

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

Client Newsletter Volume XIV Number 4 February 1, 2007

- I. Hedge Fund Hidden Risks and Commodity Investing**
- II. What Are OUR and THEIR Asset Allocations?**
- III. Vanguard Rates of Return (through December 31, 2006)**
- IV. In 2007 Smartt Rockets into the 1990s, Opens Website**
- V. Good News on Stock Transaction Costs**
- VI. Kiplinger's Asks: Can We Afford to Grow Old?**

I. Hedge Fund Hidden Risks and Commodity Investing

Jeremy Siegel, a Wharton School professor, is one of my favorite investment writers. In October, 2006, oil prices and other commodity prices were riding high, yet in this commentary, which appeared on the Yahoo Finance website, he notes the demise of one hedge fund and the lessons for investors:

"The spectacular decline in the asset values of Amaranth Advisors LLC, the once highly-successful hedge fund, illustrates an important lesson for investors, there is no easy path to higher returns.

Amaranth...specialized in energy trading. But the collapse of natural gas prices forced it out of its positions after its two main funds plunged more than \$ 6 billion, or 65%, since the end of August. It's the largest hedge fund collapse since LTCM [Long Term Capital Management] went belly up in 1998.

All this hedge fund buying raised the prices of oil, gas, and other commodities substantially above their long-term average. But these higher prices have increased the risks of owning these commodities. Hedge funds argue that many of these commodities are underpriced, and that today's higher prices are justified by putting the right 'scarcity value' on commodities. High prices, though painful for the consumer, encourage conservation efforts.

There's truth to this but commodity prices are notoriously unstable. Amaranth said it reduced risk by taking 'spread positions' in natural gas, which means buying gas for delivery in one month and selling another month, hoping to benefit by a change in the relative price. Spread positions are usually more stable than taking an outright position in the commodity.

But spread positions in and of themselves can be very unstable. In fact, spread positions torpedoed LTCM eight years ago.

What happened to Amaranth illustrates that hedge funds, for all their talk about 'controlled risk', cannot escape the natural volatility of the markets. The more active markets become, the more likely they are to experience unusual speculative moves. Amaranth claimed that the probability they would have lost so much in spread trading was 'extremely remote.' But extremely remote events do occur, even for markets with as much history as government bonds, as LTCM sadly discovered.

I would not object...that hedge funds be required to disclose their lack of knowledge of the true risks that their positions entail. Because of their investment strategy, historical analysis of ten or twenty years or longer may not properly reflect the volatility of their positions. Investors should be made aware of these facts.

What does this mean for ordinary investors? The hedge fund flame-outs could ultimately help stocks. The more that people understand that there is no magical way to generate 10% to 15% returns in alternative markets, the more investors will be satisfied with average returns of 8% to 10% in stocks.

As an asset class, I believe stocks now look far more promising than bonds, real estate, commodities, whose price declines may extend much further before they recover. Amaranth is just another reminder that there are no easy paths to higher returns.”

Smartt comment: Five months later, as stocks (as represented by the Vanguard Total Stock Market ETF) have increased in value by 7.6% while Vanguard’s most comprehensive bond index fund has declined in value by 0.5%. So from a purchasing standpoint, stocks are perhaps not as big a bargain relative to bonds as five months ago when Jeremy Siegen wrote his note.

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, 2006	Clients	The Smartts
Money Market Funds	5.4%	0.9%
Bond Funds	27.0%	3.8%
Stock Funds	<u>67.6%</u>	<u>95.3%</u>
Totals	100.0%	100.0%

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

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

Periods ended December 31, 2006	Yr. to date	5 Years	10 Years
Total Stock Market Index	15.5% (28)	7.4% (21)	8.6% (26)
Tax-Managed Capital Appreciation	14.4% (48)	6.7% (29)	8.7% (24)
Extended Market Index	14.3% (40)	12.0% (23)	9.7% (80)
Tax-Managed Small Capitalization	14.2% (59)	12.4% (37)	
REIT Index	35.1% (46)	22.7% (66)	14.2 (62)
Tax-Managed International	26.0% (36)	15.0% (19)	
Balanced Index	11.0% (52)	6.9% (36)	7.9% (31)
Total Bond Market Index	4.3% (34)	4.6% (47)	6.0% (26)
High-Yield Corporate Bond	8.2% (87)	7.6% (76)	5.9% (32)

For comparison, here are several stock and bond benchmarks:

Periods ended December 31, 2006	Yr. to date	5 Years	10 Years
S & P 500 (large stocks)	15.8%	6.2%	8.4%
Russell 2000 (small stocks)	18.4 %	11.4%	9.4%
Lehman Brothers Aggregate Bond Index	4.3%	5.1%	6.2%
CS First Boston High -Yield Index	11.9%	11.1%	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.

