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

Client Newsletter Volume XV Number 1 May 1, 2007

I. What's New at TDAmeritrade

TD Waterhouse and Ameritrade are finally getting their online systems together. The merger of the two brokerage firms was announced 15 months ago. Since there were more TD Waterhouse customers and investment advisors, these systems, the ones on which we have been relying, are generally the backbone of the new, merged system.

TDA has changed is price structure. There are small increases in fees for mutual fund purchases and sales. You can avoid all or part of the increase if you either have $500,000 of family assets at TDA or allow the firm to send you your monthly statements and transaction confirmations via email. If you need help with electronic delivery of your TDA paperwork, please let me know. The process is reasonably simple, but takes a couple of business days to complete.

TDA's price for ETF (exchange traded funds, the new lower cost versions of index mutual funds) trading is also lower if you have the higher family asset totals or allow electronic delivery of statements/confirmations.

There is a planned change coming in the name of the *back office* portion of TDA. Our accounts were opened with Waterhouse, and/or later, with TDA, but they will now be handled by TDAmeritrade Clearing. I believe that this change is a change in name and not in substance. TDA will still be the brokerage with which we deal. An effect of this change is that for the month of May, 2007 ONLY, you will be receiving *two monthly statements* for each of your accounts (whether via regular mail or email). As I understand it, one of the statements will show your activity for the month then show your assets moving from the previous clearing entity. The other statement will show those same assets moving to TDW Clearing. I urge you, at least on a test basis, to determine that the same assets which left the first entity were credited to you (were received by) the second entity.

After you get your statements, if you have questions, please do not hesitate to contact me. The various transitions which have affected how I deal with TDA have, on the whole, been handled reasonably well.

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, 2007	Clients	The Smartts
Money Market Funds	4.8%	0.9%
Bond Funds	26.8%	2.5%
Stock Funds	68.4%	96.6%
Totals	100.0%	100.0%

III. Vanguard Rates of Return (through March 31, 2007):

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

Periods ended March 31, 2007	Yr. to date		5 Years		10 Years	
Total Stock Market Index	**1.4%**	(39)	**7.5%**	(21)	**8.7%**	(23)
Tax-Managed Capital Appreciation	**1.4%**	(36)	**7.0%**	(27)	**8.8%**	(21)
Tax-Managed Small Capitalization	**3.3%**	(39)	**11.6%**	(35)		
REIT Index	**3.4%**	(47)	**21.6%**	(67)	**14.5**	(55)
Tax-Managed International	**4.3%**	(20)	**15.8%**	(15)		
Balanced Index	**1.4%**	(61)	**6.8%**	(39)	**8.1%**	(31)
Total Bond Market Index	**1.3%**	(64)	**4.9%**	(52)	**6.2%**	(27)
High–Yield Corporate Bond	**2.3%**	(78)	**6.6%**	(80)	**7.8%**	(30)

For comparison, here are several stock and bond benchmarks:

Periods ended March 31, 2007	Yr. to date	5 Years	10 Years
S & P 500 (large stocks)	**0.6%**	**6.3%**	**8.2%**
Russell 2000 (small stocks)	**2.0 %**	**10.0%**	**10.2%**
Lehman Brothers Aggregate Bond Index	**1.5%**	**5.4%**	**6.5%**
CS First Boston High-Yield Index (bonds)	**3.0%**	**11.2%**	**7.3%**

The above-listed 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 an d 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. Vanguard Lower Cost Bond ETFs Begin Trading

Vanguard’s Total Bond Market Index fund (our personal largest bond mutual fund investment) seeks to track the Lehman Brothers Aggregate Bond Index, the most comprehensive index of good quality federal and US corporate bonds. For investors who own less than $100,000 of the fund, the annual cost of the mutual fund is 0.20%, average for a Vanguard index fund. For larger investors, the Admiral version of the fund costs 0.11% per year (45% less mutual fund operating cost). Three weeks ago, t he ETF, exchange traded fund version of the fund, began to be offered. It also costs 0.11% per year.

I will be contacting smaller bond investors with a recommendation for changing from the regular mutual fund to the ETF. The change will allow you to begin saving that 45% on mutual fund costs. The costs of the change are (1) a transaction fee to sell your mutual fund and (2) another transaction fee to purchase the ETF and (3) payment of a small “spread” between the purchase and sales price of the ETF. T his spread is a requirement of trading on a securities exchange. It is not a commission which TDA earns, it is not a commission which I earn. Although these three charges add to cost, most of us are bond investors for more than just a year or two; the co sts of the change will be a reasonable investment is higher future returns on our bond investment.

Going forward, new purchases of Vanguard Total Bond Market Index fund will be made in the version of the fund which is judged to provide the lower total cost of ownership.

