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

Client Newsletter Volume XVI Number 4 February 1, 2009

I. Saving Taxes in 2009 by Contributing *FROM* your IRA:

Many of us have Traditional IRA accounts. After age 70 1/2, in most years, we are required to take a distribution, to withdraw money from the account. The money withdrawn is, generally, taxable income, increases the amount of income tax we pay. In 2009, we are **not required** to take any distribution from our IRAs.

However, it is my recommendation that, if we have a charitable intent, that is, if we are making significant charitable contributions, this is a good place to find the funds.

As has been possible for the last few years, again in 2009, we can request that our IRA trustee send a distribution direct from our IRA to a charity (deemed a "Qualified Charitable Distribution"). Although the money is withdrawn from the IRA, it does not count as taxable income. Making charitable contributions this way converts potential taxable income into a distribution that will **never be taxed**.

Thinking longer term, by reducing assets within our IRA this year, 2009, the value of those assets at the end of this year will be lower, so the amount we will be required to withdraw in future years will also be lower, reducing taxable income in future years.

Since both IRA tax breaks are scheduled to end in 2009, you might consider "doubling up" on charitable contributions; that is making contributions in 2009, from your IRA, which you would ordinarily make in 2010. Speak to your tax advisor/preparor about this. I will be pleased to assist with the forms. You will need both the name and address of the charity.

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, 2008	Clients	The Smartts
Money Market Funds	5.9%	0.2%
Bond Funds	33.3%	4.9%
Stock Funds	60.8%	94.9%
Totals	100.0%	100.0%

Remember each of us has different goals and needs and our asset allocation should fit us and our family.

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

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

Periods ended December 31, 2008	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index	**-37.0**	(39)	**-1.8%**	(32)	**-0.7%**	(37)
Tax-Managed Capital Appreciation	**-37.6**	(52)	**-1.9%**	(35)	**-0.7%**	(38)
Tax-Managed Small Capitalization	**-30.8**	(14)	**1.0%**	(19)		
REIT Index	**-37.1**	(31)	**0.8%**	(39)	**7.1%**	(46)
Tax-Managed International	**-41.3**	(20)	**2.4%**	(27)		
Balanced Index	**-22.2**	(13)	**1.0%**	(20)	**2.1%**	(31)
Total Bond Market Index	**5.1%**	(10)	**4.6%**	(6)	**5.4%**	(10)
High–Yield Corporate Bond	**-21.3**	(22)	**-0.6%**	(33)	**1.9%**	(36)

For comparison, here are several stock and bond benchmarks:

Periods ended December 31, 2008	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**-37.0%**	**-2.2%**	**-1.4%**
Russell 2000 (small stocks)	**-33.8%**	**-0.9%**	**3.0%**
Lehman Brothers Aggregate Bond Index	**5.2%**	**4.7%**	**5.6%**
CS First Boston High-Yield Index (bonds)	**-26.2%**	**0.6%**	**2.9%**

For 2008, all Vanguard index funds performed as expected; capturing the returns of each portion of financial markets, trailing the market by the expense level of the fund.

In a horrible year for stocks, not only did Vanguard's Total Bond Market Index fund, have a positive year, increaing in value by 5.1%, it also beat 90% of similar good quality bond funds. And it has done at least this relatively well, top 10% or better, for the five- and ten-year periods. This fund is indexed to the entire range of Federal government (including federally supervised) and good quality corporate bonds; it tracks the Lehman Brothers Aggregate Bond Index. (With Lehman Brothers "gone", will they rename the index?)

The average junk bond fund declined by more than 26% for the year. Vanguard's High-Yield Corporate Bond fund, which tries not to own the most risky junk bonds (by seeking to own no bonds rated lower than "C") had a big loss, but performed almost 5% better than the CS First Boston Index for junk bonds.

We hold some bonds in our portfolio, not because they make us rich, but to provide an "anchor" for our investments. They do not fluctuate in the same way that stocks do, nor do they fluctuate as much in value. Both of these attributes are handy in troubled financial times. We ought to own at least a five year supply of intended/anticipated spending within bonds. Since we do, we can sell bonds to meet our spending needs for a five year, or longer, period of time while stocks are low in price. This does NOT guarantee that we will not suffer investment losses, but it is expected to significantly lower the probability that we will have to sell stocks to meet our need for cash when stocks are low in value.

Unless we <u>have</u> to sell stocks when they are low in value, we can be content to <u>wait</u> several years for the return of higher stock values.

