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I. Buffett's Advice to the Berkshire Faithful: Buy Index Funds:

An article posted on www.seekingalpha.com, summarizes some of Warren Buffett's recent investment advice:

"We've heard it before. Play the odds and buy the market rather than try to beat it all of the time. But when the man who most personifies the exception to the rule reinforces these views, it's always nice to note.

At the annual meeting for Warren Buffett and his Berkshire Hathaway faithful, thou sands turned out, apparently spurred by mixed economic signals and an interest in hearing the latest from a money manager who truly breaks the mold.

When a shareholder asked for the single best specific investment idea, Buffett could recommend to an individual in his 30s, Buffett said: 'I would just have it all in a very low-cost index fund from a reputable firm, maybe Vanguard. Unless I bought during a strong bull market, I would feel confident that I would outperform...and I could just go back and get on with my work.'

So there you have it...buy index funds (does Warren realize exchange-traded funds are even cheaper and come in a wider assortment)."

Smartt comment: Buffet displays many of the characteristics of a successful investor: patience, discipline and an understanding that investment success is not obtainable without bearing both the positives and negatives of investment risk.

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 June 30, 2008	Clients	The Smartts
Money Market Funds	3.0%	0.7%
Bond Funds	28.2%	4.4%
Stock Funds	<u>68.8%</u>	<u>94.9%</u>
Totals	100.0%	100.0%

III. Vanguard Rates of Return (through June 30, 2008):

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

Periods ended June 30, 2008	Yr.-to-date	5 Years	10 Years
Total Stock Market Index	-10.9 (43)	8.6% (27)	3.5% (34)
Tax-Managed Capital Appreciation	-10.7 (38)	8.6% (26)	3.8% (30)
Tax-Managed Small Capitalization	-7.0% (29)	11.7% (25)	
REIT Index	-3.4% (26)	13.8% (55)	10.4 (57)
Tax-Managed International	11.2% (44)	16.8% (31)	
Balanced Index	-6.1% (28)	6.8% (47)	4.7% (37)
Total Bond Market Index	1.1% (20)	3.8% (17)	5.4% (17)
High-Yield Corporate Bond	2.0% (43)	7.6% (88)	5.0% (31)

For comparison, here are several stock and bond benchmarks:

Periods ended June 30, 2008	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	-11.9%	7.6%	2.9%
Russell 2000 (small stocks)	-9.4%	10.3%	5.5%
Lehman Brothers Aggregate Bond Index	1.1%	3.9%	5.7%
CS First Boston High-Yield Index (bonds)	-1.1%	7.2%	5.5%

For the first half of 2008, 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. Pleased to Provide Additional Disclosure

Registered investment advisors are required by law to provide disclosure, not only when any of the facts of their business change (e.g. move office location, change method for charging fees to clients, etc.). In addition, in spite of the lack of change, advisors **must offer** to provide such **disclosure to all clients** on an annual basis. This is that required offer. My four page Required Disclosure document is available on my website, or by return email, or by return mail. It has not undergone significant change in the last year. If you wish to have a copy, please let me know. This is the first document which a client should receive and if you would like to see a copy, please do not hesitate to request it (even you wish to pass it along someone else whom you believe might benefit from my services!).

In addition to the Required Disclosure, copies of the privacy statement are to be offered annually. Again, there has been no significant change, you may receive a copy via request.

Not required but the object of some pride is my entrance, earlier this year, into full membership of NAPFA, the National Association of Personal Financial Advisors (the “fee-only” association). I take NAPFA’s fiduciary oath annually. You may obtain a copy of this upon request.

Finally, I have a personal code of ethics. If you’d like to see this, just ask.

V. Study Shows Investors Suffer Using Active Load Funds:

From the NAPFA monthly magazine, March, 2008 issue:

“The reported performance of a mutual fund, net of expenses, is generally assumed to represent the performance also obtained by the shareholders of the fund. However, advisors know that in many cases the actual performance experienced by shareholders differs substantially from the performance of the funds in which they invest. This discrepancy arises due to the timing of investor cash inflows.

In theory, investors pay advisors to help them make good timing decisions, or at least to avoid poor timing. That’s one of the reasons that so many investors are attracted to load funds [“load funds” are mutual funds sold along with a sales commission, a sales “load”].