V. The Efficient Market Hypothesis and Mutual Fund Costs

Here, from a Certified Financial Planner textbook on investing is a one-paragraph summary of the Efficient Market Hypothesis:

> "…[F]inancial markets are efficient. The competition among investors, the rapid dissemination of information, and the swiftness with which security prices adjust to this information produce efficient financial markets in which an individual cannot expect to consistently outperform the market. Instead, the investor can expect to earn a return that is consistent with the amount of risk he or she bears."

The text says that there is no way to use information, or any supposed system of investing to consistently take only average risks and "beat the market." You might beat the market here and there, but there is no prospect for obtaining higher than market/average returns on investment unless you take risks that are higher than average. This is a very important point, one which most investors, professional or not, find hard to accept. We all wish there was some system, some "secret sauce" we could use to increase our probability of future investment profit without bearing the risks of the ups and downs in short term values which the market provides.

The Efficient Market Hypothesis is one of the important reasons for using index funds We diversify our investments broadly (by owning a fund which owns hundreds of different stocks, or bonds, or both) and then we seek to minimize our investment costs. The expected result is that we will, long term, be handed the market's rate of return less this very small level of costs. Because most investors do not understand this and do not follow this path, their investment costs are higher, whatever their level of risk. Our low cost structure and diversified portfolio will allow us, over the very long term, to earn higher net investment returns than most investors.

Dimensional Fund Advisors ("DFA") is a group of professors and investment theorists who run a family of mutual funds. The funds are primarily index funds, their costs are a bit higher than Vanguard funds. This higher cost structure has prevented me from recommending their funds. They believe that the Efficient Market Hypothesis has some small holes in it, that there are inefficiencies in the market which can be exploited. In the November, 2006 issue of *Financial Planning Magazine*, this what DFA's Advisor Service director wrote about efficient markets and professional money management in the section "Efficient Enough":

> Theorists who believe that markets are inefficient like to point to instances when securities prices don't appear to be rational. One example involves Royal Dutch and Shell Transport, which merged in the early 1900s and agreed to split their combined cash flows on a 60/40 basis. Instead of trading at 1.5 times the value of Shell Transport, as you might expect, Royal Dutch often deviated—sometimes significantly—from that price, according to Harvard University researchers Ken Froot and Emil Dabora.
>
> This study and others like it highlight an important point: The market is not 100% correct at all times. Efficient-market proponent and Nobel Prize candidate Eugene Fama of the University of Chicago has said that 'the extreme version of the market efficiency hypothesis is surely false.'
>
> I agree that we probably don't live in a perfect efficient world. There's a more relevant issue at stake, however. Do pricing errors occur frequently enough and to a large enough degree to make them exploitable—and allow you (or the manager you hire) to generate outsize returns?
>
> One of the best ways to answer this question is to review the performance of professional money managers. If anyone can find and capture inefficient pricing opportunities, it's the pros. And with thousands of mutual funds sharing the goal of beating the market, there's no shortage of candidates. The vast majority of pros running these funds are smart, driven, resourceful and plugged into every available channel that can give them a leg up on stocks, the economy and market trends.

How have they done over the years? The most rigorous studies—those with adequate sample sizes and periods, benchmarks that control for risk and for survivorship bias—reveal a trend: The pros don't add value on a consistent enough basis to warrant their fees. …

Some of the studies found continued strong performance among winners during one period. But the study by Mark Carhart showed that the reason for this persistence was momentum in the underlying stocks. What managers did not do, however, was actively exploit momentum to boost returns. When the stocks' momentum died, so did the outsize performance.

Then there's the issue of cost. Consider a 2000 study by Russ Wermers, a University of Maryland professor, that found that mutual funds underperformed the CRSP value-weighted index by 1% per year on average, from 1974 through 1994—despite the fact that the stocks they owned actually beat the index by 1.3% per year. According to Wermers, 1.6% of that 2.3% gap is directly due to fund expenses and transaction costs.

The upshot: pricing errors do occur in the financial markets. But research shows that profitably exploiting those errors is incredibly difficult. …Certainly there are many active managers who are extraordinarily smart and even more who work extremely hard. But the payoff doesn't appear to cover the costs associated with the effort."

VI. **<u>May I Use You as a Reference?</u>**

Not often, but occasionally, a prospective client will ask for references; names and contact information of current clients with whom to discuss the services we provide. As a CPA I am required to maintain your privacy. With your permission, I am allowed to provide them with your name and contact information.

Might you allow me to use you as a reference? If so, would you prefer to be contacted by phone, by email, or is either acceptable to you. I value our association and am grateful for it and for your support. Thank you.

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