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I. Changing My Personal Stance on Social Security Benefits

My father's road racing career has probably come to an end. At age 92 he had a fall during a 5k race here in Knoxville in October. He has decided, at least at this date, not to enter any more road races. His muscles work just fine but he doesn't see very well and he has concerns about his balance. And so Knoxville, at least for a while, has lost its only runner still competing in his 90s.

Yes, I believe I have been endowed with VERY good genetics. As a result, I have always told myself that I had planned to begin accepting Social Security benefits at age 70. By delaying accepting benefits, I would earn an 8% higher benefit for each year I wait after my "full retirement age" (age 66 for me).

I began receiving my Social Security benefit in September, about three years earlier than I had planned. The change in strategy has nothing to do with my health. About two months ago, I began to believe that the stock market was valued so low in relation to the earnings of corporations, that I am now taking my SS check and am investing it through my 401k plan in (1) additional purchases of Vanguard's lowest cost, most diversified US stock fund and (2) my first ownership of Vanguard's High–Yield Corporate Bond fund.

I am not claiming any ability to forecast the future, especially the short term future. I continue to believe that investors who purchase stock based mutual funds (or their less expensive cousin, ETFs) should do so understanding both: (1) the risk that the value of that stock might drop, and drop rapidly, thus (2) stock should never be purchased if the anticipated investment period is less than five years, ten years is better.

There is so much dreary economic news, much of it about unemployment and underemployment. But news about corporate profits, a main determinant of stock prices, continues to be good. Corporations have lots of cash stored up, cash which might be used to purchase other businesses, expand existing businesses, or start new businesses. Cash is also a cushion which might be needed if the growth rate of our economy slows further. That cash might even be used to increase dividend payments to shareholders.

Vanguard's high-yield (using the term "junk bonds" would be calling a spade a spade) bond fund is riskier than most better quality bond funds. In fact, at a rough estimate, its value fluctuates about 1/3 in the way that good quality bonds fluctuate and 2/3 in the way the stock market fluctuates. So, this is another, though modified (call it diversified) investment largely based on the stock market as well.

I have been fortunate so far. I reached the decision while stocks were priced about 10% lower than they are as I write these words. I have made a lucky start. Long term, I continue to believe that the best estimate for the performance of the stock market, on average, is to increase about 6.8% per year after subtracting out the effects of inflation. I expect 3.5% to 4% after inflation return from “junk bonds.” I expect inflation plus 2 to 2 ½% for good quality bonds in a good year for bonds. Since the “financial unpleasantness” of four years ago, at least after some righting of the ship after the initial panic, bonds have been a very good investment. For the three years ended September 30, 2011, the Barclays Aggregate Bond Index, the broad index of good quality US bonds, has provided and annual return of 8.0%, a great return for bond owners.

However, I believe that that good run of profits for bond owners is nearing an end. The primary reason is that interest rates are at historic lows. In a presentation last month, sponsored by a study group of my “fee only” advisors’ association, a bond researcher pointed out that there has been a 30 year bull market for bonds, but that this market might be coming to an end since interest rates are now at historic lows. Bond values can only increase when interest rates decrease further, and there is very little room for such decrease.

So, that is my change of plans this quarter. Please contact me if you have questions about your investments. I do understand that much of the financial news for individuals continues to be bad. If you are looking for a job or trying to sell a home, this is an extremely tough economy. And the worries this economy generates can sap your willingness to take investment risks. But it is my belief that the general unrest results in this being a good time to continue to bear, or even to increase such risks.

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, 2011	Clients	The Smartts
Money Market Funds	1.2	0.5%
Bond Funds	36.6	4.6%
Stock Funds	62.2	94.9%
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, 2011	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**-9.9%**	(37)	**-0.6%**	(22)	**3.9%**	(16)
Tax-Managed Capital Appreciation Admiral	**-9.5%**	(33)	**-0.8%**	(25)	**3.6%**	(20)
Tax-Managed Small Capitalization	**-13.7%**	(16)	**0.5%**	(26)	**7.4%**	(23)
REIT Index Admiral	**-5.7%**	(35)	**-2.0%**	(22)	**9.2%**	(34)
Tax-Managed International Admiral	**-15.9%**	(26)	**-3.4%**	(46)	**5.1%**	(31)
Balanced Index Admiral	**-3.2%**	(8)	**2.7%**	(12)	**4.9%**	(20)
Total Bond Market Index Admiral	**6.7%**	(7)	**6.6%**	(27)	**5.5%**	(34)
Interim-Term Investment-Grade Bond	**5.6%**	(30)	**6.8%**	(21)	**6.9%**	(16)
High–Yield Corporate Bond	**1.0%**	(4)	**5.6%**	(36)	**6.6%**	(72)

For comparison, here are several stock and bond benchmarks:

