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

Client Newsletter Volume XVI Number 3 November 1, 2010

I. <u>Financial Reform Legislation, Other Effects:</u>

The August newsletter noted that the Dodd-Frank financial reform bill, passed and signed earlier this year, would have the effect of keeping me a State of Tennessee Registered Investment Advisor ("RIA") until my practice reached $100 million of managed asset size. I also noted that growth of my practice to this size (from more than $20 million then currently) was possible but not probable.

Here are a couple of other effects of the legislation, both of them important:

A. Brochure rule changed

As I began to serve each of you, you were provided with a four page "Required Disclosure" which states certain facts, practices and background of the person (yours truly) and business that would serve you. In addition, if an RIA business wished to do so, it could summarize some of that information into a brochure, and present this "slicker" document to you instead. I have chosen not to go to the expense of producing a brochure, so you received the Required Disclosure. The Dodd-Frank law has changed, a bit, the information which must be disclosed. Effective from early next year, the Required Disclosure and the company brochure are the same. And, amazingly enough, the language in the new brochure is required to be "*plain English*" not legalese. As my Required Disclosure was drafted by me, I believe it to be largely plain English already, so, while important from a regulatory perspective, you should not be surprised by the new brochure. I will distribute it later this year or early next year and will offer it to each of you annually thereafter.

B. TDAmeritrade, our custodian, to begin reporting Cost Basis of security sales to the IRS

If I have been assisting you with a regular, currently taxed investment account, we use TDAmeritrade as our custodian. I have been responsible for calculating the amount of the cost of sales and taxable gain/loss on each transaction, I report this to you in early January, and you pass it along to your tax preparor. Phasing in over the next three years, TDAmeritrade will be calculating cost for us and will be reporting the cost of each sale, from our regular, currently taxed accounts, to the IRS. The purpose of this is to try to further insure that we are paying our fair share of income taxes.

There is some difficulty in the transition, because TDAmeritrade's records to date have assumed the use of a cost basis different than the one I have been using on your behalf. I have been using, generally, the assumption that when a sale has occurred, the most expensive lot purchased is the one which is being sold (so that the amount of taxable gain is lower; revenue from the sale, minus higher cost equals smaller gain [or larger loss]). My method has reduced or deferred income taxes on your behalf. In the next couple of months I will be acquainting TDA with just exactly how I have been doing this and, thereafter, they will be responsible for doing it for us. I will continue to summarize each calendar years worth of taxable transactions and will continue reporting them to you early in each new year.

The method that will be used is known as "HIFO", e.g. sell the highest cost lot(s) first. This may seem unimportant, but the deferral of payment of income taxes is an important topic. And the more income you have, the more important is the topic!

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 September 30, 2010	Clients	The Smartts
Money Market Funds	2.4%	1.7%
Bond Funds	32.0%	3.7%
Stock Funds	65.6%	94.6%
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 Latest Quarter End):

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

Periods ended September 30, 2010	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index	**4.9%**	(20)	**1.1%**	(33)	**0.3%**	(40)
Tax-Managed Capital Appreciation	**4.1%**	(29)	**0.8%**	(39)	**-0.9%**	(68)
Tax-Managed Small Capitalization	**8.6%**	(47)	**1.7%**	(44)	**6.1%**	(42)
REIT Index	**19.4%**	(33)	**2.3%**	(33)	**10.2%**	(29)
Tax-Managed International	**1.5%**	(65)	**2.2%**	(46)	**2.7%**	(38)
Balanced Index	**6.3%**	(23)	**3.5%**	(26)	**3.0%**	(38)
Total Bond Market Index	**5.3%**	(42)	**5.5%**	(29)	**6.2%**	(32)
Interim-Term Investment-Grade Bond	**12.3%**	(4)	**6.7%**	(18)	**7.0%**	(10)
High–Yield Corporate Bond	**10.4%**	(45)	**6.2%**	(57)	**5.9%**	(65)

For comparison, here are several stock and bond benchmarks:

Periods ended September 30, 2010	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**3.9%**	**0.6%**	**-0.4%**
Russell 2000 (small stocks)	**9.1%**	**1.6%**	**4.0%**
MSCI EAFE Index	**1.1%**	**2.0%**	**2.6%**
Barclays Aggregate Bond Index	**7.9%**	**6.2%**	**6.4%**
BofAML US High Yield Master II TR (bond index)	**11.8%**	**8.3%**	**7.8%**

Vanguard mutual funds and ETFs continue to perform as expected.

