/23/11	$19.33	Yes	$1,000	51.733	$19.33
12/27/11	$19.42				
12/28/11	$19.16				
12/29/11	$19.34				
12/30/11	$19.25	Yes	$1,000	51.948	$19.25

Total Invested:	$27,000
Ending Share Price:	$19.25
Beginning Share Price:	$20.33
Total No. Shares Bought using DCA:	1,446.788
Market Value at End using DCA:	$27,851
Rate of Return using DCA:	3.15%
Average Cost per Share using DCA:	*$18.66*
Average Price per Share using DCA:	*$18.73*
Total No. Shares Bought using Start/End:	1,328.087
Market Value using Start/End:	$25,566
Rate of Return using Start/End:	-5.31%
Gain by using DCA:	$2,285
% Improvement by using DCA:	8.94%

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Castling Defensive Portfolio: Recap of 2013 and the Hammering of the Bond Market

During the past couple years, a number of market strategists, advisers and fund managers have been proclaiming that the thirty plus year "secular" bull market in bonds was finally over. We like to look at shorter periods that define "cyclical" bull and bear markets. In addition, we have recommended shorter bond maturities that carry less risk, due to smaller changes in bond yields.

A bit of background is needed here. Bond prices move in the opposite direction of bond yields. The Federal Reserve may exert major control of very short term interest rates, such as the Federal Funds rate. However, their control on longer term rates is questionable, unless they exercise some extraordinary measures, such as the Quantitative Easing (i.e. QE1, QE2, QE3) that we have seen over the past five years. The Fed buying longer term bonds has created demand that has kept prices up and, therefore, yields lower than they would otherwise be. Once they even hinted that this process would be scaled back (the so called "taper"), the bond market growled and sold off, thus causing yields to spike.

The longer term bull market in bonds has seen higher (double digit) rates in the early 1980's, lower (single digit) rates in the 1990's and yet lower (low single digits) after the financial crisis.

If you are sure you know where interest rate are going (with precision), then congratulations. Even the smartest bond pros on the planet make mistakes periodically. Bill Gross of Pimco is one of the best in the industry and even he has admitted to making the wrong call on interest rates. Multiple times even. So let's not throw the bond baby out with the bond bath water.

The reason for this discussion is to review what happened to our freely published asset allocation, called the Castling Defensive Portfolio (CDP). This is a model portfolio for very conservative investors. Its stated objective is to achieve a 7.2% net pretax annualized return, in a rolling period, with the least amount of risk and the highest probability. It is somewhat unique in that this objective is attempted with only a 31% allocation to stock mutual funds. We have now documented fourteen years worth of actual fund data: 2000-2013. This is an example of the type of work we do, helping clients achieve their objectives, while holding down risk. Other asset allocations, actual investment portfolios and other required rates of return, are available for our clients.

We just finished 2013 amid a hammering in the bond market. Yet, the CDP finished the year with another gain (unlike most bond funds): **+5.74%**.

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This does seem puny compared to the outstanding gains in stocks, especially plain vanilla index funds. By contrast, the Vanguard 500 Index closed the year with a 32.18% gain.

Far from being displeased, we are happy that the CDP did as well as it did, given that the yield on the 10 year Treasury note essentially doubled from 1.5% to 3%, sparking widespread losses.

We would like to emphasize a couple things. First of all, our goal with this portfolio is a 7.2% net pretax return, in a rolling period. We make no attempt at market timing. In the long run view, from 2000-2013, the Castling Defensive Portfolio's annualized return has been 7.4% , thus meeting its objective. For the last five year period, the annualized return has been 8.3%.

In addition, we would like to point out that all investing involves risk, including risk of loss of principal. But this has been something we have made a conscious effort to minimize, where possible. The CDP has sustained only one calendar year loss and that was barely 6% in the 2008 carnage. By contrast, the Vanguard 500 Index has had four losing years in the past fourteen, with a 37% drubbing in 2008. In fact, the 500 Index has shown only about a 3.5% annualized gain over the past 14 years.

There is no question that in a stock bull market, investment portfolios emphasizing equities will greatly outperform the CDP. Please refer to the below details for more specifics.

But the important issue has nothing to do with beating or matching the performance of the stock market. The critical question is: Will I reach my financial goals in life? This requires the ability to stay the course in the midst of adversity. Such has not been the case for most investors in the stock market. Sticking to an investment plan is much easier, if your goals are well defined and your *Willingness* to take risk, *Ability* to take risk and above all, your *Need* to take risk, have all been identified, taken into account and balanced out.

In retrospect, it is easy for an investor to say they would like to take more risk after 2013. But staying the course after a year like 2008, is where willingness to take risk is sorely tested. When we put together the CDP, it was built from an asset allocation “blueprint” from our proprietary database. The idea was to come up with a truly low volatility portfolio that could appeal to someone who may otherwise not invest in the stock market at all.

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Please review the risk measures called "Standard Deviation" and "Coefficient of Variation", even if they look arcane to you. Just remember that lower is better. Markets can go both up or down, but these risk levels tend to remain more stable. In our opinion, investors would be better served to spend more time focusing on risk, rather than chasing return. The level of risk selected for their portfolios should naturally be based on the three dimensions of risk tolerance we mention above.

