

John M. Smartt, Jr., CPA
FINANCIAL COUNSELING & ADMINISTRATION
Registered Investment Advisor

Client Newsletter Volume XII Number 4 February 1, 2005

- I. The Emerging Field of Behavioral Finance**
- II. What Are OUR and HIS Asset Allocations?**
- III. Vanguard Rates of Return (through December 31, 2004)**
- IV. Best Fiduciary-Rated Fund Groups**
- V. Bond Funds or Individual Bonds?**

I. The Emerging Field of Behavioral Finance

In 2002 The Nobel Prize for economics was awarded to Princeton University's Daniel Kahneman. It says something about how young is the discipline of behavioral finance that Kahneman, a psychologist and not an economist, was awarded the economics prize.

In an interview published in the Financial Advisor Magazine in June, 2004, Kahneman was interviewed by Harold Evansky, Kahneman's own financial advisor. Here are quotes:

"What are some of the examples of the biggest behavioral errors that the traditional retail investor makes?"

"The biggest of them all is probably what is called narrow framing—looking at investment problems in isolation from the whole portfolio. This is probably the most common and fundamental source of mistakes."

"People are probably more rational when they take a very broad view and derive their specific decisions from a broader view. The idea is to begin with strategic decisions —like how safe you want to be, what the basic allocation is going to be. These general rules should govern decisions. As an individual investor, you shouldn't be spending too much effort in trying to guess about a particular stock or about the trends of particular economic indicators. That, I think, is one of the main lessons of behavioral economics. When people put too much emphasis on being right in very specific choices, they end up doing the wrong thing."

"One of the major findings from academic studies of the behavior of individual investors is the disposition effect: When people are selling stocks from their portfolio, they tend to sell winners and hang on to their losers. It's very natural why people do that. If you sell a stock that is currently worth more than you paid for it, then you can pat yourself on the shoulder for a successful investment. When you cut your losses on the stock, in contrast, you have to accept the punishment right now for having made a choice that didn't turn out well. It is not surprising that people prefer rewarding themselves rather than punishing themselves. But recent research...has shown that this is really costly, for several reasons. On average, you will do much better if you sell losers and hang on to your winners. This is a pretty good example of normal investor behavior leading to generally bad outcomes."

"The question advisors all have is, what can we do about [the mistakes individual investors make] it? Are there any specific kinds of tools, techniques —other than being aware of it and trying to warn people, but often they don't pay attention. They would much rather chase the hot story."

"The best advice may well be, 'Do little and don't think too much,' and 'Leave it to me and don't check your results too frequently because that will cause you to make mistakes,' but this advice can sound very

self-serving. For good advice to be acceptable, we are dependent on the public getting educated. This is happening, but it is a slow process.”

“Still, there is more money under passive management [e.g. being invested using indexed mutual funds]. People are aware of the difference between long term and short term, and the idea of staying the course is more popular than it was. ... What an individual investor can do is to lay down a line that is reasonable. ... Proposing a reasonable line basically means for individual investors to become relatively [passive], not to do much, not to check too often and not make too many decisions.”

“The systematic study of how institutions make decisions [as opposed to individual investors] is just beginning and not much is known... you might expect that institutions would be better at handling some of these problems. One conclusion that I remember was that they do a better job than the public in distinguishing news that is worth acting on from noise. And, of course, they have more information. So I think they are better dealing with risks, because they are more likely to adopt a broad frame and view life as a repeated game. They are professional and there is an advantage to being professional. I don’t mean to suggest that professionals can guess what individual stocks will do, but they will be able to avoid certain mistakes.”

Smartt comment: So nice to know that indexed investing and long term investing are both growing in acceptance and that both have a positive effect on investment outcomes. I continue to recommend both.

After the November election I’ve noted numerous times that though some are very concerned about the economic direction of the US (Social Security funding, large Federal government deficits, high military spending), such has happened before, and “on the watch” of a supposedly conservative US President (Reagan). The US economy has a lot of momentum, momentum which is independent of the actions of government in total, let alone the announced policy of a President. Over long periods of years our economy does well, and we prosper with patience and a bit of discipline.

II. What Are OUR and HIS Asset Allocations?

Each of us has a different ability to live with uncertainty (risk) and so our investments will be different:

As of December 31, 2004	Clients	JMS, Jr.
Money Market Funds	1.8%	0.0%
Bond Funds	36.5%	0.0%
Stock Funds	<u>61.7%</u>	<u>100.0%</u>
Totals	100.0%	100.0%

With several decades of investment experience, I continue to be comfortable with 100% stock mutual funds within my portfolio. Most of us need bonds to help us over the bumps in the stock market. All long-term investors need some allocation to stocks to help protect against future inflation.

The client overall allocation above is a composite of all clients’ investments at the end of the year. Client needs change, the group of clients changes (thank you for your confidence and trust) so the above allocation cannot be considered to be a recommended individual allocation. It is the result of a set of individual, customized, portfolio decisions, not a recommendation to be adopted, without custom fitting, for all.

III. Vanguard Rates of Return (through December 31, 2004):

Performance percentages are per Morningstar. Amounts in parentheses are percentile rankings (1= best and 100= worst) within category.