Nevertheless, a new study has found that investors in load funds make significantly worse timing decisions than investors in no-load funds. The study found that mutual fund investors in all three principal load-carrying classes (A, B, and C) experienced worse performance than did investors in pure no-load funds and no-load index funds. In other words, investors in load funds—i.e., those who paid for a broker’s investment advice—actually did more poorly than did investors who didn’t have specialized investment advice.

Entitled ‘Investor Timing and Fund Distribution Channels,’ the study was sponsored by the Zero Alpha Group, an international network of nine independent advisory firms, including several NAPFA members. The study was co-authored by Mercer Bullard, founder and president, Fund Democracy, [a] securities law professor, University of Mississippi [and two other professors from two other colleges].

The data samples were taken from the CRSP Survivor-Bias Free U.S. Mutual Fund Database, and they include domestic common stock funds from 1991 to 2004. The result of the study shows the following:

- Investors in load funds experienced annual returns that lagged the performance of the funds in which they invested by 1.82 percentage points.
- Class B investors, suffered from the poorest cash flow timing, underperforming a buy-and-hold strategy by 2.28 percentage points annually
- Investors in pure no-load funds still struggled with timing, but they underperformed by 0.78 percentage points annually.
- No-load index funds were the only funds that showed no evidence of poor investor timing. Meanwhile actively managed funds severely underperformed index funds based on cash-flow-returns.”

Smartt comment: The contract we share, clients and advisor, is that I do not pretend to be able to provide successful “market timing”; I don’t know which future periods will be better or worse than average. Instead, I counsel (1) investments which are broadly diversified, (2) investments based on the timing of future need for withdrawals, (3) investments which are purchased and then held, *regardless*, until money is needed, for retirement, college educations, etc.

This buy and hold philosophy minimizes costs, including both transaction costs and tax costs, both important drains on the expected returns on investments.

VI. The SEC Looks at Rule 12b-1 fees charged to mutual fund owners.

In the latest year available, a study has shown that the owners of mutual funds were charged \$12 billion. Note that no Vanguard fund or ETF charges these fees. The following is excerpted from the May/June 2008 issue of the *Journal of Indexes*:

“Rule 12b-1 fees pay for fund advertising and distribution services provided by broker-dealers and other intermediaries. The original justification for Rule 12b-1 (approved in 1980) was that it would enable mutual funds to attract new shareholders through advertising and financial incentives to brokers.... It was argued that fund asset growth would benefit shareholders through increased economies of scale and reduced flow volatility. These increased scale economies were supposed to provide shareholders with expense reductions sooner than they would be in the absence of 12b-1 fees.

Mahoney’s (2004) study of mutual funds also provides a summation of the pros and cons...of the use of 12b-1 fees:

‘The mutual fund industry argues that these fees are a means by which investors who purchase through brokers can spread out the broker’s compensation over time rather than bear it all at once in the form of a sales load.’

Critics of 12b-1 fees note that they, unlike sales loads, are not paid directly by the investor in connection with a transaction, but deducted from the fund’s assets. Thus in effect, current shareholders bear the cost of attracting new shareholders. Because the manager has a greater interest in maximizing the size of the fund than do investors, the manager may spend more on marketing than the share holders would prefer.

Conclusion

The stated and objective empirical findings of this study (and others) are generally consistent. There is no evidence that mutual fund shareholders benefit from Rule 12b-1 plans, which provide a serious conflict of interest.

The promise that 12b-1 fees would be used to increase mutual fund assets and thereby lower fund shareholder expenses appears to have been a cynical industry effort to gain SEC approval, while the intended beneficiary was (and is) fund management—and what a bonanza it has been.

The opportunity to prohibit 12b-1 fees, as both abusive and costly conflicts of interest to mutual fund shareholders, will never be better than now. The major question is not whether Chairman [of the Securities and Exchange Commission] Cox is determined to prohibit or drastically change 12b-1 fees for the better, but, rather, if he will be able to prevail over the opposition of the industry and its Washington supporters.”

Smartt comment: The original argument had some merit: charge shareholders a fee which would fund advertising and sales costs. More dollars into the fund would allow fund operating expenses, per \$1,000 invested, to decline. The larger funds would be more stable. But things haven’t worked out that way. The biggest example of the rule NOT working is that there are always dozens of mutual funds which, while they are CLOSED to new investors (e.g. are too big to accept any more new investments), still charge 12b-1 fees to their existing investors.

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