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Client Newsletter Volume XVII Number 4 February 1, 2012

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I. Medical Privacy and Your Unmarried Child

At a continuing education seminar in November, a new reason to use lawyers was explained to me. The federal medical privacy law, HIPAA, will not allow you to obtain medical information on your child once that child has reached the age of majority. So, in most states, if your child is age 18 or older, and is injured in an auto wreck, you will, by law, not be able to obtain medical information. Your child's spouse can, but you cannot. If your child is unmarried, you are probably one of the persons who ought to be able to obtain and use that information to assist in your child's medical care.

The solution is a durable power of attorney for health matters (also called "an advanced directive") which your child signs and which appoints you, or someone else whom your child trusts, as the person who is allowed to obtain medical information and assist with making medical decisions.

So you might consider "getting thee to a lawyer."

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, 2012	Clients	The Smartts
Money Market Funds	1.4	1.0%
Bond Funds	33.7	3.9%
Stock Funds	<u>64.9</u>	<u>95.1%</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.

I continue to add to my investments in US stock and in Vanguard's lower risk "junk bond fund" both sited within my 401k plan, the stock investment is within the Roth portion, the junk bond fund is within the traditional portion of the plan.

If you have questions about your asset allocation, or your retirement plan investments, I'd be pleased to assist.

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, 2011	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	1.1%	(31)	0.3%	(21)	3.8%	(15)
Tax-Managed Capital Appreciation Admiral	1.4%	(27)	0.1%	(24)	3.4%	(22)
Tax-Managed Small Capitalization REIT Index Admiral	1.2%	(8)	2.2%	(22)	7.1%	(24)
Tax-Managed International Admiral	8.6%	(40)	-0.9%	(21)	10.3%	(34)
Balanced Index Admiral	-12.5%	(30)	-4.5%	(49)	4.8%	(30)
Total Bond Market Index Admiral	4.3%	(6)	3.3%	(10)	5.0%	(20)
Interim-Term Investment-Grade Bond	7.7%	(12)	6.5%	(30)	5.6%	(35)
High-Yield Corporate Bond	7.5%	(15)	6.9%	(20)	6.2%	(14)
	7.1%	(2)	6.1%	(32)	6.8%	(65)

For comparison, here are several stock and bond benchmarks:

Periods ended December 31, 2011	Yr.-to-date		5 Years		10 Years	
S & P 500 (large stocks)	2.1%		-0.3%		2.9%	
Russell 2000 (small stocks)	-4.2%		0.2%		5.6%	
MSCI EAFE Index	-12.1%		-4.7%		4.7%	
Barclays Aggregate Bond Index	7.8%		6.5%		5.8%	
BofAML US High Yield Master II TR (bond index)	4.4%		7.3%		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 1/4 (stock funds) after income taxes.

IV. Big Bond Fund Manager Stumbles

The January, 2012 issue of *Kiplinger's Personal Finance Magazine* says that Bill Gross, the manager of the nation's largest mutual fund, Pimco Total Return (principally a bond fund):

“calls his recent performance ‘a stinker.’ Over the past year the [fund] landed in the bottom 6% of taxable, intermediate-term bond funds and lagged its benchmark by 4.8 percentage points. Behind the stumble was Gross’s decision in early 2011 to bet against Treasury bonds—that is, he expected yields to rise (and prices to fall), but instead yields fell.”

The two good quality Vanguard bond fund/ETFs in general use for client portfolios continued to adhere to more narrow, established mandates and did very well in 2011, both in the top 15th percentile for the year.

The lesson here is that Gross’s picks over the last ten or so years have been much above average, but his prior record did not keep him from producing a “stinker” in 2011. The more one exercises judgment/guesses as to the direction of financial markets, the more one may either win or may lose. Past success and the

accumulation of the assets of lots of investors (Pimco total Return is a particular favorite of 401(k) plan rosters) do not guarantee better than average performance. Part of Gross's past success is the taking of more risk, his "total return" fund bears that title, perhaps, to serve subtle notice of the fact that such fund has often included a significant dose of high yield ("junk") bonds, yet the fund is generally classified as a good quality, intermediate-term fund. So when high yield bonds do better than average, Pimco gets a boost.

We use the Vanguard High Yield Corporate Bond Fund as the "junk bond" fund in portfolios, so we have a separate reading of the approximate percentage of good quality bonds which you own and another, separate reading, of the "junk bonds" you own. This helps further specify the investment risks we are bearing.

