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I. Tax-Efficient Equity Investing: a Tale of Two Funds

Vanguard Investment Counseling & Research, a part of the Vanguard Group, the largest mutual fund company, published a research paper last year on tips for minimizing taxation of a mutual fund portfolio. Here are the four conclusions of the paper (*Tax-Efficient Equity Investing: Solutions for Maximizing After-Tax Returns):*

"Because of the relative cost advantage of broad-market index funds/ETFs and tax-managed funds over their actively managed counterparts, their pre-tax performance historically has been in the top half of their respective style categories; for the same time period, their after-tax performance has been in the top 25% of their respective style categories.

Broad-market index funds/ETFs and tax-managed mutual funds' after-tax performance advantages are not time-period dependent but, instead, are enduring owing to these structures' strategy relative to actively managed mutual funds.

Not all exchange-traded vehicles or conventional index funds are the same, from a number of standpoints. Whether considering a multiple-share-class ETF, a stand-alone ETF, or a conventional index fund, the primary characteristics to evaluate are structure, benchmark choice, tracking precision, costs, and tax-efficiency. The best way to compare these investments while taking into account all of these characteristics is to evaluate their longer-term after-tax returns.

So long as cash flows remain positive, broad-market index and tax-managed mutual funds that remain open to cash flow from new investors are likely to be better options than the vast majority of separate-account mandates over long-term holding periods."

Smartt comment: The study's language is a bit dense. What I believe it says is: (1) low cost index funds (and their ETF cousins) wind up beating the investment rates of return of actively managed funds. If you look at what is left after you have paid income taxes on earnings (and capital gains distributions), then index funds/ETFs have an even larger advantage, routinely winding up in the top one-quarter of investments. (2) Index funds/ETFs don't just win the after-tax investment race in some periods, their relative advantage will show itself in any reasonably long time period.
(3) There are many different structures of mutual funds/ETFs and the best way to evaluate them is their long-term (I urge clients to look at the last 10 years, if available) rates of return after income taxes have been paid. (4) Index funds/ETFs also beat separately managed accounts of individual stocks.

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, 2008	Clients	The Smartts
Money Market Funds	2.5%	1.1%
Bond Funds	28.0%	4.6%
Stock Funds	69.5%	94.3%
Totals	100.0%	100.0%

III. Vanguard Rates of Return (through March 31, 2008)

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

Periods ended March 31, 2008	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index	**-9.5%**	(44)	**12.3%**	(26)	**3.9%**	(31)
Tax-Managed Capital Appreciation	**-9.5%**	(47)	**12.2%**	(27)	**4.2%**	(28)
Tax-Managed Small Capitalization	**-7.8%**	(23)	**15.5%**	(28)		
REIT Index	**2.1**	(26)	**17.8%**	(51)	**10.5**	(47)
Tax-Managed International	**-8.3%**	(28)	**21.6%**	(24)		
Balanced Index	**-4.8%**	(17)	**9.3%**	(49)	**5.0%**	(34)
Total Bond Market Index	**2.2%**	(20)	**4.5%**	(21)	**5.8%**	(15)
High–Yield Corporate Bond	**-2.4%**	(19)	**6.2%**	(84)	**4.4%**	(30)

For comparison, here are several stock and bond benchmarks:

Periods ended March 31, 2008	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**-9.4%**	**11.3%**	**3.5%**
Russell 2000 (small stocks)	**-9.9%**	**14.9%**	**5.0%**
Lehman Brothers Aggregate Bond Index	**2.2%**	**4.6%**	**6.0%**
CS First Boston High-Yield Index (bonds)	**-2.7%**	**9.5%**	**5.5%**

For the above periods, 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. <u>Exchange-Traded Funds (ETFs), Another Definition</u>

In the same Vanguard research paper quoted in section I, above, the following definition and description of Exchange-traded funds is presented:

"ETFs are index-based security baskets that trade like stocks. The main difference between ETFs and conventional indexed mutual funds is ETFs trading flexibility. Like stocks, ETFs provide intraday [e.g. during the day] pricing and liquidity…. ETFs furthermore carry very low operating costs that rival, and in some cases beat, the costs of conventional index funds. With these advantages, however, come two additional layers of potential costs. First, as with stocks, a purchaser or seller of ETFs must pay a commission and a bid-ask spread. Second, it is possible, particularly in times of heavy volatility or limited liquidity, for intraday prices to be well below the fund's net asset value (NAV). Conventional indexed mutual funds, on the other hand, trade shares directly with investors at the closing NAV….

