

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

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I. Jeremy Siegel's Forecast for 2008

Jeremy Siegel is the Wharton School finance professor who has authored several books on the long-term history of financial markets, including the stock market. Here is part of his outlook for 2008, published originally in the February, 2008 issue of *Kiplinger's Personal Finance* magazine:

"Nobody knows for sure what will happen in the coming year, but the demand for predictions is so high that I will throw mine into the ring. Let's start with the economy. There will be no recession in '08. The economy will start the year slowly, with the gross domestic product growing less than 1% in the first quarter (after a similar increase in the last quarter of 2007). By the middle of the year, the economy should begin picking up steam; it should grow 2% to 3% in the second half.

By June, the subprime mortgage disaster will ease. Although delinquencies will have risen, the foreclosure crisis will ebb as most lenders make deals with beleaguered mortgage holders. As the housing crisis eases, the flow of credit will return to more normal levels and lending will revive. However, housing prices will keep falling or remain stagnant at best. Prices of real estate just got too high during the last boom, and down cycles for housing last much longer than they do for the stock market. ...

[Interest] rate movements will closely follow the pattern of economic growth. The fed is likely to lower short-term rates several more times in early 2008 and bring the key federal funds rate down to about 3.5% by midyear. But the pickup in economic activity by the second half of the year will cause the Fed to raise rates again.

Prospects for stocks: Shares should have a good year, returning 8% to 10%. Stocks will rise as economic growth picks up in the year's second half and headwinds from the credit crisis ease. Earnings will take a hit in the first quarter of 2008, but profits will begin to recover by the second quarter. Stocks are reasonably priced against poor earnings. Once earnings increase, stock returns will be considerably better."

Smartt comment: No economist can know the future for sure; all such forecasts are just highly educated guesses. Further, there is no sure, lockstep, relationship between the short-term twists and turns of the economy and the level of prices in the stock market.

While I find Siegel's forecast comforting, I do not rely on it to choose my personal asset allocation, nor to choose yours. Our asset allocations should suit us and be sound for good stock market times and bad. There is just no way to know what will happen to stocks given any set of economic

conditions, tomorrow, next week or next year. Part of the price we pay for the anticipation (but not the guarantee) of significantly higher returns on stocks is to bear the pain, usually temporary, of stock market declines. Just sitting tight also costs nothing, no brokerage fees or other costs for selling and buying.

Further, there is no proven way to use economic data to predict either when is a good time to get out of stocks, or, less obvious but at least as important, to get BACK IN TO stock market investments. So we keep our investment costs low by “staying the course.” Remember: selling when the market is down turns a PAPER loss into a REAL loss!

If you have questions, or wish further discussion, please do not hesitate to contact me. Part of what you pay me for is to provide not only investment advice but reassurance when the road is bumpy.

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, 2007 | Clients | The Smartts |
|---------------------------|--------------|--------------|
| Money Market Funds | 2.0% | 1.1% |
| Bond Funds | 25.8% | 4.4% |
| Stock Funds | <u>72.2%</u> | <u>94.5%</u> |
| Totals | 100.0% | 100.0% |

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

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

| Periods ended December 31, 2007 | Yr.-to-date | 5 Years | 10 Years |
|---|-------------------|-------------------|------------------|
| Total Stock Market Index | 5.5% (49) | 13.8% (24) | 6.1% (31) |
| Tax-Managed Capital Appreciation | 6.1% (43) | 13.9% (23) | 6.7% (25) |
| Tax-Managed Small Capitalization | 0.5% (34) | 16.0% (37) | |
| REIT Index | -16.0 (51) | 17.5% (60) | 10.2 (56) |
| Tax-Managed International | 11.2% (59) | 21.6% (26) | |
| Balanced Index | 4.9% (62) | 10.1% (50) | 6.4% (37) |
| Total Bond Market Index | 6.9% (10) | 4.4% (36) | 5.7% (20) |
| High-Yield Corporate Bond | 2.0% (43) | 7.6% (88) | 5.0% (31) |

For comparison, here are several stock and bond benchmarks:

| Periods ended December 31, 2007 | Yr.-to-date | 5 Years | 10 Years |
|---|--------------|--------------|-------------|
| S & P 500 (large stocks) | 5.5% | 12.8% | 5.9% |
| Russell 2000 (small stocks) | -1.6% | 16.3% | 7.1% |
| Lehman Brothers Aggregate Bond Index | 7.0% | 4.4% | 6.0% |
| CS First Boston High-Yield Index (bonds) | 2.7% | 11.0% | 6.1% |

For 2007, all Vanguard funds performed as expected, capturing the returns of each portion of financial markets, trailing the market by the expense level of the fund.

