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

Client Newsletter   Volume XIII   Number 4   February 1, 2006

I. Mutual Fund Roulette, the More You Play, the More You Lose
II. What Are OUR and THEIR Asset Allocations?
III. Vanguard Rates of Return (through December 31, 2006)
IV. Big Fees Hit Small Plans
V. Things Your Car Insurer Won't Tell You
VI. Spending Patterns—Spending Declines as We Age?

I. Mutual Fund Roulette, the More You Play, the More You Lose:

From the *Wall Street Journal, Sunday Edition*, comes the following excerpted from an article by Jonathan Clements. The article appeared on December 4, 2005:

> It's worse than I thought.
>
> Again and again…I have argued that most stock-mutual-fund investors won't earn market-beating returns and that these folks would be better off buying market-tracking index funds. It turns out, however, that your chances of outpacing the stock-market averages are far slimmer than even I imagined.
>
> To understand why, consider some calculations by Alan Roth, [a CFP]. Mr. Roth ran a "Monte Carlo" simulation comparing the results of two sets of portfolios, one that included index funds incurring total expenses equal to 0.25% of assets each year and the other consisting of actively managed funds that cost 2% annually.
>
> To be sure, most actively managed funds have published annual expenses that are closer to 1.5%. But once you figure in trading costs, which aren't included in published expense ratios, the tab could easily hit 2%, especially if you own funds that invest in smaller stocks or foreign markets.
>
> Mr. Roth's Monte Carlo simulation not only considers performance in a slew of market environments, both good and bad, but also takes into account the possibility that some actively managed funds will beat the market.
>
> Result? Suppose the two sets of portfolios each consisted of just one fund. According to Mr. Roth's calculations, the chance that an actively managed fund will beat an index fund over one year is 43%.
>
> Once again, those odds may not seem so bad. But as Mr. Roth notes, 'the more funds you pick and the longer the time period, the worse the odds get.' Indeed, with a single actively managed fund, the chances of beating an index fund shrink to 31% over five years, 25% over 10 years, and 13% over 25 years.
>
> Mr. Roth's model is right in line with what you would expect. …Just 23% of comparable large-company funds outperformed Vanguard 500 over the last 10 years.
>
> But here's where it gets interesting. Suppose, instead, that the two sets of competing portfolios consist of five funds. Suddenly, the odds of an actively managed-fund portfolio beating an indexed portfolio shrink to 35% over one year, 18% over five years, 12% over 10 years and just 5% over 25 years.
>
> As you add more funds, it gets even worse. Let's say you own 10 actively managed funds. Your chances of beating an indexed portfolio are 29% over one year, 11% over five years, 6% over 10 years and a scant 2% over 25 years.

It's like gambling in Las Vegas. Yes, you might get lucky on your first few bets. But the longer the night goes on and the more hands you play, the less likely you are to come out ahead. The reason: If you make enough bets in which the odds are against you, eventually mathematics is almost certain to triumph over luck.

Mr. Roth notes that his model considers only fund performance. He says the odds of beating an indexing strategy would look even worse if you figured in taxes and investors' bad timing.

"People get into the market at the wrong time, and they get out of the market at the wrong time, and they chase hot funds, " he notes. "The model doesn't build in human mistakes, beyond the mistake of buying higher-cost funds."

Admittedly there are funds that beat the stock-market averages over long periods. But that doesn't mean it's easy to pick these winners in advance.

Smartt comment: Right on! If all the percentages above make you dizzy, I'd be pleased to visit you re: other "real world examples" of the concepts. Remember the actively managed Fidelity Magellan Fund, that great winner in the 1970s and 1980s? According to the same article quoted above, it has lagged behind the S&P 500 average in seven of the last ten calendar years (even though it has taken more risk by wandering into medium and smaller sized stocks within its portfolio).

II. What Are OUR and THEIR 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, 2005	Clients	The Smartts
Money Market Funds	1.6%	0.0%
Bond Funds	29.7%	3.8%
Stock Funds	68.7%	96.2%
Totals	100.0%	100.0%

.

III. Vanguard Rates of Return (through December 31, 2005):

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

Periods ended December 31, 2005	Yr. to date		5 Years		10 Years	
500 Index	**4.8%**	(61)	**0.4%**	(44)	**9.0%**	(26)
Total Stock Market Index	**6.0%**	(47)	**2.0%**	(23)	**9.1%**	(25)
Tax-Managed Capital Appreciation	**7.5%**	(27)	**0.5%**	(43)	**9.3%**	(21)
Extended Market Index	**10.3%**	(43)	**6.9%**	(61)	**10.0%**	(80)
Tax-Managed Small Capitalization	**7.7%**	(37)	**10.6%**	(43)		
Small Capitalization Index	**7.4%**	(41)	**9.1%**	(60)	**10.3%**	(71)
REIT Index	**11.9%**	(58)	**18.3%**	(49)		
Tax-Managed International	**13.6%**	(55)	**4.5%**	(25)		
Balanced Index	**4.7%**	(60)	**3.8%**	(32)	**8.2%**	(34)
Total Bond Market Index	**2.4%**	(18)	**5.4%**	(42)	**5.9%**	(24)
High–Yield Corporate Bond	**2.8%**	(41)	**6.5%**	(70)	**6.1%**	(31)

