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I. Being the "One Percent" with Your Investments

I have recently reread a later edition of a book which I have been recommending for more than a decade: The "Fully Updated 10th Anniversary Edition" of *Common Sense on Mutual Funds* by John Bogle (the founder of Vanguard). The original book was a fine primer on both mutual funds and what is important in investing.

The 10th Anniversary Edition, published in 2010, is a faster read because all of the updating material; even updates of original charts/graphs appears in front of a light magenta colored background. The following quote is from one of these updated sections:

> Ten Years Later -- Tax Efficiency
>
> When we incorporate the results of the Vanguard 500 Index Fund since 1998 with its previous record over 15 years, we find that the fund outpaced about 68% of all general equity funds on a pretax basis <u>but nearly 90 percent on an after-tax basis</u> (Emphasis added). Over that quarter century, the annual return of the Index Fund was 9.9 percent *before* taxes and 9.4% *after* taxes, both smart margins over its peers of 9.2 percent and 7.5 percent, respectively, <u>which total up to huge additional capital accumulations for the index investor</u> (Emphasis added).

So, net of income taxes, the original index fund, premiered by Vanguard, was in approximately the top 10% of all stock-based mutual funds for the first 25 years of its life. My college statistics classes tell me that the chances of picking a fund which will perform in the top 10% are 1 out of 10, a 10% chance of being successful.

Very shortly after the fund became available, I began to invest in that fund, moving to Vanguard's Total Stock Market Index Fund, a more diversified stock fund, when it became available several years later.

Study after study reveals that that 10% estimate, only a one chance in 10 of picking an investment which will perform in the top 10% *in the future* is accurate. But I can, with great confidence, predict that such low cost mutual funds (and now ETFs—exchange traded funds) will outperform the average mutual fund in the future due to the very fact of their ultra low relative costs. In fact, in these newsletters you often read that over 10 year periods I expect that each Vanguard fund I use will be in the top 1/3 and, after income taxes are considered, in the top 1/4. Expanding this to a 25 year time period, I am reasonably confident that, after taxes, the broad based stock index funds of Vanguard will beat close to 90% of their competition.

The chance that anyone, using some model, or throwing darts, can pick a top 10% fund is 1 in 10, but low cost gives us confidence that we are more likely to do it.

The chance of having picked one top 10% investment and then, at some other time, picking another top 10% investment is 1 chance in 100, a one percent chance. This is what can occur if you minimize costs and diversify broadly. You too might be in or near the top one percent with your investments.

The only other large capitalization US stock mutual fund I have ever recommended broadly is the Vanguard Tax-Managed Capital Appreciation fund. I continue to own shares of this fund and many of you do as well. After several years of its existence it was merged into the Admiral Class (for larger shareholders at Vanguard). As of June 30, 2012, that Admiral version of the fund did not yet have a 15 year history, let alone a 25 year history. But the Morningstar mutual fund reporting service reports that among large cap. US stock funds it rates in the 7th percentile for the 10 years then ended, the top 7%, in rate of investment return after income taxes.

No crystal ball, but have been fortunate to have discovered low cost investing 20+ years ago.

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, 2012	Clients	The Smartts
Money Market Funds	2.5	0.0%
Bond Funds	31.6	7.4%
Stock Funds	65.9	92.6%
Totals	100.0%	100.0%

Remember each of us has different goals and needs and our asset allocation should fit us and our family.

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 June 30, 2012	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**9.4%**	(19)	**0.7%**	(17)	**6.1%**	(11)
Tax-Managed Capital Appreciation Admiral	**9.3%**	(23)	**0.4%**	(21)	**6.0%**	(13)
Tax-Managed Small Capitalization	**7.9%**	(32)	**2.0%**	(12)	**8.0%**	(20)
REIT Index Admiral	**14.9%**	(19)	**3.2%**	(20)	**10.4%**	(37)
Tax-Managed International Admiral	**3.6%**	(57)	**-5.8%**	(52)	**5.3%**	(33)
Balanced Index Admiral	**6.6%**	(24)	**3.6%**	(7)	**6.3%**	(14)
Total Bond Market Index Admiral	**2.4%**	(80)	**6.8%**	(36)	**5.5%**	(41)
Interim-Term Investment-Grade Bond	**4.7%**	(17)	**7.7%**	(16)	**6.4%**	(15)
High–Yield Corporate Bond	**6.6%**	(53)	**7.1%**	(28)	**7.6%**	(78)

