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*Client Newsletter   Volume XVI   Number 2   August 1, 2010*

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**I.     Financial Reform Legislation, Some Effects:**

Passed and signed by President Obama in July, a bill with more than 2,000 pages, calling for more than 500 new studies or sets of regulations, is tough to summarize. So this narrative only addresses a couple of provisions:

First, consumer protection in the area of financial instruments, from bank savings accounts through investment management and advice, should be more consumer friendly, and the consumer should be better protected in future years. Many of the provisions do not take effect immediately. Other protections will only be installed, eventually, depending on the results of a number of future studies commissioned by the legislation itself.

A separate consumer financial protection agency, a very contentious provision of the bill, will eventually be established and should be a force to protect us as we make certain financial decisions, e.g. mortgage financing and refinancing.

Finally, there is a provision which will affect my practice, Financial Counseling & Administration, and will, indirectly, affect you as well. For more than 15 years there has been a separation between the Securities and Exchange Commission (a federal agency) and the individual state agencies, as to which body is primarily responsible for regulation of Registered Investment Advisors and RIA firms. FCA and I are both registered with and regulated by the State of Tennessee. Back in the early 1990s, as I began FCA, I was registered with the SEC. A piece of legislation handed small RIAs from the SEC to individual state regulatory bodies. As I was then managing substantially less than \$25 million of client investments, I began to be regulated by Tennessee.

The importance of this to you, my clients, is that the SEC at the time and still today, though responsible for examining RIA firms, has not been doing very much of it. This lack of examining became a national issue only when, after several SEC visits to Bernie Madoff over the years, visits which did not result in any real examination of him or his investment management firm, we naturally became concerned about both the SEC's competence and its scope of examination of RIAs.

The new law passes back to the states all RIAs managing up to \$100 million of client investments. FCA currently manages more than \$20 million. It appears that I will continue to be regulated by the State of Tennessee for the foreseeable future. The importance of this to you is that Tennessee has an audit function with the announced objective to visit EVERY RIA under its purview

approximately every three to five years. It was this higher level of actual state examination which convinced the Congress to make the states responsible for more RIA examination/regulation.

In 2007 Tennessee established an RIA audit function. I was visited in June, 2008 by the State of Tennessee RIA auditor. It is my understanding (since I did not receive any report as a result of the exam) that these first examinations were the State's way of looking relatively quickly at all firms to determine where the problems might lie. So apparently I "passed", even though I cannot prove it.

Bottom line, I believe you are protected better by my being regulated by Tennessee than if I were passed to the SEC. I'd be pleased to discuss this further.

## 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, 2010	Clients	The Smartts
<b>Money Market Funds</b>	3.0%	1.0%
<b>Bond Funds</b>	33.5%	3.9%
<b>Stock Funds</b>	<u>63.5%</u>	<u>95.1%</u>
<b>Totals</b>	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 Latest Quarter End):

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

Periods ended June 30, 2010	Yr.-to-date	5 Years	10 Years
<b>Total Stock Market Index</b>	-6.0% (23)	-0.3% (35)	-0.8% (42)
<b>Tax-Managed Capital Appreciation</b>	-6.7% (34)	-0.5% (40)	-0.2% (69)
<b>Tax-Managed Small Capitalization</b>	-0.9% (20)	0.9% (41)	5.6% (42)
<b>REIT Index</b>	5.6% (30)	0.5% (35)	9.6% (31)
<b>Tax-Managed International</b>	-13.7 (71)	1.0% (46)	0.2% (36)
<b>Balanced Index</b>	-1.4% (10)	2.4% (24)	2.4% (36)
<b>Total Bond Market Index</b>	5.3% (42)	5.5% (29)	6.2% (32)
<b>Interim-Term Investment-Grade Bond</b>	7.1% (4)	5.5% (29)	6.8% (11)
<b>High-Yield Corporate Bond</b>	3.6% (48)	5.0% (63)	5.4% (63)

For comparison, here are several stock and bond benchmarks:

Periods ended June 30, 2010	Yr.-to-date	5 Years	10 Years
<b>S &amp; P 500 (large stocks)</b>	-6.7%	-0.8%	-1.6%
<b>Russell 2000 (small stocks)</b>	-2.0%	0.4%	3.0%
<b>MSCI EAFE Index</b>	-13.2%	0.9%	0.2%
<b>Barclays Aggregate Bond Index</b>	5.3%	5.5%	6.5%
<b>BofAML US High Yield Master II TR (bond index)</b>	4.7%	7.1%	7.1%

Vanguard mutual funds and ETFs continue to perform as expected.

