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

Client Newsletter Volume XIV Number 3 November 1, 2006

I. <u>Pension Protection Act of 2006 – Charitable IRA Rollovers</u>

Most of the new law deals with the funding and administration of company defined benefit pension plans. But, per Natalie Choate's newsletter, there are "long -awaited rollover goodies" within the Act:

"Not quite the ultimate charitable IRA rollover that the nonprofit community dreams of, but it's a good start: Money can be distributed from an IRA directly to a charity, and the distribution will be excluded from the IR A owner's income. Now here are the limitations and restrictions on these new 'Qualified Charitable Distributions' (QCDs):

When: This is a temporary measure, good for 2006 and 2007 only.

Who: The IRA owner must be age 70 ½ or older. This is the first tax provision that has made the age 70 ½ 'birthday' itself a significant event; minimum required distributions are based on the year the participant reaches age 70 1/2 , not the DAY he reaches that age. This should be an ideal way for … individuals to fulfill the MRD requirement while helping a favorite charity.

How much: The QCD income exclusion is limited to $100,000 per year.

Which charities: A QCD can be made to any charity EXCEPT a donor -advised fund … or certain private foundations. … split-interest gifts will NOT qualify. Thus QCDs cannot be made to a charitable remainder trust … or charitable gift annuity.

Which plans: This is ONLY for distributions from IRAs (other than SEPs and SIMPLEs).

Which assets: The QCD must come from pre-tax money."

Smartt comment: If you make charitable contributions and are required to take $$s from your IRA each year, this is for you. Make the contribution directly to the charity out of your IRA and your income is reduced, no big news there. What's important to realize is that this serves to reduce your income for the purpose of calculating how much of your Social Security income is taxed; so making the charitable gift this way reduces taxable income twice: the gift to the charity (which would not have been dedu ctable if you do not itemize deductions) and, second, reduces the income figure on which the extent of taxability of Social Security is based. Neat idea.

Let me know if I can assist you with this. Early each year, again in January 2007, I assist clients with fulfilling their requirements.

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 September 30, 2006	Clients	The Smartts
Money Market Funds	5.6%	0.9%
Bond Funds	27.2%	3.8%
Stock Funds	67.2%	95.3%
Totals	100.0%	100.0%

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

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

Periods ended September 30, 2006	Yr. to date		5 Years		10 Years	
Total Stock Market Index	**7.9%**	(33)	**8.5%**	(17)	**8.6%**	(25)
Tax-Managed Capital Appreciation	**7.2%**	(49)	**8.1%**	(20)	**8.6%**	(25)
Extended Market Index	**5.2%**	(55)	**14.1%**	(20)	**9.2%**	(80)
Tax-Managed Small Capitalization	**5.8%**	(55)	**14.9%**	(32)		
REIT Index	**23.8%**	(32)	**21.7%**	(62)		
Tax-Managed International	**14.7%**	(19)	**14.3%**	(21)		
Balanced Index	**6.1%**	(47)	**7.0%**	(35)	**8.0%**	(31)
Total Bond Market Index	**2.9%**	(37)	**4.3%**	(50)	**6.1%**	(24)
High–Yield Corporate Bond	**4.6%**	(87)	**7.6%**	(81)	**6.0%**	(37)

For comparison, here are several stock and bond benchmarks:

Periods ended September 30, 2006	Yr. to date	5 Years	10 Years
S & P 500 (large stocks)	**8.5%**	**7.0%**	**8.6%**
Russell 2000 (small stocks)	**8.7 %**	**13.8%**	**9.1%**
Lehman Brothers Aggregate Bond Index	**3.1%**	**4.8%**	**6.4%**
CS First Boston High -Yield Index	**7.2%**	**11.3%**	**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 fund s are also expected to yield higher rates of return.

IV. The Benefits of Paying Lower Mutual Fund Fees

First, a "plain English" statement from Vanguard on how they have assisted us who believe that the way to keep more of the fruits from the investment risks we run is to minimize the costs of our investment program.

From a recent Vanguard newspaper advertisement: "A funny thing happened when we made low -cost mutual funds available to individual investors back in 1975. Friends told friends, and a small circle of investors grew into a large one. They told a simple story. With shares in a Vanguard fund, for example, you get to benefit from a powerful, long-term commitment to keep costs low. Low costs means you get to keep more of your investment returns working for you. Compounding that money over time can help you build wealth. And good performance attracts more investors. As a client-owned investment management company, it's just one way we put our investors' interests first. What's more, managing over $995 billion in assets as of April 30, 2006, we actually charge clients two-thirds less than we did thirty years ago, and our average expense ratio is 80% lower than the industry average."