Periods ended September 30, 2011	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**-8.7%**	**-1.2%**	**2.8%**
Russell 2000 (small stocks)	**-17.0%**	**-1.0%**	**6.1%**
MSCI EAFE Index	**-15.0%**	**-3.5%**	**5.0%**
Barclays Aggregate Bond Index	**6.7%**	**6.5%**	**5.7%**
BofAML US High Yield Master II TR (bond index)	**-1.7%**	**6.9%**	**8.6%**

Vanguard mutual funds and ETFs continue to perform as expected. I expect each Vanguard fund or ETF, for each ten year period 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, there is only one fund which is not within or near the top 1/3; the High Yield Corporate Bond fund. This fund takes significantly less risk than the average junk bond fund. It tries to own no bonds rated below "C". Surprisingly, over the last ten years, high risk, "junk" bonds have provided a rate of investment return almost 3% higher than good quality bonds (8.6% vs. 5.7%). Since the average junk bond fund takes more risk than the Vanguard fund, when junk bonds do relatively well, the Vanguard fund, taking less investment risk, suffers by comparison.

IV. <u>Low Cost Investment Wins in Fourth Research Study</u>

Most of the financial press concentrates on the short term and on the sensational. With thousands of mutual fund managers, most highly paid and many with performance bonuses, working very hard to find the best investments, a few will always "beat the market" in the short term. These fortunate few get much of the press attention.

Over the last 20 years I have found three research studies which, comprehensively, take the mutual fund universe and divide it up in two ways in order to study which funds have been successful on behalf of their investors. First, mutual funds are placed in categories so that funds with similar investment objectives are grouped together. As an example, funds investing primarily in very large companies ("large cap stocks") are generally placed in a category. Second, each category is then stratified by its level of annual operating costs. So, for example, the 25% of mutual funds within the large cap category with the highest annual cost of operations become a sub category. Then the investment results for some multi-year period, generally three years or five years, are determined for all four subcategories.

In each of the three previous studies, the lowest cost subcategories do better at providing investment returns to mutual fund owners than the next to lowest cost group, which do better than the next to highest cost group, which do better than the very highest cost group. The results are almost always the same, across the board, in every category.

Such studies are important to investors since the relative cost of a mutual fund or an ETF does not change very much each year. Such relative costs can thus be depended upon in the future (unlike the relative performance of individual mutual fund investment managers). And, since index funds and ETFs have the lowest level of costs (largely by avoiding paying salaries to investment managers) the indexed products have, in the past, outperformed the "actively managed" funds.

The fourth study, completed several months ago by Morningstar, the leading supplier of mutual fund and ETF data, confirms the findings of each of the earlier studies. Over multi-year periods, lower cost investments perform better for owners than do higher cost investments.

Why don't more investors see this? First, the higher cost funds spend more on advertising. Their higher cost structure allows spending on advertising and the more dollars which are attracted to the fund, the higher are the profits of the fund (and the higher are the salaries of the investment managers). Index funds and ETFs are not as profitable, are less advertised.

Second, as mentioned above, the financial press dwells on the sensational, so the few successes of active managers receive more press coverage.

Third, all of us are always on the lookout for an advantage. If *Money Magazine* or the *Wall Street Journal* highlights a successful fund manager, we are tempted to trust our money to that manager. John Bogle, the founder of Vanguard, calls this "the triumph of hope over experience." That fourth research study provides more experience. Many investors could use independent advice and/or supervision to keep our hopes from overruling our heads.

V. <u>Kiplinger's Personal Finance Magazine: "Vanguard Takes the Lead"</u>

An article in the September 20, 2011 edition states in part:

> Last year, Vanguard Group became the nation's largest provider of mutual funds, overtaking Fidelity Investments. Benefiting from its focus on index fund, its, super-low fees, and growing investor disenchantment with funds that shine for a time and then blow up, the company has seen its assets surge over the past decade. …
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> Fund companies can screw up in a number of ways. They can offer slipshod service, which by all accounts Vanguard does not do. They can charge too much, which isn't a problem with Vanguard, the fund industry's low-cost leader. And, of course, they can perform poorly—the quickest way to drive away investors. Just look at Legg Mason Value Trust and Fidelity Magellan, two onetime behemoths that crashed and took a piece of their sponsor's goodwill along with them. But Vanguard focuses on index funds—products that seek only to match a market's return—most of the firm's assets are insulated from the risk that they will lag their benchmark substantially. …
>
> From the day John Bogle started the firm in 1975…Vanguard was a different kind of fund company. Instead of being owned by a money management firm (or a bank or an insurance company), it was set up essentially as a co-op to be owned by the shareholders of its funds. Unlike other fund companies, Vanguard makes no profit. It sells all of its funds without loads, or commissions, and the company insists on ultra-low fees because that's what the owners want and because lower costs lead to better results. The alignment of Vanguard's interests with those of its customers is the foundation of the trust the firm engenders among it clients.

VI. <u>Firm Brochure and Privacy Disclosures Available</u>

Both these documents have not changed in any significant respect in the past year and are available upon request.

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