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I. Wharton and Harvard Students: “Low...Financial Sophistication”

This excerpt from *Financial Planning* magazine, June, 2006 is titled “The Clueless Investor”, the result of a study by a three Ivy League professors:

What It Is: To test if investors consider fees when selecting mutual funds, the authors gave Wharton and Harvard students prospectuses of four S&P 500 Index funds and had them create a hypothetical \$10,000 portfolio. Front end loads [i.e. sales charges] ranged from 2.5% to 5.25%. Expense ratios [i.e. annual mutual fund operating costs] ranged from 0.59% to 0.80%. The ideal allocation would have been 100% to the lowest-cost fund.

Major Finding: Many participants failed to recognize the importance of fees when making investment decisions. Most student’s didn’t put the entire portfolio into the least expensive fund and many chose several funds in the mistaken belief that they were diversifying their portfolio.

Highlights: Information in prospectuses may not equip investors sufficiently to make informed decisions about mutual funds. Even students presented with a separate sheet of more ‘transparent’ information didn’t choose the lowest-fee funds. Instead, they often based their decisions on brand names and historical returns (when provided) since the funds’ inception —which varied based on the funds’ start dates and therefore were not comparable.

The Authors Say: Our subjects demonstrate a low absolute level of financial sophistication, including those enrolled in an elite MBA program. However, our subjects are significantly more sophisticated than the typical American household that is contributing to a retirement account. This does not inspire optimism about the financial choices made by most households.

The federal government did provide financial support for the study, and the authors state some possible policy implications of their findings. Policymakers, they say, should think carefully about how to select fund options in any future personal -account component of the Social Security system. They also suggest creating incentives for intermediaries, such as 401(k) providers and state 529 [i.e. college savings] plan administrators, to pay attention to fund fees —since many individual investors do not.”

Smartt comments: Vanguard’s groundbreaking S&P 500 index fund was not included within the study alternatives, or the lowest cost fund would have been 0.18% per year, not 0.59%. As a Wharton grad, I’m disappointed in my university’s ability to pour basic investment knowledge into its students.

Further, it continues to surprise me that more 401(k) investment decisions are made as a result of “water cooler conversations” than any of the supposed helpful data provided by the employer. If someone in your family could use assistance with their 401(k) choices, a bigger component of the average person’s retirement income every passing year, I’d be pleased to assist.

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 June 30, 2006	Clients	The Smartts
Money Market Funds	1.6%	0.7%
Bond Funds	28.3%	4.0%
Stock Funds	<u>70.1%</u>	<u>95.3%</u>
Totals	100.0%	100.0%

III. Vanguard Rates of Return (through June 30, 2006):

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

Periods ended June 30, 2006	Yr. to date	5 Years	10 Years
Total Stock Market Index	3.3% (28)	3.8% (22)	8.4% (24)
Tax-Managed Capital Appreciation	2.3% (56)	2.8% (35)	8.4% (24)
Extended Market Index	5.5% (31)	8.9% (31)	9.5% (77)
Tax-Managed Small Capitalization	7.3% (44)	11.0% (35)	
REIT Index	13.2% (55)	18.9% (64)	
Tax-Managed International	10.3% (18)	10.8% (18)	
Balanced Index	1.7% (64)	4.5% (35)	7.8% (33)
Total Bond Market Index	(0.9%) (61)	4.4% (52)	5.9% (28)
High-Yield Corporate Bond	1.1% (91)	6.3% (76)	6.1% (31)

For comparison, here are several stock and bond benchmarks:

Periods ended June 30, 2006	Yr. to date	5 Years	10 Years
S & P 500 (large stocks)	2.7%	2.5%	8.3%
Russell 2000 (small stocks)	8.2 %	8.5%	9.1%
Lehman Brothers Aggregate Bond Index	(0.7%)	5.0%	6.2%
CS First Boston High-Yield Index	3.5%	9.7%	7.1%

The above mutual fund rates of return are for the investor class of the regular, "open -ended" Vanguard mutual fund. Vanguard ETFs have lower costs and, long term, including brokerage and other charges, are expected to yield higher rates of return. Vanguard also has an Admiral class of funds with lower costs for investments of more than \$100,000. These funds are also expected to yield higher rates of return than are shown in the table above.

A note on the last mutual fund listed, High-Yield Corporate Bond fund. When the economy is rocking along, without significant "panic", then the junk bond funds which take the highest level of risk do significantly better than this mutual fund, which tries to own no bonds rated lower than "B". But panics occur with some frequency in financial markets so, although the return of the fund is one full percent per year lower than the comparable index (CS Boston High-Yield Index), the Vanguard fund is in the upper 1/3 of all funds for the

ten year period ended June 30, 2006. The Vanguard fund takes significantly less risk. On behalf of my clients, I wouldn't want it any other way.

