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I. *The Economist's* Take on the Risks of Owning Real Estate

The more I read *The Economist Magazine*, and I try to read it almost cover-to-cover each week, the more I am challenged by its content, its advice. Here are excerpts from an analysis of real estate (the Brits call it “property”) as an investment from the March 5, 2011 edition:

Property is widely seen as a safe asset. It is arguably the most dangerous of all.

Property moves in cycles and the more ambitious the scale of construction on the way up, the steeper the drop on the way down. A sharp turn in the property cycle is a serious matter. The five big banking blow-ups in the rich world before the latest crisis (Spain in the 1970s, Norway in the 1980s and Sweden, Finland, and Japan in the 1990s) had property at their heart. Banking crises in the developing world have also tended to happen at the peak of housing booms or just after a bust in prices.

Why is property so dangerous? One obvious answer is the sheer size of the asset class. The aggregate value of property held by American households in the peak year of 2006 was \$22.7 trillion, their biggest single asset by a wide margin (pension-fund reserves were next, at \$12.8 trillion).... When credit conditions loosen it is likely to absorb a lot of the extra liquidity; and when something goes wrong the effects will be serious.

With only a small sliver of their own capital to protect them, many owners were quickly pushed into negative equity when property prices fell. As borrowers defaulted, the banks' losses started to erode their own thin layers of capital. ‘Banks are leveraged and property is leveraged, so there is double leverage,’ says Brian Robertson, who... used to be [a] bank's chief risk officer. ‘That is why a property crash is a problem for the banks.’

As prices rise, property is arguably more likely than many other asset classes to encourage speculation. One reason is that property is so much a part of everyday life. People do not gossip about the value of copper and tin, but they like to talk about how much the neighbor's house went for. They watch endless TV shows about houses and fancy themselves as interior designers, able to raise the price of their home with a new sofa and artful lighting. Eventually the temptation to take a punt [e.g. a bet] on property becomes overwhelming.

An analysis of relative returns from home-ownership and a portfolio of other investment assets, by [two university professors] suggests that for most of the past 30 years it would have made economic sense for Americans to rent rather than buy.

Political rhetoric in favor of home-ownership has fallen silent. Other countries have achieved the same or higher rates of ownership as America without destructive government subsidies. Plans to wind down Fannie Mae and Freddie Mac, the government-sponsored mortgage giants, are now on the table. If more people rent, house prices should become less volatile.

Smartt comment: Most of us have significant investments in our home, and will continue to do so, not as investment but as part of our way of living. Home ownership represents stability, in the same way that renting represents flexibility. But another of the tough lessons learned in the last four years of financial unpleasantness is that homes are not uniformly positive investment assets.

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 March 31, 2011	Clients	The Smartts
Money Market Funds	1.2%	1.5%
Bond Funds	32.4%	4.0%
Stock Funds	<u>66.4%</u>	<u>95.5%</u>
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 March 31, 2011	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	6.4%	(27)	3.2%	(24)	4.5%	(20)
Tax-Managed Capital Appreciation	6.3%	(29)	2.9%	(30)	3.8%	(33)
Tax-Managed Small Capitalization	7.7%	(53)	3.7%	(44)	9.2%	(32)
REIT Index Admiral	6.5%	(37)	2.2%	(19)	11.6%	(32)
Tax-Managed International	3.1%	(46)	1.6%	(43)	5.5%	(34)
Balanced Index Admiral	3.9%	(43)	4.8%	(19)	5.3%	(24)
Total Bond Market Index Admiral	0.3%	(86)	6.0%	(39)	5.4%	(46)
Interim-Term Investment-Grade Bond	1.0%	(48)	6.6%	(21)	6.1%	(16)
High-Yield Corporate Bond	3.6%	(56)	6.7%	(69)	6.3%	(75)

For comparison, here are several stock and bond benchmarks:

Periods ended March 31, 2011	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	5.9%	2.6%	3.3%
Russell 2000 (small stocks)	7.9%	3.4%	7.9%
MSCI EAFE Index	3.4%	1.3%	3.5%
Barclays Aggregate Bond Index	0.4%	6.0%	5.6%
BofAML US High Yield Master II TR (bond index)	3.9%	9.0%	8.4%

Vanguard mutual funds and ETFs continue to perform as expected.

Note that most of the rates of return for several of 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 will compound over the years. Small differences in operating cost are expected to result in large differences in total investment value over long periods of years. I'd be pleased to discuss your situation with you further.

IV. Is that iPad 2 Really Worth \$2,000?

I'm proud of Janet, my daughter. She got her MBA two years ago and is currently taking the Certified Financial Planner preparation courses at University of California a Berkeley (as well as working full time teaching larger businesses south of there how to further their recycling efforts). She sent this article to me from the March 30, 2011, online edition of *SmartMoney*:

When someone asks me if I've changed my mind yet and want one of Apple's new Ipads, I tell them, 'Well, even if I did, I probably wouldn't want to spend \$2,000 on one.'

They generally look at me baffled, 'What do you mean, \$2,000? I thought they started at \$500. But I figure \$2,000 is the minimum that Steve Job's new toy is going to cost me. How come?'

Simple. If I don't spend that \$500, I'll invest it. Historically, the stock market has produced average long-term returns of maybe 5% a year above inflation [really closer to 7%]. At that rate, in 10 years' time my \$500 will have grown to about \$800. That's in today's dollars—after inflation. In 15 years it'll be about \$1,000, and in 30 years, \$2,000.

I figure I'll be retiring in about 30 years, which is when I'm going to need lots of capital. I can have the iPad now, or about \$2,000 then.

Thanks, but I'll take the \$2,000.

As you can imagine, I get some funny looks when I tell people how I think... I'd argue that it's the conventional 'here and now' thinking about money that's ridiculous... It doesn't reflect the fundamental truth about our lives. We're short of capital... If you're like most people, you're going to have less money over the course of your life than you'd like... One way or another, you are already rationing your capital across your lifespan, whether you realize it or not.

If you choose to spend a dollar today, you are actively choosing not to have four dollars, or six, or even eight later.

Smartt comment: How many thousands of times have I said, generally to my kin, “You can spend it once or you can save and invest it and it will begin paying you, forever.” The above does not always represent Janet’s way of thinking about consumption versus investment, but in many respects “the apple hasn’t fallen far from the tree.” I am pleased with her instincts.

V. Book Review – Fault Lines

Dr. Raghuram Rajan, is the former chief economist of the International Monetary Fund. He is one of the very few economists who warned of the global financial crisis before it hit. He shows how individual choices that collectively brought about the economic meltdown—made by bankers, government officials, and ordinary homeowners—were rational responses to a flawed global financial order in which the incentives to take on risk are seriously out of date with the dangers those risks pose.

He really is not able to be pigeonholed as a liberal, moderate or conservative, either socially or politically. He believes that government regulation is often wrong, that right regulation is difficult to bring into being. He believes that the housing/mortgage crisis was a result, in some important respects, of the end of our national lead in education several decades ago, as well as of the US’s relatively weak safety net. With declining relative incomes, many of our citizens became unhappy, and promising easier access to housing (at low mortgage interest rates) was the political solution to that discontent.

I find the book troubling as solutions to such large problems, not just in the US, but worldwide, are never every easy. On the other hand, even with his pessimism, he is hopeful:

Governments have to do more to help their citizens build capabilities that will allow them to be productive. But they also have to step back in other areas to allow the market to function effectively. This crisis has resulted from a confusion about the appropriate roles of the government and the market. We need to find the right balance again, and I am hopeful we will.

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