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I. Book Review and Some Thoughts

Recommended by my principal weekly newsmagazine, *The Economist*, I have just completed reading the 622 pages of Why the West Rules—For Now: The Patterns of History, and What They Reveal About the Future. The book is a very detailed telling of human history, not just since the Industrial Revolution, or since year 1 AD, but all the way back to the beginning of our race in Africa thousands and thousands of years ago. The author, Ian Morris, is an archeologist.

He is not a proponent of the "great man" theory of history which holds that events are mainly the result of great (and not so great) rulers, leaders and inventors. Instead, he says that geography and climate are largely determinative of what has happened and will happen.

The last sixty pages of the book contain his predictions of our future. The West (The Americas, Europe and part of the Middle East) will be reduced in relative economic power as China continues to emerge as both an economic and a military power. He calls Africa, the Middle East and the area east through India to Southeast Asia, "The Arc of Instability." In this region, economic hardship, political and religious movements have the power to disrupt progress of the rest of the world. Whether the world will continue to "muddle through" after a more than 200 years of rapid progress since the Industrial Revolution, or whether social development and civilization will decline is, for him, an open question. He presents alternatives, some optimistic, some decidedly not.

The book is a very long read, quite comprehensive, and thought provoking. My take is that we need to stay informed and active. Financially, it wouldn't be a bad idea to increase our level of savings for possible, various "rainy days" ahead.

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, 2010	Clients	The Smartts
Money Market Funds	2.5%	1.4%
Bond Funds	29.4%	4.2%
Stock Funds	68.1%	94.4%
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 December 31, 2010	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**17.3%**	(12)	**3.1%**	(25)	**2.5%**	(27)
Tax-Managed Capital Appreciation	**15.9%**	(19)	**2.5%**	(37)	**1.5%**	(43)
Tax-Managed Small Capitalization	**26.0%**	(46)	**4.7%**	(40)	**7.6%**	(37)
REIT Index Admiral	**28.5%**	(30)	**3.5%**	(22)	**10.7%**	(29)
Tax-Managed International	**8.4%**	(68)	**2.8%**	(44)	**3.6%**	(35)
Balanced Index Admiral	**13.3%**	(24)	**4.6%**	(21)	**4.2%**	(28)
Total Bond Market Index Admiral	**6.5%**	(70)	**5.8%**	(35)	**5.7%**	(36)
Interim-Term Investment-Grade Bond	**10.5%**	(10)	**6.2%**	(22)	**6.4%**	(14)
High–Yield Corporate Bond	**12.4%**	(85)	**6.3%**	(71)	**6.4%**	(75)

For comparison, here are several stock and bond benchmarks:

Periods ended December 31, 2010	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**15.1%**	**2.3%**	**1.4%**
Russell 2000 (small stocks)	**26.9%**	**4.5%**	**6.3%**
MSCI EAFE Index	**7.8%**	**2.5%**	**3.5%**
Barclays Aggregate Bond Index	**6.5%**	**5.8%**	**5.8%**
BofAML US High Yield Master II TR (bond index)	**15.2%**	**8.8%**	**8.6%**

Vanguard mutual funds and ETFs continue to perform as expected.

The High-Yield Corporate Bond fund takes less risk than the average "junk bond" fund and, accordingly, its investment return departs from that Morningstar fund category. I believe such bonds are an appropriate diversification for most clients and continue to be satisfied with this fund. Note that, with a second great year of returns, high yield ("junk") bonds have now significantly out-performed good quality bonds, for the latest year, the latest five-year and the latest ten-year period.

Another good year of stock market returns now means that for the last five and ten years, though not performing as well as stocks have historically, they are at least positive. In order to meet our long term financial objectives, most of us must bear some stock market risk.

Note that most of the rates of return for most the Vanguard mutual funds in the table above are for the regular class of the fund. Many clients own, instead, the ETF version or the Signal or Admiral version of the same fund with even lower annual costs. Thus most clients, through ownership of the lower cost version, earned slightly higher rates of return. Such slight savings in cost compound/multiply over the years. 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. Past is No Guarantee of Future Investment Performance—Fidelity Magellan?