IV. In 2007 Smartt Rockets into the 1990s, Opens Website

We're all proud of our children, and I'm no exception. While in Knoxville for her Christmas visit, daughter Janet built my website, www.johnsmarttcpa.com. Take a look. The site's objective is to better serve clients and prospective clients. If content raises any questions, please let me hear from you.

V. Good News on Stock Transaction Costs

In a series of articles in finance publications over the last two decades, the Plexus Group, a management consulting firm, established a reputation for teaching mutual fund companies how to be more efficient in their stock buying and selling activities. Mutual funds have a big problem; they are so large that when they decide to replace one of the stocks in their portfolio, e.g. General Motors, with another, e.g. Ford, their buying and selling activities move the market prices, to the detriment of the mutual fund. Plexus Group computed that to change all of the stocks in a large capitalization portfolio would cost 1.01%, an additional cost of investing for mutual funds and for those of us who own them. Further, Plexus calculated that "changing out" a portfolio of small cap. stocks would cost more than 4% (1.16% for the average, fully diversified portfolio of US stocks).

Plexus Group has been purchased by another company. Its former president, Wayne Wagner, is writing articles for *Traders Magazine*. In the May 11, 2006 issue he states that by 2005 large cap transaction costs had fallen to 51 basis points (51/100%) and small cap. costs had fallen to 98 basis points.

He notes three reasons why mutual funds have become more efficient:

1. Money managers lowered the expected returns of their portfolios after the end of the market bubble (of the late 1990's).
2. Low-cost trading mechanisms became widely available. "This occurred just as regulatory zeal forced out higher cost market structures through decimalization [stocks being traded in one cent increments, not 1/8th of a dollar increments] and changes to the order-handling rules.
3. Increased scrutiny of portfolio operations, combined with a maturing of the cost-measurement industry, forced managers to more carefully consider the costs of implementing their decisions."

The good news for investors is that, although portfolio turnover (selling one stock and purchasing another) occurs in even broadly based index funds, the costs of such turnover, costs which lower the net investment return to mutual fund owning shareholders, has declined significantly in the last few years.

VI. Kiplinger's Asks: Can We Afford to Grow Old?

Here from the February, 2007 issue of *Kiplinger's Personal Finance Magazine*, is editor in chief Knight Kiplingers' take on this important question:

"The new Democratic Congress will take up a number of important issues in the coming two years... . But all of these issues pale in comparison with one that Congress has refused to take seriously....When Congress finally finds the guts to address it, the political strife will be enormous. The neglected issue? The cost of supporting an aging America.

These days, it takes the payroll taxes from five working Americans to finance the Social Security and Medicare benefits of one retiree. But by 2030, each retiree will be supported by only three workers. Even if the U.S. economy continues to achieve strong productivity gains, this declining worker-to-retiree ratio—

accompanied by surging medical costs—will almost certainly lead to a reduction in living standards. That's because generations yet to come will face a much higher tax burden if nothing is done to change senior benefits—maybe 33% more, the Federal Reserve Board estimates.

The choices for funding future retiree benefits are clear, and painful: much higher taxes; flat or declining government spending on everything—defense, education, public infrastructure, housing, scientific research—except programs for seniors; slower growth of spending on senior entitlement programs; an ever-larger national debt; or some combination of these.

Among these choices, Fed chair Ben Bernanke leans toward fundamental reform of the senior entitlement programs. And the sooner the better, he says, so it will be easier 'for people now in their working years to prepare by saving more today.'

The need for sacrifice. Of all the things we should be doing now to prepare for the graying of America, Bernanke says the most important is to boost our national savings rate. By saving more as individuals and by borrowing less as a government, 'we can reduce the future burden of demographic change' on our progeny, he believes. 'Saving more requires that we consume less or work more. Either case entails some sacrifice on the part of the current generation.'

Is sacrifice an archaic value in an era in which we fool ourselves that we can have it all? I hope not. Fairness to generations unborn requires it."

Smartt comment: the Social Security problem is the easier of the two to fix. Gradually, the date at which retirement benefits can begin being collected needs to be lengthened, to match the longer lifespans we are enjoying. There may need to be some additional taxation of Social Security benefits. The Social Security tax rate may need to be increased by a small percentage. Finally, the compensation base on which the tax is collected may need to be increased, gradually, over the years, at a faster rate than currently.

Medicare I know less about and have fewer thoughts.

Wish I knew the answer to Medicare. I suppose if I were king, I would charge smokers higher rates for Medicare coverage. Many small answers may be needed here.

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
Website: www.johnsmarttcpa.com