(One technical note for 2013. We had mentioned in a previous Newsletter reviewing the CDP's 2012 performance that one of our recommended funds, Royce Special Equity [RYSEX], had closed to new investors. At that time, we recommended the Vanguard Small Capitalization Value Index fund [VISVX, Investor class shares], as a replacement. These 2013 performance figures include this Vanguard fund[6], while 2000-2012 stated performance uses returns from the Royce fund[7]. This has been the one and only change to the composition of the CDP. Once again, the only reason for this change is due to the Royce fund's closing.)

We feel that unless the investor has a significant amount of experience to analyze all of this on their own, the use of low cost, hourly financial planning and investment advisory services, is a great value. This is where we specialize.

Castling Defensive Portfolio (CDP) Comparison	2008	2009	2010	2011	2012	2013
Castling Defensive Portfolio Yearly Returns	-6.15%	13.15%	10.05%	5.26%	7.48%	5.74%
Back-Tested Cumulative Return Since 20000	82.33%	106.31%	127.03%	138.96%	156.84%	171.59%
Hypothetical Growth of $10,000 Since 2000	$18,233	$20,631	$22,703	$23,896	$25,684	$27,159
Annualized Return (2000-2013)					***7.53%***	***7.40%***
Standard Deviation (2000-2013)					***4.99%***	***4.82%***
Coefficient of Variation (2000-2013)					***0.66***	***0.65***
Wellesley Income (VWINX) Yearly Returns	-9.84%	16.02%	10.65%	9.63%	10.06%	9.19%
Back-Tested Cumulative Return Since 20000	68.84%	95.89%	116.76%	137.63%	161.54%	185.57%
Hypothetical Growth of $10,000 Since 2000	$16,884	$19,589	$21,676	$23,763	$26,154	$28,557
Annualized Return (2000-2013)					**7.68%**	**7.78%**
Standard Deviation (2000-2013)					***6.55%***	***6.30%***
Coefficient of Variation (2000-2013)					***0.85***	***0.81***
Wellington (VWELX) Yearly Returns	-22.30%	22.20%	10.94%	3.85%	12.57%	19.66%
Back-Tested Cumulative Return Since 20000	48.62%	81.61%	101.48%	109.23%	135.53%	181.84%
Hypothetical Growth of $10,000 Since 2000	$14,862	$18,161	$20,148	$20,923	$23,553	$28,184
Annualized Return (2000-2013)					**6.81%**	**7.68%**
Standard Deviation (2000-2013)					***11.65%***	***11.65%***
Coefficient of Variation (2000-2013)					***1.71***	***1.52***
Vanguard 500 Index (VFINX) Yearly Returns	-37.02%	26.49%	14.91%	1.97%	15.82%	32.18%
Back-Tested Cumulative Return Since 20000	-28.72%	-9.84%	3.60%	5.64%	22.36%	61.73%
Hypothetical Growth of $10,000 Since 2000	$7,128	$9,016	$10,360	$10,564	$12,236	$16,173
Annualized Return (2000-2013)					**1.56%**	**3.49%**
Standard Deviation (2000-2013)					***19.02%***	***19.83%***
Coefficient of Variation (2000-2013)					***12.16***	***5.68***

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	The Castling Defensive Portfolio:	Ticker	% Allocation	Expenses	Equity %	Weighted Exp.	Min. Invest.	Initial Min.	2013	Contribution
1	FDIC Insured Certificates of Deposit (Avg. of High Yielding)	Bank CD's	9%	0.00%	0%	0.000%	Varies	$6,750	1.00%	0.09%
2	Vanguard Short-Term Treasury Investor Shares	VFISX	9%	0.20%	0%	0.018%	$3,000	$6,750	-0.10%	-0.01%
3	Vanguard Short-Term Investment-Grade Investor Shares	VFSTX	9%	0.20%	0%	0.018%	$3,000	$6,750	0.97%	0.09%
4	Vanguard Intermediate-Term Treasury Investor Shares	VFITX	12%	0.20%	0%	0.024%	$3,000	$9,000	-3.09%	-0.37%
5	Vanguard Inflation-Protected Securities Investor Shares	VIPSX	12%	0.20%	0%	0.024%	$3,000	$9,000	-8.92%	-1.07%
6	Vanguard GNMA Investor Shares	VFIIX	11%	0.21%	0%	0.023%	$3,000	$8,250	-2.22%	-0.24%
7	Vanguard Wellesley Income Investor Shares	VWINX	11%	0.25%	4%	0.028%	$3,000	$8,250	9.19%	1.01%
8	Vanguard Small Capitalization Value Index Investor Shares	VISVX	15%	0.24%	15%	0.036%	$3,000	$11,250	36.41%	5.46%
9	Vanguard REIT Index Investor Shares	VGSIX	8%	0.24%	8%	0.019%	$3,000	$6,000	2.31%	0.18%
10	Vanguard Total International Stock Index	VGTSX	4%	0.22%	4%	0.009%	$3,000	$3,000	15.04%	0.60%
	Totals		**100%**		**31%**	**0.20%**		**$75,000**		**5.74%**

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6. 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/.

7. Information about the Royce Special Equity Fund, including performance, was obtained through the **Royce Funds Advisor Website**. This same information is available to investors at: http://www.roycefunds.com. Please note that this fund has been closed to new investors since 2012.

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