The BofAML (Bank of America/Merrill Lynch) US HY Master II Trust is the high yield (“junk bond”) index now used by Morningstar, a change from the prior month..

Note that the rates of return for the Vanguard mutual funds in the table above are for the regular class of the fund. E.g. the Total Bond Market Index fund results included are for the regular, investor class fund which has annual operating costs of 20/100%. (Most clients own, instead, the ETF version of the same fund with annual cost of 10/100%--half as much cost.) The Total Stock Market Index fund above has operating costs of 16/100%, but “VTI” the ETF version of the fund has costs of only 7/100%. Thus most clients, through ownership of the lower cost version, earned slightly higher rates of return. Such slight savings in cost compound/multiply as the years roll on. Small differences in operating cost are expected to earn large differences in total investment value over long periods of years.

For some investors there are reasons to continue to own the investor, (higher-cost)class of these funds rather than the ETFs. First, the fund may have increased significantly in value since the purchase and be owned within a regular, currently taxed account. Sale of the fund and purchase of the ETF might cause a taxable capital gain levy. Second, to change from the mutual fund to the ETF costs brokerage commissions, and such commissions, in relation to small holdings, may be high enough to wipe out projected mutual fund cost savings.

I'd be pleased to discuss your situation with you further.

#### **IV. Healthcare Reform Effect on Roth IRA Conversions:**

Passed by the Feds in March, the healthcare reform act contains an additional tax which affects individual taxpayers with relatively high income. Beginning in 2013, there will be a 3.8% tax, (the legislation calls it an additional Medicare contribution), on investment income for individuals with more than \$200,000 of “modified adjusted gross income” or couples with more than \$250,000.

For these taxpayers, the additional levy provides an additional incentive to convert traditional IRA investments to Roth IRAs. For these individuals, income tax rates are almost surely going up so converting some or all of a traditional IRA to a Roth IRA, even though it involves paying income tax on the amount of the conversion, may make sense.

Further, the incentive created (by the additional income tax) is to complete the conversion before 2013. Having a higher income tax bill in 2010, 11 or 2012 will not subject you to the additional 3.8% Medicare levy.

So if you are what President Obama often defines as “high income” and/or if you may be high income in retirement, this issue might affect you.

Note that this additional tax makes more necessary owning investments in the proper account. E.g. some of your investments ought to be in your traditional IRA and/or 401(k), others in a Roth, if you have one, others ought to be owned within a regular, currently taxable account.

Note further that, since capital gains distributions of mutual funds are considered to be investment income, owning mutual funds which are less liable to distribute taxable capital gains (often called

“the December surprise”), is more important than previously. Vanguard index funds and ETFs have, for more than two decades, been almost totally free of taxable capital gain distributions.

As I have mentioned several times in the recent past, such action should be taken **ONLY** after consulting your tax preparator and/or tax counsel. As the last newsletter noted, Roth conversions involve many more issues than just paying “front end” additional income tax (see “15 Roth IRA Conversion Traps” article in last issue).

As of this writing, the “Bush tax cuts” are scheduled to expire. Those of us with *relatively* high income may be paying more income tax when the income tax rates snap back to where they were during the later part of the Clinton Administration. This provides an additional incentive to consider Roth IRA conversions on a timely basis.

I'd be pleased to assist. Contact me if you wish to discuss this further.

#### **V. Staying the Course:**

The last three years have been frankly horrid for investors. (The press has been referring to the last 10 years as the “lost decade” for stock market investors.) We have not only suffered the worst decline in the stock market since 1987, a decline from which markets have only partially recovered, but markets continue to fluctuate in value more than many of us are used to. It's been enough to cause many to panic and sell all stocks, some to even sell bonds in an attempt to sidestep the uncertainty of financial markets.

I have continued to advise clients to change their investments only in response to changes in other aspects of their financial lives. Unemployment, full or partial retirement and other financial changes should cause us to take a second look at the investment risks we are running and to make changes as a result.

Most of us have “stayed the course” in our stock market investments and, from the bottom of the stock market in March, 2009, we have benefited significantly from a recovery in stock prices.

Please accept my thanks for your trust and for carefully considering and accepting most of the advice I have provided. There are no guarantees in the investment world. In order for our investments to have a chance of increasing in value, we have to expose ourselves to investment risk. Accepting these risks comes with **NO** guarantee. When we flee from stock market risk we are probably exposing our financial future to other uncertainties; e.g. inadequacy of retirement income through the effects of future inflation.

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