For more than a decade this stock mutual fund was a star. Its manager, Peter Lynch, beat the stock market averages most years for an extended period of time and Magellan grew to be the largest mutual fund in the world. The latest issue of the *Morningstar FundInvestor* notes that another of Lynch's successors is not doing so well. Whereas over the last four years growth stocks have performed slightly better than the S&P 500 Index, about 5% better in total, Magellan has lagged the index by 8%. This underperformance has resulted in investors withdrawing from the fund so that, at $23 billion, it is only half as large as it was four years ago.

Contrast that with the various classes of Vanguard's Total Stock Market Index fund. This fund/ETF is now the largest mutual fund and, with other index funds and ETFs has gained market share since the market crash three years ago. Owning more than 3,000 stocks and costing, in the ETF version, as little as 7/100% per year in operating costs, this has been my recommendation and my largest personal holding for more than 15 years. The fund does not try to pick winners, it just owns a gigantic sample of all available US stocks, owned in proportion to their market size. It is truly diversified.

V. The U-bend of Life, Why Beyond Middle Age, People Get Happier

This is the title of an article in the December, 18, 2010 issue of *The Economist*. Here are some excerpts:

> Ask people how they feel about getting older, and they will probably reply in the same vein as Maurice Chevalier: 'Old age isn't so bad when you consider the alternative.' Stiffening joints, weakening muscles, failing eyesight and the clouding of memory, coupled with the modern world's careless contempt for the old, seem a fearful prospect—better than death, perhaps but not so much. Yet mankind is wrong to dread ageing. Life is not along slow decline from sunlit uplands toward the valley of death. It's rather, a U-bend.
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> When people start out on adult life, they are, on average, pretty cheerful. Things go downhill from youth to middle-age until they reach a nadir commonly known as the mid-life crisis. So far, so familiar. The surprising part happens after that. Although as people move towards old age they lose things they treasure—vitality, mental sharpness and looks—they also gain what people spend their lives pursuing: happiness.
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> This curious finding has emerged from a new branch of economics that seeks a more satisfactory measure than money of human well-being. Conventional economics uses money as a proxy for utility—the dismal way in which the discipline talks about happiness. But some economists, unconvinced that there is a direct relationship between money and happiness, have decided to go to the nub of the matter and measure happiness itself.
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> Ask a bunch of 30-year-olds and another of 79-year-olds (as [three professors] of the Sanford School of Public Policy at Duke University) which group they think is likely to be happier, and bot lots point to the 30-year-olds. Ask them to rate their own well-being and the 70-year-olds are the happier bunch.
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> People, studies show, behave differently at different ages. Older people have fewer rows [quarrels] and come up with better solutions to conflict. They are better at controlling their emotions, better at accepting misfortune and less prone to anger.

There are other possible explanations [for the U-bend of happiness]. Maybe the sight of contemporaries keeling over infuses survivors with a determination to make the most of their remaining years. Maybe people come to accept their strengths and weaknesses, giving up hoping to become chief executive, or having a picture shown in the Royal Academy, and learn to be satisfied as assistant branch manager with their watercolour on display at a church fete. 'Being an old maid,' says one of the characters in a story by Edna Ferber, an (unmarried American novelist), was 'like death by drowning—a really delightful sensation when you ceased struggling.' Perhaps acceptance of aging itself is a source of relief. 'How pleasant is the day' observed William James, an American philosopher, 'when we give up striving to be young—or slender.'

Whatever the causes of the U-bend, it has consequences beyond the emotional. Happiness doesn't just make people happy—it also makes them healthier. John Weinman, professor of psychiatry at King's College London monitored the stress levels of a group of volunteers and then inflicted small wounds on them. The wounds of the least stressed healed twice as fast as the most stressed. At Carnegie Mellon University…Sheldon Cohen infected people with cold and flu viruses. He found that happier types were less likely to catch the virus, and showed fewer symptoms of illness when they did. So although old people tend to be less healthy than younger ones, their cheerfulness may help counteract their crumbliness.

The ageing of the rich world is normally seen as a burden on the economy and a problem to be solved. The U-bend argues for a more positive view of the matter. The greyer the world gets, the brighter it becomes.

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