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.

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

IV. Using Morningstar “Star Ratings” or Expenses to Pick Funds?:

The largest provider of mutual fund information is Morningstar. I use it to report your mutual fund (a) rates of return and (b) percentile rankings to you. Morningstar rates mutual funds using a star system, the more stars, it implies, the better the mutual fund. For almost 20 years it has been my position that low expenses are the only attribute of a mutual funds past performance that is worth considering (because the rest of past performance will probably not be repeated).

The *Morningstar Advisor*, in its October/November 2010 edition compares the predictive power of fund expenses versus their star ratings. Here are quotes from the article titled “How Expenses and Stars Predict Success”:

“Investors should make expense ratios a primary test in fund selection… The study looked at how expense ratios and the Morningstar Rating for funds predict future performance.

The study found that expense ratios are strong predictors of performance**. In every asset class over every time period** [emphasis added], the cheapest quintile of funds produced higher total returns than the most expensive quintile.

Perhaps the most compelling argument for [low] expenses is that they worked every time—because costs always are deducted from returns regardless of the market environment, ‘ says Russell Kimmel, Morningstar’s director of mutual fund research.”

Smartt comment:

Cynics might ask why Morningstar does not give greater day-to-day emphasis to mutual fund expenses if they are a better predictor than the company’s own star system. Those of us who use Vanguard’s ultra-low-cost indexed mutual funds, and even lower costs indexed ETFs, often feel like we know a secret that the majority of the financial press ignores: Low Cost Wins!

In Vanguard’s recent magazine advertising, they quote the Morningstar study cited above.

V. Dodd-Frank Wall Street Reform Act Humor:

Although there has been little to cheer about as a result of the various financial messes in the last three years, here is a humorous “Insider’s Guide to Financial Reform” published in the September/October 2010 issue of the *Journal of Indexes*:

“Weighing in on at over 2,100 pages, the new Dodd-Frank Wall Street Reform and Consumer Protection Act is a staggering achievement in verbosity, even by congressional standards.

The new law is stuffed with hundreds of technicalities and loopholes that will take decades of man-hours and a mountain of Adderall to figure out. But never fear! Ever since DFWSRACPA hit—and broke—the office desk, we’ve had our crack forensics team her at *JOI* poring over the new law to find its most important—and overlooked—provisions:

- Prop. trading, or the practice of banks trading securities for their own profit, has been banned. Banks may still trade securities for their own account, but only if they do so at a loss.
- To help consumers get back on their feet, their cars will be repossessed.
- The first-time homeowner tax credit will now be permanent, and redeemable in Chinese yuan.
- Tense last-minute negotiations led to the ‘Jersey Shore Compromise,’ which gives the Commodity Futures Trading Commission oversight over pickle futures and hair gel options but not spit swaps.
- Due to an unfortunate typo, the Office of Financial Literacy is now the Office of Financial Liberace. Its focus will include credit education, retirement planning and sequins.
- Over-the-counter swaps must now go through Publishers Clearing House. No word yet if you are already a winner.
- The new ‘consumer watchdog agency ‘ actually consists of only one man: a [guy] named Tony with a bulldog tattoo.
- A new Financial Services Oversight Council will monitor the markets for troubled businesses, identifying potential threats and labeling them with Parental Advisory Stickers. Members will include, Tim Geithner, Tipper Gore, Gordon Gekko and the South African Young Men’s Vuvuzela Choir.

The financial reform isn’t perfect, of course. As critics have often pointed out, the new regulations do not address the government’s role in the crisis, and do nothing to fix the still-troubled Freddie Mae and Fannie Mac. But the law does tighten restrictions on the biggest contributors to the 2008 credit crisis: the student loan industry, Congolese miners and that FreeCreditReport.com guy. So readers can rest assured that the new regulations will protect all of us from another financial crisis—or at least a lack of pickles.”

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