For comparison, here are several stock and bond benchmarks:

Periods ended June 30, 2012	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**9.5%**	**0.2%**	**5.3%**
Russell 2000 (small stocks)	**8.5%**	**0.5%**	**7.0%**
MSCI EAFE Index	**3.0%**	**-6.1%**	**5.1%**
Barclays Aggregate Bond Index	**2.4%**	**6.8%**	**5.6%**
BofAML US High Yield Master II TR (bond index)	**7.1%**	**8.2%**	**9.9%**

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. See more very long-term information in section I. above.

The Vanguard High Yield Corporate Bond fund takes significantly less risk that the average "high yield" (also known as "junk bond") fund. When junk bonds are doing well, as they have for ten years per the above benchmark, the Vanguard fund doesn't compare as well. I continue to recommend it as an additional diversification from good quality bonds and am satisfied with its absolute performance.

IV. 401(k) Costs can be Hazardous to Your Investment Health

In an article in the July 2, 2012 edition of *Fortune Magazine*, the author found that the average 401(k) investor is charged 0.83% per year in expenses as a percentage of assets. Many smaller plans charge much more and larger plans usually charge a bit less. If you are not at least contributing enough to your plan to earn any company match, then you are "leaving dollars on the table." But if your plan's costs exceed 1% per year, then you ought to find another place to do the rest of your investing. One percent cost is too high.

Vanguard offers 401(k) plans to individuals who run their own one-person businesses (I have one of those plans) and offers retirement plan services to larger employers. It is my understanding that Vanguard is becoming more receptive to assisting smaller businesses. Workers of the world unite, high plan costs are hazardous to your investment health.

The same article notes that, over 30 years, higher fees can eat away half of your investment return.

V. Investment Returns and US Presidential Terms

I have seen this particular analysis before; here is an update of surprising news. The news is surprising because, just looking at things rationally, one would expect the Republican Party to do a better job of running the economy than the Democrats (and that, perhaps, the Democrats do a better job of avoiding involving the US in wars). Not true with regard to investment returns experienced during the presidential terms of Republican and Democratic US Presidents.

The update appeared in the February 27, 2012 issue of *Investment News*:

> Investors Have Fared Far Better Under Democratic Presidents
>
> Edge is so large, party comes out ahead even without Bill Clinton

Although Republicans promote themselves as the friendlier party to Wall Street, stock investors do better when Democrats occupy the White House.

In fact, from a dollars-and-cents standpoint, it isn't even close.

The BGOV Barometer from Bloomberg Government shows that over the five decades since John F. Kennedy was inaugurated, $1,000 invested in a hypothetical fund tracking the S&P 500 only when the Democrats were in the White House would have been worth $10,920 at the close of trading [mid-February].

That is more than nine times the dollar return an investor would have realized from following a similar strategy during Republican administrations. A $1,000 stake invested in a fund that followed the S&P 500 under Republican presidents, starting with Richard M. Nixon, would have grown to $2,087 on the day that George W. Bush left office.

"The market does tend to do better under Democrats…" said Sam Stovall, chief investment strategist at Standard & Poor's Equity Research.

"Some of the difference may stem from the fact that every Republican president since the end of World War II has faced a recession during his first term of office." he said.

"Democratic administrations also have been more likely to spend money on government programs that stimulate the economy," Mr. Stovall said.

The Democratic edge is so large that the party comes out ahead even without counting Bill Clinton (the Democrat with the biggest S&P 500 gain) and George W. Bush (the Republican with the worst market record). A hypothetical $1,000 invested under Democrats excluding Mr. Clinton would be worth $3,539, versus $3,296 invested under Republicans, except Mr. Bush.

<u>Smartt comment:</u> The article also notes that adding in the eight years of the Eisenhower administration does not change the picture. I doubt that this will change any votes come November, but one has to wonder. Wife Paula has stated for years that the good economic times during the Clinton Administration were just the result of "Reaganomics finally kicking in.!" And it is true that Democrats are firmer in their belief that government spending benefits the economy.

For investment advice, and occasional political humor, don't hesitate to contact me.

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