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I. Vanguard Requires Conversion of Admiral Shares to Signal Shares

Anyone who owns more than $100,000 of individual Vanguard funds, e.g. Total Stock Market Index fund or Total Bond Market Index fund, and who owns them as regular mutual funds (not ETFs, exchange traded funds) does so under the title "Admiral class". This class of mutual funds costs less each year because Vanguard calculates that it costs less, per $1 of share value, to serve larger shareholders.

In middle October, these shares were converted by Vanguard into a fairly new class of shares called "Signal class." This class of shares is reserved for mutual fund owners who are served by financial advisors and investment advisors. So, if you were an Admiral class shareholder, now you are a Signal class shareholder. Your October monthly statement from TDAmeritrade, if applicable will show this conversion. There is no difference in cost, at present. Vanguard believes that the cost to serve Signal shareholders may be lower (per $1 of share value), than Admiral shareholders. So there is some prospect, but no guarantee, that the cost of our Signal class mutual fund will decrease, and decrease faster than has the cost of Admiral shares.

For those few shareholders who owned Admiral class shares within currently taxed accounts, e.g. not within IRAs or other retirement plans, Vanguard assures me that the exchange of classifications is NOT an income taxable event; e.g. we will not owe capital gains taxes, nor do we even have to report this on Schedule D of our personal income tax returns.

I view this is a positive development, but have been warned by a Vanguard representative that **Vanguard may *revoke Signal share status* three years from now if, by then, my clients, myself, and my family have not accumulated at least $5 million in value in Signal class shares**, within each Vanguard mutual fund where these less expensive share classifications are offered. Vanguard would then offer us another share class, possibly one which is *more expensive*. I have stated my reaction to the possible unfairness of this planned action. We'll see what the future brings.

Meanwhile, I continue to believe in the basic soundness and overall fairness of the Vanguard product, both mutual funds and ETFs. I will continue to use Vanguard for my clients, my family and myself. Vanguard is a true mutual, that is, it is **owned by us**, the shareholders of Vanguard investment funds. As a true mutual it seeks to cut costs where it can and continues to insure that all of the individual shareholders are bearing their share of the costs of the organization.

If you have questions, you should not hesitate to send an email or give me a call. I look forward to visiting with you on this issue.

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, 2007	Clients	The Smartts
Money Market Funds	2.2%	0.3%
Bond Funds	24.7%	3.7%
Stock Funds	73.1%	96.0%
Totals	100.0%	100.0%

III. Vanguard Rates of Return (through September 30, 2007):

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

Periods ended September 30, 2007	Yr. to date		5 Years		10 Years	
Total Stock Market Index	**9.1%**	(45)	**16.3%**	(20)	**6.8%**	(28)
Tax-Managed Capital Appreciation	**9.7%**	(36)	**16.7%**	(15)	**6.8%**	(27)
Tax-Managed Small Capitalization	**7.0%**	(25)	**18.6%**	(33)		
REIT Index	**-4.1%**	(50)	**20.8%**	(68)	**11.9**	(53)
Tax-Managed International	**13.5%**	(54)	**23.7%**	(23)		
Balanced Index	**5.7%**	(70)	**11.4%**	(52)	**6.7%**	(34)
Total Bond Market Index	**3.7%**	(19)	**4.0%**	(45)	**5.7%**	(24)
High–Yield Corporate Bond	**3.0%**	(54)	**9.0%**	(87	**5.3%**	(31)

For comparison, here are several stock and bond benchmarks:

Periods ended September 30, 2007	Yr. to date	5 Years	10 Years
S & P 500 (large stocks)	**9.1%**	**15.5%**	**6.6%**
Russell 2000 (small stocks)	**3.2%**	**18.8%**	**7.2%**
Lehman Brothers Aggregate Bond Index	**3.9%**	**4.1%**	**6.0%**
CS First Boston High-Yield Index (bonds)	**3.7%**	**12.5%**	**6.4%**

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 and other charges, are expected to yield higher rates of return (e.g. the Vanguard Total Stock market ETF has costs of approximately 0.1% per year less than the regular mutual fund. The dividend yield of the ETF is thus approx. 0.1% HIGHER than the regular mutual fund). Vanguard also has an Admiral or a Signal 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. Morningstar Gives Up, Can't Pick:

In 2001, Morningstar, the leading provider of mutual fund data, began three model portfolios of mutual funds, aggressive, moderate, and conservative. Their objective was to provide readers of their monthly *FundAdvisor* publication with suggestions of mutual funds which could be expected to do better than average. To provide an benchmark, each portfolio was rated against a mix of three Vanguard index funds (Total Stock Market Index, Total Bond Market Index, Total International Stock Market Index).

Each month, through the May 2007 issue of *FundAdvisor*, the portfolios were valued and compared with the benchmark. Morningstar's picks have generally done WORSE than the Vanguard index benchmark. So, the May issue was the last issue to carry this feature.

