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FINANCIAL COUNSELING & ADMINISTRATION

Registered Investment Advisor

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I. Short-term vs. Long-term and Important vs. Relatively Unimportant

Most of our investment objectives are medium- or long-term. Most of the investments we own are to be used in our retirement, a retirement expected to last for decades. If we are a bit older, then, in addition to retirement, we plan and hope that some our investments will last longer than we do, will be passed down as a legacy to our children, and/or to various good causes, our church, our university.

Because our objectives are long-term, our investments are chosen for their long-term potential earning power ("potential", not "guaranteed"). Some of us are already retired and are withdrawing from our investments to help finance our lives and so some of our investments need to be short-term or medium-term. Generally, we all have at least five years of probable, anticipated withdrawals from our investments owned in the form of bonds, not stock. If the stock market goes down in value and stays down for several years, we will be selling bonds to finance withdrawals from our investments, we will not have to sell stock.

As I write this early on the morning of August 1st, the television news reports are that the leadership of the two houses of the US Congress has reached a compromise which will probably result in the needed increase in the federal government debt limit. So **perhaps** the uncertainty has abated. But think back over the last several weeks; the news has been filled with dire predictions about what might happen if the debt limit were not to be raised. More than just one or two of you have contacted me with these concerns.

I believe that this issue, the federal debt limit, is a short-term concern. As I mentioned in the July 1st cover letter which accompanied the June 30th quarter ending report, such concerns were expected, and did lead to fluctuations in the market values of stocks and bonds (and there could be more significant fluctuations as markets react to this continued uncertainty). My point continues to be that we have very little need to worry about the federal debt limit because this is a **short-term** issue. Whatever happens, how ever badly the Congress and the President have acted and will continue to act, this issue will not be of importance 2, 3, 4, or 5 years from now.

Yes, it's o.k. to keep up with the news. But most of the news, as dire as it may seem, is of short-term issues and we are invested, mainly, for the long-term.

Please feel free to contact me with your concerns. I am not as happy with our federal government's leadership currently as I have been for many years. This is not a political statement. For decades I had more of a belief in our federal system than I do now. I am discouraged by all the political posturing; it seems to have increased in the last few years, and in the last couple of decades. But, note well, that this does not alter my outlook for investing. The corporate/capitalist system in our country has tremendous momentum which is not reliant on what the federal government does. In spite of, for example, the very slow pace of the recovery of our economy (after the biggest shock since the Great Depression of the 1920s-30s), corporate profits have rebounded quickly. And it is corporate profits and the outlook for future profits which are the major determinates of the price of stocks.

Many of us are bothered by the high levels of unemployment, both as reported by the official statistics and as experienced in our families and among our friends. Our investments are much more dependent, for their value and future prospects on the economy and the health of corporations, not on the health of government or the level of employment.

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, 2011	Clients	The Smartts
Money Market Funds	1.4%	0.6%
Bond Funds	32.3%	4.3%
Stock Funds	66.3%	95.1%
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 June 30, 2011	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**6.3%**	(29)	**3.6%**	(24)	**3.8%**	(20)
Tax-Managed Capital Appreciation Admiral	**6.5%**	(27)	**3.4%**	(27)	**3.1%**	(32)
Tax-Managed Small Capitalization	**7.7%**	(30)	**4.7%**	(35)	**7.8%**	(31)
REIT Index Admiral	**10.3%**	(45)	**3.0%**	(22)	**10.7%**	(33)
Tax-Managed International Admiral	**5.2%**	(30)	**1.8%**	(49)	**5.8%**	(31)
Balanced Index Admiral	**4.9%**	(24)	**5.2%**	(18)	**4.9%**	(30)
Total Bond Market Index Admiral	**2.5%**	(68)	**6.5%**	(37)	**5.5%**	(40)
Interim-Term Investment-Grade Bond	**3.3%**	(24)	**7.2%**	(20)	**6.3%**	(16)
High–Yield Corporate Bond	**4.9%**	(21)	**7.1%**	(61)	**6.7%**	(75)

For comparison, here are several stock and bond benchmarks:

Periods ended June 30, 2011	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**6.0%**	**2.9%**	**2.7%**
Russell 2000 (small stocks)	**6.2%**	**4.1%**	**6.3%**
MSCI EAFE Index	**5.0%**	**1.5%**	**5.7%**
Barclays Aggregate Bond Index	**2.7%**	**6.5%**	**5.7%**
BofAML US High Yield Master II TR (bond index)	**4.9%**	**9.2%**	**8.8%**

Vanguard mutual funds and ETFs continue to perform as expected. Although of interest, I don't spend a lot of time with the "year-to-date" percentile rankings. I pay a lot more attention to the 10 year rates of return and the 10 year percentile rankings. I expect that each Vanguard fund or ETF will be in the top 1/3, the top 33rd percentile for each 10 year period. This is not because Vanguard has good stock pickers (most Vanguard funds/ETFs used are indexed, where stock picking is irrelevant). The relatively high long term performance of Vanguard funds/ETFs is, rather, a function of their extremely low costs, relative to other funds.