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>Thoughts on the Madoff Scandal:</u>

Bernie Madoff was a leader in investment circles and was a leader in the regulation of investment advisors/managers. His firm has been registered as an investment advisor, just as my firm is. Mr. Madoff managed more than $25 million so he has been registered with the Securities and Exchange Commission, the SEC. (I manage less than this amount and am registered, instead, with the State of Tennessee).

In Tennessee, registered investment advisors ("RIAs") are **required** to use an independent custodian for client assets. The SEC allows larger RIAs to maintain custody of client assets if and only if the RIA is audited by an independent CPA firm. Madoff's firm was apparently audited, but the CPA firm had only one significant client—the Madoff firm. In this instance, the CPA firm cannot be considered independent. Although the facts are unclear (will be made clearer as a number of court cases proceed), when the SEC auditors came to visit the Madoff firm, they were provided with copies of audit reports which were worthless, they did not represent audit work worthy of the name.

In 44 states, if a CPA firm performs audit work, it's audit practice must be reviewed every three years. This process is called "peer review." This is a significant incentive for the auditor to perform quality audit work, not "just give it a lick and a promise." New York State is one of only six states which **does not require peer review.** Embarrassed by this situation, the New York State Legislature quickly began to pass legislation which would require peer review.

Two big questions arise: (1) Who is at fault? This remains to be seen. Since court proceedings occur indoors, where the temperature is warm in the winter and cool in the summer, we can be assured that the press will cover the Madoff trials in some detail. (2) What should investors do to protect themselves? There are several important answers to this question. Investors should know, for sure, where their money is. Investors should be aware of an auditing principle called "separation of duties." This principle notes that the probability of correct conduct and appropriate accounting is enhanced when more than one party is involved in a transaction, e.g. <u>there is a separation between investment management and investment custody.</u>

A lack of separation of management and custody may be another reason that hedge funds are so risky for investors. A hedge fund which uses a mysterious "black box method" to generate investment gains and which holds custody of client assets may be "a Ponzi scheme waiting to happen."

Users of RIAs are better protected than users of brokers since, at least in Tennessee, RIAs must have an independent custody agent for client assets, but brokers generally use their own firm.

Another way to protect yourself is to assure yourself that the custodian of your investment really is independent and is whom they say they are. Do the statements which you receive appear to be real or were they printed on a 20 year old dot matrix printer (as Madoff statements allegedly were)?

If you have an investment in some business venture and are presented with copies of audit statements, you might consider assuring yourself personally and directly that the audit reports are those generated by an independent auditor of good repute. With 20 years of audit experience, with two of the "Big Eight" audit firms, I'd be pleased to assist you techniques to assure yourself that you are being protected in this regard.

Yet another aspect of the Madoff scandal is the Madoff firm's use of paid referrals. Apparently there were several hedge funds which took client investment dollars and merely turned them over to Madoff, while taking significant commissions for "making the introduction."

Such arrangements are required to be disclosed, in advance, to potential investors. I do this as part of my practice. Without further cost to investors, I provide part of my revenue to CPA firms who refer clients. Clients are notified in both my Required Disclosure and in the Investment Management Service contract we sign. I believe that CPAs do an excellent job preparing individual tax returns, that the satisfaction level of their customers is high. Accordingly, I believe CPA firm tax clients are well served by what I do when done in connection with CPA firm tax consulting and return preparation.

V. Donor-Advised Funds ("DAF")—an Attractive Way of Giving It Away:

A DAF gives an individual or family a flexible, efficient way to manage charitable giving through the use of an intermediary that oversees the fund. The client typically gets immediate tax benefits from donating assets to the fund, while maintaining effective control over decisions on who gets how much from the fund each year. TDAmeritrade, where most of our investment assets are custodied, has a works with the American Endowment Foundation. For a minimum of $100,000 an individual or family can establish a DAF. It can be an important estate planning tool and can assist in involving younger family members in philanthropic goals.

A typical situation is that an investor has a charitable intent, wishes to make contributions now or in the immediate future (not waiting until after death), so that results may be viewed. Payments to charities can be made a bit each year. Charities receiving benefit and the amounts of contributions can be changed at will. An income tax deduction generally occurs when assets are transferred to the DAF, not in the later year of the contribution to the charity. While owned within the DAF the investments continue to be managed for growth of principal and availability of funds to contribute.

A DAF is lower in cost than a private foundation. If you have long term, significant charitable goals, a DAF may be of significant assistance to you and your family. Together with your tax advisor, I'd be pleased to assist. Investments are custodied at TDAmeritrade.