The Morningstar portfolios began with $100,000 invested. The "Aggressive Wealth Maker" portfolio grew to $165,597, but the benchmark Vanguard index fund mix grew to $170,988; the "Wealth Maker" portfolio grew to $153,505 but the benchmark Vanguard mix grew to $159,724; and the "Wealth Keeper" portfolio grew to $140,662, but the benchmark Vanguard index mix grew to $141,699.

Interestingly, Morningstar routinely used the same Vanguard index funds as part of the portfolio which it picked. Morningstar's non-Vanguard choices thus did even worse that the above differences show.

Conclusion, Morningstar, with all its data bases and current sources of information cannot beat Vanguard index funds. If Morningstar cannot do it, no individual investor should try.

V. Vanguard Performance in ETFs Compared:

The *Journal of Indexes* is a bi-monthly magazine with a wide variety of information about indexed investing. One of their columnists is Dr. Craig Israelson, a Brigham Young University finance professor. In an article late last year, he compared ETFs (exchange-traded funds) with Vanguard index funds. Now ETFs are mutual funds sold, not directly by mutual fund companies, but bought and sold on stock exchanges, just like shares of IBM or General Motors. ETFs have generally lower prices than regular mutual funds and, so far, all are index products, each ETF portfolio is managed to try to replicate some security index.

I recommend using Vanguard ETFs because (1) Vanguard has a couple of decades of experience in indexing and (2) Vanguard ETFs are ultra low in continuing costs (e.g. the Vanguard Total Stock Market Index ETF has costs of 7/100% per year).

Here is the last paragraph of Israelson's article:

> In summary, our date indicates that while there are certainly differences among individual funds, the differentiating factor is generally not fund structure (ETF or traditional mutual fund), but the management philosophy and execution. In short, Vanguard has demonstrated across this data set, if often only by a whisker, that it can consistently do well on performance. Whether or not that will be the case 20 years from now is anyone's guess, but the data does seem to indicate that it's the case now. At the same time, ETFs generally have demonstrated close tracking and low fees that leave pretty much all other index funds in the dust. These results and this competition can only mean good things for investors.

Smartt comment: low cost wins long-term. An investment that only does "a whisker" better each year, over the decades, will return significantly higher value than one which loses by a whisker each year. We each need an asset allocation which has a reasonably high probability (but not a guarantee) of helping us reach our investment/net worth goals, a broad diversity of investments and, *very importantly, a low cost of investing.*

VI. **Brokerage Firm Discloses "Preferred Mutual Funds" Effects**:

For several months ending earlier this year, the Securities and Exchange Commission had a rule in effect which required brokerage firms to disclose possible conflicts of interest which it had with its clients. The rule, commonly known as "the Merrill Lynch rule", required brokerage firms to state the lack of alignment of the firm's self-interest with its clients' interest.

Alerted to the disclosure of Edward Jones by a fellow investment advisor, I used the internet to find Edwa rd Jones' disclosure. This brokerage firm is often credited with having employees who assist investors to make long-term investments (and not engage in costly, short-term trading).

It took three clicks down into the detail on the Edward Jones corporate website to find a section titled "Mutual Fund Families, Including Information about Our Preferred Fund Families and Revenue Sharing."

Here are some quotes from that website section, italics is mine:

> Edward Jones receives payments known as revenue sharing from the preferred fund families' advisors or distributors…. It's financial advisors and equity owners benefit financially from the receipt of revenue sharing payments from the advisors and distributors of the preferred fund families… *As a result, Edward Jones' receipt of revenue sharing payments creates a potential conflict of interest in the form of an additional financial connection with the sale of the funds from these fund families. Virtually all of Edward Jones' transactions relating to mutual funds involve preferred family funds*….
>
> For the year ended December 31, 2006, Edward Jones received approximately $110 million in revenue sharing payments from the preferred fund families as designated throughout 2006. For that same period Edward Jones' net income was $391 million.

Smartt comment: so getting paid extra to sell mutual funds **MIGHT be a conflict of interest**. It may not be just a coincidence that, therefore, Edward Jones and its representatives sold virtually no other mutual funds. If it had, for example, recommended only Vanguard funds, the profit of the brokerage firm would have been 39% less.

Under protest from the brokerage firm industry, and after being successfully sued by the main organization of financial planners, the SEC set aside the rule.

Most of what Edward Jones calls "revenue sharing", the SEC calls 12(b)-1 fees. The SEC has calculated that $11 billion was taken from the pockets of mutual fund shareholders in the form of 12(b) -1 fees in 2006. Such fees are used by mutual fund families largely to reward brokerage firms and others who sell and/or recommend these mutual funds.

Vanguard is the largest mutual fund family which doesn't pay anyone anything to recommend its mutual funds and ETFs.

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