In my year end report I noted that bonds have had a wonderful, historic run of higher than average performance, over the last 30 years, and this historic performance is largely a function of a 30 year decline in interest rates (remember that when interest rates rise, the value of the bonds you already own goes down, and when interest rates fall, the value of your bonds goes up). Since there is little room for interest rates to fall further, at least in the US (and we own only the bonds of the US government and US corporations), I believe that, as the US economy strengthens (and it does appear to be strengthening slowly) interest rates will rise and that bonds will not be a particularly good investment. We own bonds because they pay more interest income than money markets and we own at least a five year supply of probable withdrawals from our account because we do not wish to sell stock if stock values have declined and we need money from our investments.

V. S&P Stock Funds and ETFs have Added Costs

The *Morningstar Advisor Magazine*, August/September issue of last year in an article about how to analyze an ETF, notes that ETFs which track the S&P 500 or the Russell 2000 indexes (of large US stocks and small US stocks, respectively) suffer "price-impact costs. When hundreds of billions of dollars buy or sell the same stock at the same time, the stock can become misvalued. NYU Professor Antti Petajisto estimated that investors have lost about 0.3% and 0.8% annually in the S&P 500 and the Russell 2000, respectively because of coordinated index-fund trading." Such trading is a result of the periodic changes in the two indexes. A few companies shrink in size or in stock market valuation and are pitched out of the S&P 500 index, to be replaced by growing companies so that the index continues to be the site of the largest 500 public companies headquartered in the US (with only minor definitional exceptions). The reverse happens to the Russell index.

In addition to the high volume of trading, which may cause the stocks purchased to be purchased at a higher than reasonable price, and cause the stock sold to be sold at a lower than reasonable price, there are a lot of risk-taking investors, other than the S&P committee, who can successfully guess which stocks will be cast out and which will be added to the index. These "guessing" investors sell several days or weeks before the replacements occur and thus S&P 500 index funds have to make transactions at unfavorable prices.

I use the whole US stock market, Total Stock Market Index Fund or ETF, rather than the separate S&P 500 and Russell 2000 funds so that all this trading is irrelevant to my clients. The Total Stock Market Index Fund/ETF already owns all of the stocks which are exchanged between the two indexes and does not incur either the trading costs or the cost of being behind other, "front-running" investors. Further, over longer periods of years, the amount of capital gains which must be declared by the Russell 2000 funds, which "lose" their larger companies, and have to sell their winners, are not a problem for the Total Stock Mkt. Index fund, which just continues to own them.

VI. Chasing Investment Trends—“The Foolishness of Crowds”

The Economist magazine, my chief business reading each week, in an article with the above title, says that investors tend to chase the latest fad:

“If you see a crowd outside a department store it is reasonable to assume that there is a sale, If you see a queue outside a bank there is a good chance that nervous depositors are trying to withdraw funds. In both cases the actions of other people send a signal that may be useful for others to follow.

But does the wisdom of crowds apply to investment? At the peaks it certainly pays to head in the opposite direction from the masses. Bubbles occur when the population develops an enthusiasm for a particular asset class, whether it be technology stocks in the late 1990s or houses in the mid-2000s. ...

To investigate the investment success of crowds, *The Economist* asked Morningstar, an investment research firm, to send us fund-flow data and performance statistics for its American mutual fund range. We then applied some simple tests. Did investors plunk down their money into an asset class that had been performing strongly over the previous 12 months? And was their judgment borne out over the subsequent 12 months?

The [result] shows that the crowd was more foolish than wise. The most popular sector, measured by the net inflow of money, had generally performed well in the previous year, beating the average sector by more than two percentage points.

Investors were clearly chasing the trend. Alas, over the next 12 months that most popular sector lagged behind the average by just under three percentage points. On around 60% of the occasions, the return of the most popular sector was much lower after investors bought it than before.”

So, the results are generally poor when we chase the latest “hot” investment. Further costs, each of which lowers net investment returns are capital gains taxes on sales of investments and brokerage fees and other transaction costs of the sale. Better to obtain an asset allocation suitable to your and your family’s financial objectives and then just buy-and-hold.

If you wonder if your investments could use additional attention, and/or if you (or someone you know) might have been chasing “hot” investments, I’d be glad to try to assist.

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