For comparison, here are several stock and bond benchmarks:

Periods ended December 31, 2005	Yr. to date	5 Years	10 Years
S & P 500 (large stocks)	**4.9%**	**0.5%**	**9.1%**
Russell 2000 (small stocks)	**4.6 %**	**8.2%**	**9.3%**
Lehman Brothers Aggregate Bond Index	**2.4%**	**5.9%**	**6.2%**
CS First Boston High-Yield Index	**2.3%**	**9.8%**	**7.1%**

IV. Big Fees Hit Small Plans :

The online edition of the *Wall Street Journal* notes the high level of costs within the 401(k) plans of smaller employers. Appearing October 21, 2004, the subtitle of the article: "Costs Take Huge Toll on Retirement Accounts of Firms with Fewer than 50 Employees."

> Investors in 50-person plans pay an average of 1.4% of their assets annually in fees…--assuming an average participant balance of $40,000 according to a … study by HR Investment Consultants in Baltimore. That compares with 1.17% for investors in 1,000-person plans. But many investors in small plans pay as much as 3% or more, according to HR.
>
> That could mean an significant difference to participants over time. Over 20 years, a 1% increase in fees on a $100,000 investment can reduce the portfolio's ultimate gain by $66,254, assuming annual investment returns of 7%. And fees can take a particularly large bite out of an investor's annual return when investment returns are low….
>
> Small retirement plans are more vulnerable to paying higher fees for several reasons. One is that they aren't able to spread the costs of running a 401(k)—including legal compliance, shareholder communications and record keeping—across as many participants as large plans.
>
> Smaller companies also have a less attractive choice of investment options. Many smaller plans are built around pricey group-annuity contracts issued by insurance companies, whereas many big-company 401(k)s utilize lower-cost mutual funds. Mutual-fund companies, which typically generate their retirement-plan profits from the assets invested in their mutual funds, tend to shun small plans. The low-cost zealots at Vanguard Group, for instance, typically won't take on plans that have less than $3 million in assets, according to a spokesman.

Smartt comment:

As an employee, you can cut some costs by intelligent shopping: look for lower -cost investments within your company's plan. I assist many of my clients to do this, balancing their other investments to take the few relatively favorable 401(k) choices into consideration.

Another possibility to consider is to avoid contributing to a high cost plan, using a Roth IRA instead. But watch loss of the company match. The math is complicated here, too. I'd be pleased to assist.

V. Things Your Car Insurer Won't Tell You:

The February issue of *SmartMoney* magazine has ten suggestions, here is the first:

> When I say this is a good policy, I mean it's good for me.
>
> Recently broker commissions have landed the commercial insurance industry in hot water with New York Attorney General Elliot Spitzer. But auto policyholders may be surprised to learn that some of the same issues afflict the car insurance industry. While agents can help you navigate auto policies, some may not have your best interest at heart: In 2005 the Consumer Federaltion of America found that 14 out of the 20 largest auto and home insurers used 'contingent commissions' to compensate agents who sold their policies.

Contingent fees come in two types: 'steering' commissions for signing customers with a particular carrier, and profit-based commissions, when clients don't file a lot of costly claims. The concern with the former is that unscrupulous agents push certain policies to reap larger commissions; with the later they might delay or discourage claims. "It doesn't mean that this happens often," says CFA Insurance Director J. Robert Hunter. "Most agents are honest, but if the system provides an incentive, if there's money on the table, well, people do things."

How to protect yourself? Ask about commissions, and have prospective agents explain their recommendations.

.

VI. <u>Spending Patterns—Spending Declines as We Age?</u>

Wealth Manager Magazine reports findings from the *Journal of* Financial *Planning* regarding how our spending changes with our age:

> Ty Bernicke … cited the U.S. Dept of Labor Bureau of Labor Statistics which showed dramatically lower spending among the over-75 crowd compared to younger retirees. While some practitioners doubted the applicability of the Bureau's numbers, anecdotal information … gives credence to the notion that—barring an uninsured spike in healthcare expenses—spending wanes as people age.
>
> There are a few theories about why this seems to be the case. One is that it simply reflects a generally higher level of health and vitality among younger retirees. The more active they are, the more likely they will need money to fund their activities.
>
> Others believe that it's a matter of pent up demand. After working for someone else for many years and not having the time or means to do some of the things they've always wanted to, the new retirees are more likely to spend money to knock things off that life-long 'to-do list.' Increased travel early in retirement is possibly the most common manifestation of this phenomenon.
>
> One of the most intriguing theories is that lower spending is a generational mind-set issue. Older retirees often have some memory of the Great Depression. For some, their spending habits have been impacted by the teachings of their parents, who likely were impacted directly by the economic trials prior to World War II. According to this theory, statistics like those from the BLS simply reflect a continuation of previous lower spending levels and not a decrease from younger years. If this theory is correct, it diminishes the likelihood that planning for expense reductions in later years would be a viable strategy.

Smartt request: what do you think? I'd like to hear from you on this one.

John M. Smartt, Jr., Paula W. Smartt	Phone: 865 588-4159
2001 Partridge Run Lane	Fax: 865 588-4159
Knoxville, TN 37919-8967	E-mail: johnsmarttcpa@yahoo.com