Tax-efficiency is another touted benefit of ETFs, owing to the ability of all ETFs to manage capital gains through in-kind redemptions. Unlike some cash redemptions, in-kind redemptions do not generate capital gains for tax purposes. Moreover, in-kind redemptions can actually reduce imbedded capital gains because they allow the fund manager to 'push out' the fund's lowest-cost share lots. As this process continues, more of the fund's portfolio is composed of higher-cost shares. This tax-sensitive accounting technique is also available to conventional index funds.…Since comparable tax-management strategies are available to conventional index funds and ETFs (regardless of structure), the tax-efficiency of like products should be similar."

Smartt comment: Long-term investors, and I urge all to become long-term investors, don't need to worry about the price of a mutual fund share during the day. Being able to buy more shares, or to receive one's investment back, one time per day (as with regular mutual funds), is sufficient. We have better things to do with our time than try to guess what will happen with short-term price movements.

ETFs are important to both tax-deferred (e.g. IRA, and 401k) accounts and regular, currently taxed accounts, because Vanguard offers ETFs which have the exact same investments as many of their regular index funds, but the annual mutual fund expenses are LOWER for the ETFs. This is why they are of interest and importance to us.

If you wonder if you should be considering ETFs for your next investment, or if you are tired of paying both federal and state income taxes on capital gains distributions, we should visit. In order to save future income taxes, it may even be worth paying a bit of income taxes this year.

V. <u>A Decade of Success in Using the Secret to Picking Investments</u>

Looking at the past performance of mutual funds, or any other investment, is often tempting. Before investing one's money, the temptation to say, "How has this investment performed in the past?" is an often overwhelming need. Often those trying to sell investments urge us to use this approach. The trouble with making this your principal method of selecting investments is that past performance is not only no guarantee to future performance, but it is NO GUIDE AT ALL.

If a mutual fund company wishes to grow, it generally establishes several mutual funds, often several with the same general investment objective. By trying to pick winning investments, some of the funds will do better than average, some worse. The company then urges its sales force to sell the better performing funds, and the underperforming funds are simply discontinued. The records of these "lagging funds" disappear, leaving only the better performing funds on the established track record of the mutual fund company.

This method of operation can easily mislead us as investors. The antidote is to pay attention to only two parts of the track record of an investment: (1) what have been its costs and (2) how broadly diversified is it. The rest of past performance, though it may be above average, is neither fully and fairly presented, nor is it relevant to the investment of your next investment dollar.

A more interesting question, one that is not often asked, let alone answered is, “How well did you personally do in picking investments in the past?” How many sellers of investments are willing to tell you what they recommended, what their clients and what they themselves owned 10 years ago? Not many.

The research report quoted in section I, above, also contains the percentile rankings of several broadly based Vanguard stock mutual funds, both before income taxes, and after income tax cost. For the ten years ended March 31, 2007, the percentile ranking of the Vanguard Total Stock Market Index fund was 24, just barely in the top quarter of mutual funds with similar investment objectives. For the same period the ranking of the Vanguard Tax-Managed Capital Appreciation fund was 21. After taxes the percentile ranking of the two funds were, respectively 17 and 13.

What are the chances that the investment, which you purchase today, will, after income tax costs, be in the top 20%, or better, of all similar investments in the next 10 years? I believe my clients have a good chance of being this successful because my clients ten years ago were generally this successful.

At March 31, 1997, I was serving far fewer clients and the amounts invested were a fraction of the dollars being managed today by Financial Counseling & Administration. At that date most of client funds were investment in Vanguard stock mutual funds and tax-managed funds. In fact, **85% of the stock fund investments at that date were invested in the two funds mentioned above, Total Stock Market and Tax-Managed Capital Appreciation.**

How well will we do in the future? I offer no ability to foretell the future of stock market returns. It is my sincere belief that if the lowest cost, broadly diversified, tax-efficient mutual funds and ETFs are used, we will do better than 4 out of 5 investors.

VI. Study Finds Hedge Funds Fail to Help Diversify Portfolios

Investors would seem to have fallen partially out of love with hedge funds, one of the “investment darlings” of the 1990s. Hedge funds were sold as (1) excellent diversification from stocks and bonds and (2) because they took higher levels of risk, could be expected to provide higher rates of investment return. In a study by the Bank of New York Mellon, as quoted in the NAPFA Advisor (Feb, 2008 issue):

“Hedge fund returns are tracking the performance of common stock mutual funds instead of delivering absolute returns independent of the equity market.…Investors have unrealistic return expectations for this strategy. The convergence between hedge fund and stock market returns, combined with inconsistencies in hedge fund classification, could lead to confusion about how the funds should be used in portfolio diversification.…The study also shows that hedge funds are not as volatile as investors fear. As a result, hedge funds contribute little marginal risk to a core equity portfolio. On the other hand, as hedge fund and equity fund returns converge, these vehicles are less effective in diversification.”

Smartt comment: They don’t diversify and their volatility is not as expected—two more good reasons to stay away from hedge funds.

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