Periods ended December 31, 2004	Yr. to date	5 Years	10 Years
500 Index	10.7% (36)	-2.4% (52)	12.0% (17)
Tax-Managed Growth & Income	10.8% (35)	-2.3% (50)	12.1% (15)
Total Stock Market Index	12.5% (18)	-1.4% (38)	11.8% (20)
Tax-Managed Capital Appreciation	11.8% (17)	-3.0% (15)	11.7% (14)
Extended Market Index	18.7% (22)	1.4% (86)	12.2% (66)
Tax-Managed Small Capitalization	22.8% (16)	11.7% (54)	
Small Capitalization Index	19.9% (43)	7.0% (82)	12.3% (75)
REIT Index	30.8% (65)	21.2% (52)	
Tax-Managed International	20.3% (17)	-1.2% (27)	
Balanced Index	9.3% (40)	2.4% (41)	10.5% (27)
Total Bond Market Index	4.2% (35)	7.2% (34)	7.4% (25)
High-Yield Corporate Bond	8.5% (76)	5.7% (46)	7.6% (20)

For comparison, here are several stock and bond benchmarks:

Periods ended December 31, 2004	Yr. to date	5 Years	10 Years
S & P 500 (large stocks)	10.9%	-2.3%	12.1%
Russell 2000 (small stocks)	18.3 %	6.6%	11.5%
Lehman Brothers Aggregate Bond Index	4.3%	7.7%	7.7%
CS First Boston High-Yield Index	12.0%	8.2%	8.6%

The three original Vanguard Tax -Managed funds are now more than 10 years old. Within currently taxable accounts, several funds from this group are my primary recommendation for broad diversification, low mutual fund cost, low portfolio turnover cost, and low incidence of income taxes. The Tax-Managed Capital Appreciation fund is my clients' and my personal largest holding (within currently taxed accounts). As the table above shows, this fund's rate of return for the ten year period ended December 31, 2004 placed it in the top 14% of similarly classified stock funds (large growth). The Morningstar website notes that AFTER maximum Federal income taxes are applied, the fund's rating rises to top 6%. The primary reason is that this fund, like ALL of the Tax-Managed funds, have yet to be required to pay a taxable capital gains distribution. This is not a guarantee, but an excellent record.

Will it be rated this high in the next ten years? No guarantee there either. We hope to be rewarded with positive investment returns via acceptance of risks, not indulgence in supposed guarantees. Experience teaches that low mutual fund cost and low portfolio turnover costs both contribute to relatively positive, long -term, investment returns.

IV. Best Fiduciary-Rated Fund Groups

Morningstar continues to monitor 21 mutual fund families for possible violation of fiduciary duties toward investors. In an effort to assist investors, Morningstar now gives funds fiduciary grades.

According to the NAPFA Advisor Magazine, “Morningstar looks at an investment company’s commitment to fund shareholders through such criteria as the quality of the funds’ boards of directors. It evaluates the fund firm’s corporate culture, regulatory compliance, the number of funds that directors oversee, the relationship between the directors and the fund firm, and the performance of the trustees in looking after shareholder interests, fund manager incentives, and fund expenses.”

Another firm, Fiduciary Analytics, has begun to provide ratings of mutual fund families. It should come as no surprise that The Vanguard Group is ranked near the top (4th). Vanguard is a true mutual, claiming that it keeps its mutual fund shareholders’ best interests at heart, not the interests of shareholders who own the Vanguard company itself. Surprising in these ratings is that TIAA-CREF Mutual funds, a group run by the same provider of pensions for many universities, and another true mutual, is only rated 21st. Missing from the top 25 is Fidelity, the largest mutual fund group in terms of assets under management.

V. Bond Funds or Individual bonds

Quoted in Financial Planning Magazine, the Litman/Gregory Research group provides this view of owning individual bonds versus mutual funds containing a diversified portfolio of bonds:

“We often get asked...about why we use bond mutual funds rather than individual bonds. The typical argument is that by buying bonds and holding them to maturity, you don’t have to worry about losing money, and you don’t have to pay an expense ratio.” [E.g. mutual fund operating costs]

“One of the big myths about owning individual bonds is that you don’t have to worry about losing money. Corporate bonds have default risk. And just because a client owns an individual bond and plans to hold it until maturity doesn’t mean its value won’t fluctuate. All bonds move in response to daily changes in interest rates and credit conditions.”

“We understand the appeal of owning a bond to maturity —bond owners know the value they will get at the end of the period, while fund owners don’t. But the appearance of added safety is more a function of simply not looking at the value of a bond along the way. Funds publish their prices each day. When a fund sees a price drop, it benefits more quickly from the higher prevailing yields that created the price drop. History and bond math show that, over longer time frames, the chances of doing poorly in a fund versus owning an individual bond (or a laddered portfolio of bonds) are too small to outweigh the advantages of funds.”

This is the author’s list of bond fund advantages: diversification and added value from a wider investment universe, better analysis, better portfolio management, and less impact from cash drag.

“Another big advantage is that it’s much easier to rebalance a portfolio and manage asset allocation when using a fund. This is trickier with individual bonds where clients not only have to consider their total exposure to bonds but also which individual bonds they own. ...It’s reasonable to pay something for liquidity, ease of use, and good professional management.”

John M. Smartt, Jr.
2001 Partridge Run Lane
Knoxville, TN 37919-8967

Phone: 865 588-4159
Fax: 865 588-4159
E-mail: johnsmarttcpa@yahoo.com

