

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

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I. 30th Birthday of Indexed Investing Coming!

In June, 1976, Vanguard's first index fund was formed. According to John Bogle and the Vanguard Experiment, the underwriters (Dean Witter was lead underwriter) raised \$12 million in the next three months. By the end of 1976, the fund assets had grown to \$14 million.

Although pension funds had previously adopted indexing to manage investment assets, the Vanguard fund was the first investment "product" open to individual investors. This first fund, then called "First Index Investment Trust", followed the Standard & Poors 500 Index, an index of the largest 500 publicly traded corporations headquartered in the US. Counting all of the various classifications of the fund, it is now the largest mutual fund in the US, passing Fidelity's Magellan fund, an actively managed fund, several years ago.

By June 30, 1995 Vanguard offered 19 index funds which had grown to \$26.18 billion. Dan Jamieson, writing in the *Journal of Indexes* ("Mom and Pop Go Passive"), notes that by the end of 1995 only 2% of mutual fund assets were invested in index funds. Five years later, "passive" index funds had grown to 10% of mutual fund assets. In doing so, these funds attracted between 13% and 40% of new mutual fund inflows in the years between 1998 and 2004.

There are several hallmarks of an indexed mutual fund:

- broad diversification, since the fund follows an index
- low cost of the mutual fund structure itself (since following an index can be performed largely by computer, does not require the services of an investment management firm)
- low cost of portfolio turnover within the portfolio,, since there are only limited changes in the stocks (or bonds) which comprise each index
- low income tax costs, since low portfolio turn over frequently leads to low propensity to declare taxable capital gains distributions.

Jane Bryant Quinn, long time financial writer, states that she dates her financial independence from the date she discovered index funds.

Smartt comment: I continue to believe that for most types of investing, index funds are the best alternative. They do not guarantee absence from all losses; they are expected to yield to the investor more of the fruits of acceptance of investment risk than mutual funds which are either less diversified, higher cost, or both. An important chapter in the future of index funds is currently being written by a subset of the funds, called ETFs, exchange traded funds. See section IV for more.

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 March 31, 2006	Clients	The Smartts
Money Market Funds	1.5%	0.0%
Bond Funds	35.7%	3.9%
Stock Funds	<u>62.8%</u>	<u>96.1%</u>
Totals	100.0%	100.0%

III. Vanguard Rates of Return (through March 31, 2006):

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

Periods ended March 31, 2006	Yr. to date	5 Years	10 Years
Total Stock Market Index	5.4% (23)	5.8% (18)	9.1% (22)
Tax-Managed Capital Appreciation	4.5% (43)	4.7% (30)	9.1% (21)
Extended Market Index	9.9% (9)	12.8% (22)	10.4% (79)
Tax-Managed Small Capitalization	12.8% (38)	15.0% (35)	
Small Capitalization Index	12.2% (50)	13.2% (62)	10.9% (76)
REIT Index	14.8% (29)	21.7% (59)	
Tax-Managed International	9.3% (60)	9.6% (25)	
Balanced Index	3.0% (62)	5.7% (32)	8.3% (34)
Total Bond Market Index	(0.7%) (72)	4.6% (47)	6.0% (26)
High-Yield Corporate Bond	1.6% (92)	5.9% (71)	6.2% (32)

For comparison, here are several stock and bond benchmarks:

Periods ended March 31, 2006	Yr. to date	5 Years	10 Years
S & P 500 (large stocks)	4.2%	4.0%	9.0%
Russell 2000 (small stocks)	13.9 %	12.6%	10.2%
Lehman Brothers Aggregate Bond Index	(0.7%)	5.1%	6.3%
CS First Boston High-Yield Index	3.1%	9.4%	7.2%

IV. What You Ought to Know About Exchange Traded Funds (ETFs):

The mutual funds with which we are most familiar operate like a bank. Every business day an investor can send the fund a check and the fund will credit the investor with more ownership shares. Ditto withdrawals. At the end of each day, the mutual fund has a different number of shares outstanding. Either through brokers or directly, investors deal with the bank/mutual fund. Funds such as this are known as “open end funds.”

There is another class of mutual funds, "closed end funds." All of the initial shares of these funds are sold, on a single day, by an underwriting syndicate. However, after that first sale of shares, if an investor wishes to purchase more shares, or sell the ones previously purchased, the investor uses an exchange, there is no direct access to the mutual fund.

The importance of these funds, ETFs, is their lower cost structure. By a memorandum to clients five weeks ago, I provided additional information on these funds. Let me know if you would like a copy of the memo.

An example: For investors owning or purchasing less than a total of \$100,000, the Vanguard Total Stock Market Index fund costs 19/100% annually in mutual fund operating costs. For several years Vanguard has also offered an ETF version of the same fund (both funds own the same stocks in the same proportions) for an annual operating cost of only 7/100%. The difference is, in many instances, worth paying some brokerage charges to obtain. The swap is performed without income tax consequences within tax deferred accounts (e.g. IRAs, SEPs).