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. Two Investment Pioneers Talk Investment Basics

In a 1992 paper, Eugene Fama and Kenneth French laid out a new explanation for the real source of stock market returns. A portfolio of stocks provides investment return as of result of three factors. The “three-factor model” posits that there is some return of the general market, that small stocks outperform large cap stocks (principally because they are more risky, fluctuate more broadly), and value stocks outperform growth stocks (because many people “buy the story” of growth companies, an assertion to which I do not subscribe).

Quoted in *The Journal of Indexes* almost a year ago, here these two pioneers weigh in on a number of investment topics:

Journal: What do you think of some of the recent product developments in the financial markets? It seems like there are 200 new psuedo-active indexes and ETFs for every one new broad market fund?

Fama: It will be fascinating to find out how and if these new products actually work, but we don’t have enough data to know yet. It will take a long time for the data to accumulate.

Journal: You said that momentum is the key challenge to market efficiency, and that you can’t explain why momentum exists in the market. Why can’t investors profit from it? Why is it impossible to capture?

French: It’s not impossible to capture. But it’s a high turnover strategy, so the transaction costs associated with it are substantial. I think you can use the information associated with momentum in some situations. But if you try to set up a strategy to just exploit momentum, the trading costs will eat your profits.

Fama: It is by definition a high turnover theme.

Journal: Why is active management so persistent? Why do people keep putting money in something that just doesn’t seem to work?

French: That’s what behavioral finance tells us. People’s perceptions are not consistent with reality.

Fama: They are hopes, not reality. People always think there’s money left on the table. A lot of the problem is caused by the media. If writers took the evidence seriously, they would have a lot less to write about. One of the things I love is the LA Times review of mutual funds, which they run every quarter. And

each quarter, they tell the same story: passive funds beat active funds, again. And you know the lesson they draw from that? That you have to pick your active funds more carefully.”

V. Vanguard’s New International Stock ETF

Vanguard’s FTSE All-World ex US ETF (symbol “VEU”) owns more than 2,000 non-US-based stocks. It began trading in March of last year. It has several advantages over the Tax-Managed International stock fund which I have been recommending to clients for their international, non-U.S., stock allocation for the last five years.

Canadian stocks are included in the new ETF. So are corporations headquartered in developing countries (e.g. China, India, Mexico). The T/M International fund includes neither. The ETF costs 15/100% per year in mutual fund operating costs, a little less than the T/M fund. There are no early exit penalty fees for sale of the ETF (the T/M fund has a 1% exit fee if sold within the first five years of ownership). There is no minimum purchase requirement (T/M has a \$10,000 minimum for the first purchase).

Like all ETFs, the new fund is expected to be tax efficient, to be free, or largely free, of taxable capital gains distributions. I recommend this fund in spite of a couple of caveats: (1) ETFs do not always trade at a price which reflects the exact value of the securities owned by the fund, there can be small premiums or discounts at any time. (2) In order to purchase or sell an ETF one must not only pay a brokerage commission (lower for ETFs than for mutual funds at TD Ameritrade Institutional Services) but, since, at any moment, there is a difference between the bid and asked price, there is a “spread” which must be paid by the buyer and given up by the seller.

All in all, I believe that this ETF is one which should be used for future purchases of international stocks. I’d be pleased to visit with you about your allocation to stocks of companies based outside the US. There are a couple of important tax reasons why such investments should NOT be owned within your IRA or other tax deferred account; ask me if you have questions.

VI. “A Load of Bull”, Survey Faults Broker-Sold Mutual Funds

The January, 2008 issue of the Financial Advisor, a magazine closely identified with the financial planning community, raises the issue of the performance of mutual funds sold, with commissions, by brokers:

“Brokers should add insight to the mutual fund world, but a new study shows that owners of load -carrying mutual funds bought and sold through brokers operating for commissions significantly underperform no load funds because of poor timing decisions and added fees. ...

‘Mutual fund shareholder performance is worse, sometimes much worse, than that of the fund as a whole, and there is a serious flaw in the mutual fund distribution system’, says Mercer Bullard, founder of Fund Democracy and co-author of the study. ‘If you get advice from a broker, you should have less risk. But the gap between investor performance and fund performance as a whole is wider when you rely on a broker. The SEC should require brokers to act on behalf of the investors, but the SEC continues to undermine this. ... Investors in all three principal load-carrying retail share classes significantly underperform when compared to a buy-and-hold strategy,’ the report concludes”

Smartt comment: Another reason to stay away from paying sales commissions; not worth it.

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