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I. Uncertainty, the “Fiscal Cliff” and Cash Needs from Your Investments

I don't generally advise paying income taxes in advance of “the last minute” but later this year, I believe that an exception is warranted.

You have no doubt seen news reports about the “Fiscal Cliff”, a deal which Congress and the President made a while back which, if not resolved by December 31st. of this year, will cause federal expenditures to decline and, more importantly for our investments, for federal income taxes to increase. Many commentators continue to predict that this will not happen, that there will be a compromise reached after the election, and that, somehow, income taxes will not increase.

Note: Neither of the Presidential candidates has spoken, in any meaningful way lately, regarding how to solve this important economic issue.

With the “fiscal cliff” uncertainty, one option is that, to the extent that next year you will need money from your regular account investments, to sell those investments before the end of this year, pay the lower tax rate on any capital gains now, rather than waiting to see what the compromise (if any) is sometime next year. Contact your tax advisor and let me know as early as mid-November if you'd like to do some “early selling.”

If you are over age 70 ½ and have a traditional IRA, then you are required to withdraw some money from that IRA every year, including next year, whether you need money from your investments or not. If you withdrew extra in 2012, in order to pay lower income taxes, you would still have to withdraw a specific percentage in 2013, so selling investments and taking your distribution later this year will not reduce 2013 required distributions.

If you have questions, please do not hesitate to contact me.

There have also been predictions that lack of a compromise will throw the US economy back into recession, that our slow economic growth of the last couple of years will be replaced by declines and that this will cause financial markets to decline in value. Although this is a distinct possibility, this is just a reminder that we are long-term investors. We do not change our investments based on the headlines (and there have been enough scary headlines in the last five years to last for the next two decades!), we do not try to predict what will happen to financial markets. If we sell securities when we don't really need money from our

investments it is generally because we have found an investment with an even lower cost (see section IV below, for example) or because if we sell we are REDUCING income taxes by taking a tax loss.

I'd be pleased to hear from you about the Fiscal Cliff and your investments.

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, 2012	Clients	The Smarttts
Money Market Funds	2.2	0.0%
Bond Funds	30.9	7.3%
Stock Funds	<u>66.9</u>	<u>92.7%</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.

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 September 30, 2012	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	16.2%	(27)	1.6%	(16)	8.7%	(12)
Tax-Managed Capital Appreciation Admiral	16.1%	(28)	1.3%	(22)	8.7%	(12)
Tax-Managed Small Capitalization REIT Index Admiral	13.7%	(34)	3.4%	(17)	10.7%	(20)
Tax-Managed International Admiral	14.8%	(34)	2.7%	(23)	11.4%	(38)
Balanced Index Admiral	10.2%	(63)	-5.1%	(49)	8.4%	(32)
Total Bond Market Index Admiral	11.3%	(37)	4.1%	(7)	7.7%	(22)
Interim-Term Investment-Grade Bond	4.0%	(82)	6.5%	(47)	5.3%	(46)
High-Yield Corporate Bond	8.2%	(18)	7.8%	(15)	6.1%	(18)
	11.0%	(58)	7.7%	(34)	8.4%	(79)

For comparison, here are several stock and bond benchmarks:

Periods ended September 30, 2012	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	16.4%	1.1%	8.0%
Russell 2000 (small stocks)	14.2%	2.2%	10.2%
MSCI EAFE Index	10.1%	-5.2%	8.2%
Barclays Aggregate Bond Index	4.0%	6.5%	5.3%
BofAML US High Yield Master II TR (bond index)	12.0%	9.1%	10.8%

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.

The Vanguard High Yield Corporate Bond fund takes significantly less risk than 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.

If you have questions about your investment asset allocation, please contact me.

IV. Vanguard Moves to Reduce its ETF Costs

Most of you all heard from me in recent weeks about Vanguard reducing the cost of one of its mutual funds, the regular investor classification of its High Yield Corporate Bond mutual fund. (I call it Vanguard’s “good junk bond fund”, since it tries not to own the most risky high yield bonds.) The exchange was made at TD Ameritrade without any brokerage fees or other costs.

One of the significant costs of an indexed mutual fund, or an ETF, is a payment by the provider (Vanguard) to the company that provides the index. E.g. all S&P 500 Index stock funds and ETFs pay a royalty (often of many millions of dollars per year) to Standard and Poors which owns and runs the S&P 500 index. Vanguard, for several of its other index funds, is switching the index on which the fund is based so that the cost of using the index is lower. (Standard and Poors apparently does not give discounts!). Vanguard has stated that the cost savings will be passed along to investors.

In another cost development, the Charles Schwab brokerage firm, which started providing ETFs several years ago, has announced that it has reduced the cost of several of its broad market index ETFs to a level of cost which is below Vanguard’s cost. For example, the Schwab equivalent of the Total Bond Market Index ETF is now priced at 5/100% cost per year, the Vanguard ETF presently costs 10/100% annually.

Vanguard, in press reports in early October, is making very specific moves to reduce the costs of many of its ETFs (exchange traded funds). By now almost 60% of our investments are not in mutual funds but in ETFs because, at Vanguard, ETFs own the same securities as the mutual funds but are, for long-term investors, often significantly lower in cost.

I continue to watch such cost moves with a thought to whether or not we should use Schwab ETFs rather than the (now) higher cost Vanguard products. Several thoughts in this regard:

(1) when an ETF is new or when the volume of buying and selling of the product is relatively small, there is often an additional cost—a higher bid/asked spread in purchasing or selling the product.

(2) because of the relatively small amount of the ETF available “on the market” for purchase, purchasers often have to pay a premium price to buy the ETF. (A recent look at the Schwab Total Bond ETF showed a premium 14 times greater than the Vanguard ETFs premium.)

(3) for an approved list of ETFs at TD Ameritrade, we are not charged any brokerage commission when we buy or sell most of the Vanguard ETFs routinely used for client investments.

All of these reasons mean we’ll probably stick with Vanguard for a while longer. Perhaps, with the competition presented by Schwab, and with Vanguard rejiggering the indices it uses for mutual funds and

ETFs, Vanguard will, as it has done in the past, reduce its annual costs as well. Competition often results in benefits to the consumer.

V. **Mutual Fund Costs Decline in Latest Decade, But Not by Much**

In an article in the *Morningstar Advisor* (August/September, 2012 issue), Morningstar, the largest provider of mutual fund data, presents the results of a decade-long study of mutual fund costs.

“...we focused on the 2000 to 2011 period, which spanned more than 5,800 share classes and, thus, offered a broader cross-section. We found that the average expense ratio [that is, the average annual cost of the mutual fund] that existed at the start and end of that 11-year period fell about four basis points [that is, 4/100%] to 1.26%, a roughly 3% cumulative decline.”

The stock ETF which most of us own, Vanguard's Total Stock Market Index ETF now costs 5/100% per year. If the cost of the average fund were to approach this low level of costs, falling by four basis points for each eleven years in the future, it would take over 300 years, for the average mutual fund to reduce its costs to what we are paying for the Vanguard ETF!

As Morningstar notes, the explosion in the number of mutual funds has yielded “few economies of scale for investors.”

Einstein is reputed to have said that compounding of investment returns is one of the great concepts of civilization. Note too that the costs of our investments slow that compounding over the years in a very significant way. That makes the costs of our investments a very significant issue, for each of us.

If you know of someone who might benefit from a lowering of investment costs, please do not hesitate to contact me or furnish my contact information, below.

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