For example, according to Morningstar, at June 30, 2011, the average "Large Blend" stock mutual fund ("blend" means containing both large capitalization growth and value stocks) had annual costs of 1.17%. The Vanguard Tax-Managed Capital Appreciation (Admiral class) fund had annual costs of 0.12% and the Total Stock Market Index (Admiral class) fund had annual costs of 0.06% (the Exchange Traded Fund [ETF] class of the same fund, which more of us own, also had annual costs of 0.06%). These very low costs produce relatively high rates of return. Low cost beats high cost, and the longer the period of time under consideration (say 10 years), the more confident we can be that this will happen.

So I expect the Vanguard investments to be in the top 1/3 in each 10 year period. But that's not quite the "end of the story." After income taxes are considered (and Morningstar uses top federal income tax rates, and no state income taxes in its calculations), I anticipate that each **stock fund/ETF** will be in the top 25th percentile. Since Vanguard broadly diversified, indexed funds/ETFs have, in the past, been free of capital gains declarations, the tax on capital gains of the funds/ETFs is deferred until you, the investor, sell at a gain, which may be years later. The ability to defer recognition of such gains aids in the compounding of investment returns.

So Vanguard investments ought to be in the top 1/3 before taxes based on low cost and they ought to be in the top ¼ (stock funds) after income taxes.

Looking at the actual 10 year percentile returns on the page above, note that there are 2 funds which are not in the top 1/3 for the last ten years. I believe that the reason that the High Yield Corporate Bond fund ("Vanguard's 'good' junk bond fund") is not in the top 1/3 is because it takes significantly less risk than the average junk bond fund. It tries to own no bonds rated below "C". In average times, since it takes less risk, it is expected to earn a lower level of return. I ascribe its high year-to-date ranking to a higher level of uncertainty in the bond market than usual (presumably caused by the uncertainty surrounding the possible federal government default). Other junk bond funds, taking more risk, are considered to be more exposed to present uncertainties in the bond market.

The Total Bond Market Index fund's percentile rankings for this year so far are below average (68th percentile) which I ascribe to its heavy relative level of investment in federal government bonds (and the bonds of federal government supervised entities). The debt limit uncertainties are presumed to be depressing the prices of federal government bonds. Other similar funds have moved away from federal government bonds and, for the short-term, have performed better. But note that, for the 10 year period, this fund has performed just 0.2% per year lower than the Barclays Aggregate Bond Index. The Vanguard fund is indexed to this specific index. Over the last 10 years, the annual cost of the Vanguard fund, between 0.10% and 0.20%, make up most of the under-performance.

IV. Another Way of Viewing the Importance of Investment Costs

In Section III above I mentioned the relatively low costs which characterize Vanguard funds/ETFs. In the May 16th issue of *Investment News* I found a unique way of thinking about investment costs. An investment manager in Virginia has calculated that over the 45 years in which a person would be working and saving for retirement, a 0.01% difference in return on investment, that is a 1/100th percent difference each year, would result in a change in the retirement date of the person by 25 days. By merely reducing the cost of your investments by that very small amount each year, you can retire almost one month early.

The difference between paying someone else 1% per year to manage your investments versus the ½ % per year which I charge thus ought to result, if you wish to do so, in your being able to retire, 3+ years earlier. Note that this is not a guarantee. Further, for most of you, you began to allow me to assist you after you had begun your working life, the full 3+ year effect may not present itself.

This analysis is another example of the importance of investment costs and why, for example, I don't try to predict the short-term future of the stock market, or the various bond markets. To jump in and out of investments doesn't generally produce above average returns, it just drives up costs, trading costs and income tax costs.

V. "Mattress" Investors Missed Rebound

An article in the April 11th issue of *Investment News* states:

> "If the financial downturn scared people into holding cash or other capital-preserving investments during the past few years, they should be aghast at seeing what they missed out on as the equity markets rebounded.
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> A recent revisiting of a 2009 study by the National Center for Policy Analysis [NCPA] showed that fearful investors who liquidated their equity [e.g. stock] holdings during the heart of the recent economic downturn would have been far better off staying in the market. Many investors felt the need to stash their money away in a bond fund, a money market account, or under the mattress, so to speak, but this strategy preludes the opportunity to buy shares at low prices.
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> 'Panic stock selling is a normal reaction by investors when markets turn jittery, but it can cost investors thousands of retirement dollars,' said Pam Villarreal, a senior policy analyst at the NCPA. 'If investors do sell, even if it's to stash their cash under the mattress, the sooner they return to stocks, the more money they will have for retirement.'"

Smartt comment: An important part of the service for which you compensate me is to assist you to avoid panic in the face of short-term concerns when your investments have medium- and long-term objectives to fulfill. You should not ever hesitate to contact me to discuss your concerns.

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