Second, from the complicated conclusion of an article in the July/August issue of the *Journal of Indexes.* The article is titled: "*Excessive Mutual Fund Expenses Also Mean Higher Risk and Worse Performance*."

"It is not enough to say that particular mutual funds have very excessive and most excessive expense ratios. In addition, these high cost funds are associated with negative portfolio characteristics that include more risky and less diversified portfolios, higher trading costs and lower earnings. Further, these high cost funds are associated with performance attributes that include lower risk/return performance based on three measures and lower total returns over two time periods.

The complete word, then, is that mutual funds with high expense ratios —whether two or three standard deviations above the mean of their Morningstar category—are further associated with both negative portfolio characteristics and performance attributes."

Smartt comment: in plain English: high-cost mutual funds trade their stocks/bonds more, which further drives up costs and, as a result provides generally lower returns to the shareholder/owners.

V. Does Size Matter? The Debate Over "Fundamental Indexing"

The index funds with which we are familiar are constructed so that the mutual fund owns much more of any stock of a larger company than of a smaller company. That is, if the value of all of the stock of the large company is 10 times the value of all of the stock of the smaller company, then the index fund will own 10 times as much of the large company stock as the small company stock. That's the way it has been for 30 years now. But there are now index funds which are beginning to be constructed based on other rules.

For example, Jeremy Siegel (a Wharton School finance professor, whom I have trusted for more than a decade, author of one of my favorite investment books, Stocks for the Long Run) has joined the board of directors of a company which offers several index funds which are constructed based on other than size characteristics. For example, dividend yield. Siegel notes that in the last four or so decades the higher-dividend-paying stocks have performed better. Based on this history, he believes that companies which pay dividends are better investments than those which do not.

Such funds are call "fundamentally-weighted." That is, the amount of each company stock purchased is based on some fundamental aspect of the company or the stock (or combination of these factors) rather than just the market value of the outstanding stock of the company. The argument forwarded by Siegel and others is that if you buy more of a stock just because its market value is higher, you may be "buying high", purchasing the stock after it has had a run up in its price, when it is then not as good a value as some other stock which has not shown a recent increase in price. I must say I see some logic in this approach.

Another characteristic suggested for fundamentally weighted index fund purchases is "book value." A figure familiar to accountants, this is the amount of value or "net worth" of the company based solely on its general ledger, on its "books of account." As an accountant, I see big holes in this logic. E.g. when one company buys another, their book values are not simply added together. Rather, the entire purchase price of the purchased company is added to the books of account of the acquiring company; if the new parent company overpaid, and this is often the case, then book value becomes a less reliable measure of the true value of the new, larger company.

There are two quite basic problems with mutual funds constructed based on such fundamental indexes:

(1) Mutual fund operating costs are higher. This is partially a function of their newness, since these funds are a new approach, they are presently being priced to create a profit to those who have done and are doing the research necessary to construct the fund, to find and to follow the "fundamental" which is expected to provide better future investment returns.

(2) The mutual fund must make more purchases and sales as the weighting of the fundamentals change. E.g. if a company raises its dividend rate, the mutual fund weighted based on dividend payments will then purchase more shares of that fund. There are two problems with this; first, this is often when the price of the shares is higher because other shareholders are doing the same thing—share prices of companies often increase after they announce an increase in the dividend rate. Second, the regular index fund does not have to make any change in its portfolio in this situation, so its cost of portfolio trading will be lower, increasing its lead in lower total costs.

I will continue to evaluate this new type of indexing. Currently, I believe that the possible benefits do not outweigh the sure higher rates of cost of the funds —low cost wins so reliably that no change is advised. Further evidence may make me change my mind (just as I did earlier this year in beginning to use ETFs in client portfolios and as I did several years ago when I began to recommend that clients hold a portion of their stock positions in a mutual fund which invests in stocks not headquartered in the US).

VI. Dos and Don'ts for Getting Kids into Giving

Here is a quick summary from the June, 2004 issue of Bloomberg Wealth Manager:

Dos:

get them started young,

model philanthropic behavior,

make it part of family activities and celebrations,

give teenagers money they can decide how to donate,

volunteer and take kids along,

send your children to a school that makes service a priority and that will get the whole family involved,

choose an appropriate vehicle such as, for large amounts, a family foundation or a donor-advised fund.

Don'ts:

make your children's philanthropic decisions for them. Instead, insist that they think through their giving and do the research to support their choices.

Don't expect teenagers to act philanthropically when you never have, be an example.

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