I'd be pleased to provide more information.

V. Mutual Fund Tax Bills Rise Sharply

According to a February, 2006 online column at Morningstar.com:

Taxable capital gains distributions doubled in 2005 versus 2004. The average diversified U.S. equity fund distributed 3.32% of its assets as capital gains last year compared with 1.67% in 2004. The story is much the same if you consider foreign and sector funds: The average distribution was 2.93% versus 1.46%. For both groups, those 2004 figures were also up sharply from 2003 when the average distribution was less than half a percent.

The number of funds making capital gains distributions also rose. Among diversified U.S. equity funds, the figure went from 64% to 74%. Among all stock funds it surged from 69% to 79%.

The reason capital gains spiked is that 2005 was the third positive year in a row for most equity markets. Moreover, small caps have been on a five-year tear and therefore now hold very few positions at sizeable losses. In addition, the bear market is now fading into the distance as the market climbs higher.

The upshot is that you had better start paying attention to tax issues on your mutual fund investments if you haven't before. The market, particularly small caps, has already enjoyed solid gains so far in 2006. Even if the market finishes the year flat, you'd be wise to build a tax strategy.

Tacks to Try:

Mutual funds have to distribute all the capital gains they realize (after subtracting capital losses and tax-loss carryforwards). However, those that use a tax-aware strategy to reduce distributions have proved quite successful at minimizing capital gains distributions.

That, in turn, means you can significantly increase your aftertax returns by buying tax-managed funds or, at a minimum, low-turnover funds for your taxable accounts and avoiding super tax-inefficient funds.

By buying funds that hold on to their gains rather than distributing them, you enjoy two big advantages. First, you get to keep your money compounding in those mutual funds rather than pay it out in tax. If you can hold on to another \$5,000 a year through savvy tax management, that can end up as a princely sum in 20 years. Second, by deferring taxes into the future, you're making the most of the time value of money. Because of inflation and the fact that you can compound money

over time as compensation, a dollar today is worth more than a dollar in 10 or 20 years. Thus, if you can put off a tax bill well into the future, you're effectively giving yourself a tax cut.

Smartt comment: for almost a decade I have recommended Vanguard's Tax-Managed stock funds. In a full decade of existence NONE of these funds has been required to distribute the FIRST DOLLAR of taxable capital gains distributions. Their low fund operating expenses and low portfolio turnover also assist in making these funds winners.

Note well that the State of Tennessee, which has no general personal income tax, does have a tax on most Interest and dividends AND on the capital gains distributions of mutual funds. Close to home we Tennessee Scots are well advised to seek out stock funds which are tax -managed. Investors in states with even higher personal income tax rates should insure that their currently taxable stock investments are tax -managed.

VI. Seven Clues to How Soon You Can Retire

In an April article for the Sunday edition of the Wall Street Journal, Jonathan Clements, my favorite financial writer, presents the following:

When will you have enough to retire? This is the most basic personal -finance question. And, yes, the investment returns you earn and the size of your paycheck will have some bearing on the answer. But there are other issues that are just as critical and maybe more so. ...here are seven other factors to consider.

First: Parents. Your parents can ensure you get a good education,...shower you with gifts and a fat inheritance. But in the end,...the financial values they passed along will prove more important than the dollars they bequeath. Second: Career: The bigger your paycheck, the greater your ability to amass wealth. ...but... your Social Security retirement payment will replicate a smaller portion of your pre-retirement income. Result: you will need to save far more than folks who are used to living on a smaller paycheck.

Third: House: ... Sure, if you own a larger home, you will get a greater benefit from any real-estate price appreciation. But opting for the big house is really a lifestyle choice, and it will cost you. Fourth: Children: ...I receive occasional emails from readers boasting that they retired in their 40s. The common denominator: Having kids will delay your retirement.

Fifth: Divorce: I am not advocating that people stay in relationships that make them miserable. But don't delude yourself: Divorce will hurt financially—and set back your retirement date. Sixth: Hobbies: What do you like to do in your spare time? If you spend a lot now on travel, eating out, playing golf and cruising the shopping mall, you are likely to spend a whole lot more once you quit the work force. After all, in retirement, you will be able to pursue your interests 365 days a year.

Seven: Health: If you exercise regularly, it might seem like you're setting yourself up for a long and hence costly retirement. It is a little more complicated than that. Yes, if your family history and your own health suggest you will live to a ripe old age, you should save enough to carry yourself through 25 or 30 years of retirement and maybe more. But if you are overweight, never exercise or smoke a pack a day, you could still need a fair amount saved for retirement. True, your retirement may be relatively short. But it could prove mighty expensive. There's an increased risk you will suffer a debilitating illness or struggle with your mobility, and thus you may get hit with long-term care costs—possibly the biggest expense retirees face.

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

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