IV. Morningstar: Tax-Managed Funds Are "Dead":

In article posted in late June on the Morningstar.com website, their "fund spy" writes that investors are leaving mutual funds with "tax-managed" in their titles:

The phrase 'tax-managed' is death for marketers. Nothing seems to scare away investors more than those words. Although the idea of managing a portfolio in order to maximize returns after taxes makes all the sense in the world, investors don't want to hear about it.

Consider that Vanguard Tax -Managed Growth & Income VTGIX, a tax-managed version of Vanguard 500 Index VFINX has \$3 billion in assets, while Vanguard 500 has \$110 billion in assets. The tax -managed fund charges 4 basis points [i.e., 4/100%] less than Vanguard 500 and has even slightly outperformed Vanguard 500 on a pretax basis.

Here is Morningstar's conclusion: "When you're buying for your own taxable account, be sure to investigate funds' tax-managed policies. Chances are some of the ones that look most appealing to you are following at least some tax-management guidelines. If not, you may find a close equivalent. **ETFs and Vanguard's tax-managed funds are great alternatives to traditional index funds.**" [emphasis added]

Smartt comment: Until I found that Vanguard ETFs cost significantly less than its tax -managed stock funds, I routinely used three for clients' currently taxed accounts. Now, rather than the two US Vanguard tax-managed funds, I've urged clients without significant unrealized capital gains to move to the ETF. I continue to recommend the Vanguard Tax -Managed International fund. This fund's record, see section II above, has been good for the five plus years of its existence; currently it is in the top one-fifth of international stock funds rated by Morningstar and this before the benefits of its tax -deferred policies.

V. Has Residential Real Estate Been a Good Investment Lately?

From the *Investment Advisor Magazine*, May, 2006, article titled: *Profiting by Behavior*:

"When people make decisions, they tend to base them far more on what has recently happened and ignore longer term data. [The] recency effect is what is often responsible for causing investors to make shortsighted decisions based on greed and fear. Many of you have probably witnessed this first hand. For example, how many [of you] believed that real estate was the 'only' investment to make in the last few years. Well, if you compare the return of the S&P 500 to the return of residential real estate over a 20-year period, you may have a different opinion. After subtracting the effect of general inflation, the S&P Index has returned an annual return of 8.9% over the 20 year period ended December 31, 2005. In the same 20 year period residential real estate returned 2.5% (again, after inflation is subtracted).

Yes, there are many benefits of owning your own home and residential real estate is the subject of favorable income tax laws, but year after year, unless you are an expert in that phase of our economy and an expert in the location of the real estate, investing in residential real estate must be regarded as a low yielding investment.

Here, from the May, 2006 issue of *Financial Planning* magazine, excerpted from an article titled *Buddhist Economics*, is another, non-traditional view of the residential real estate purchase decision (and some other decisions).

"Everyone thinks that homes are the perfect investment, but they never factor in the opportunity cost of household repairs, maintenance and furniture. A newly married couple in their 20s may buy \$15,000 worth of furniture. When they retire, that \$15,000 will have cost them \$250,000 in retirement assets. [The larger

value based on compounding over several decades of the initial \$15,000 as well as expected earnings on the investment of that amount.] Was it worth it? It seems to me that too many people have their identity wrapped up in what they own.

This article notes: "If I buy a \$25 tie, my opportunity cost in future retirement assets is only \$200 because I'm close to retirement. But if my son buys that tie, it costs him almost \$2,000 in future retirement assets that he would have had if he invested that \$25. If people know what they were spending in lost financial security, they would be aghast."

VI. A Quote for Everyone:

These appeared in the *NAPFA Advisor* magazine, June, 2006:

"In spite of the cost of living, it's still popular." -- unknown

"Most people will literally spend more time and money planning a vacation trip than planning their future." -- Financial Planner Guy Cumbie

"If you are properly diversified, you always have something to complain about." -- planner Patrick Collins, Jr.

"We'll never have a time in the stock market where there is a clear path to take." -- planner Jeff Feldman

"Life is 10% what happens to me and 90% how I react to it." -- John Maxwell

"The man who never talks with his father never knows what his grandfather said." -- Paul Ruseabagina

"Opportunity may knock, but temptation rings the doorbell." -- unknown

"Diversification is the conscious choice not to make a killing, in exchange for the blessing of never getting killed." -- financial writer Nick Murray

"The only investors that shouldn't diversify are those that are right 100% of the time." -- Sir John Templeton

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