John M. Smartt, Jr., CPA
FINANCIAL COUNSELING & ADMINISTRATION
Registered Investment Advisor

Client Newsletter Volume XX Number 1 August 1, 2014

I. Vanguard Funds Prosper by Low-Cost Evangelism

An article by that name, authored by Pauline Skypala, appeared in middle July online, on the website of the *Financial Times.* This newspaper is the British equivalent of our *Wall Street Journal*. Here are excerpts:

> "US investors are pouring money into Vanguard's funds as if the manager was the only game in town.
>
> In some ways it is: it remains unique (in the fund industry) in being a mutually run group, owned by investors in its funds: it has been a lone voice for may hears evangelizing the importance of low costs; and it makes good on that by offering some of the lowest cost index trackers ["Trackers" is the British word for indexed mutual funds.] and actively managed funds on the market. It has also promoted the benefits of buying and holding investments for the long term. [The author notes as full disclosure that she is a Vanguard shareholder.]
>
> The group, the world's third largest with $2.1 trillion of assets under management, has consistently ranked in the top 10 for inflows in the US over the past 10-15 years, says Michael Rawson, analyst at Morningstar, but in the last several years it has notably pulled away from the pack. There is no close second.
>
> Its popularity has been driven by the trend to low fee investing, which has in turn been helped by the growth of exchange traded funds…
>
> The group now has a US mutual fund share of 18%, compared with 10% for both Fidelity and American funds.
>
> Vanguard's focus on low costs (average expense ratio in 2013 of 0.19%, versus an industry average of 1.08%, according to the group's website) has benefitted all mutual fund investors in the US by helping to drive down annual management fees. Its mutual structure means it can operate at cost, enabling it to offer an ETF priced at just 5 basis points [e.g. 5/100% annual cost], for example. Other managers, whether offering active or passive funds, find it hard to compete with that.

> The cost advantage shows up in long-term performance. Mr. Rawson points out that over 20 years, Vanguard's Total Stock Market Index Fund ["TSMIF"] beats 82% of the funds in its category, rising to 91% allowing for survivorship bias (i.e. including all funds closed over the period in the analysis)."

Smartt comment: I began investing in Vanguard funds with its first index fund, the S&P 500 fund, in 1989 when I left Price Waterhouse. When, a while later, Total Stock Market Index fund came along, I switched to it because I believed it would be both (1) more diversified since it owns more than 3,000 stocks, not just 500, and (2) because I believed it would be lower total cost. The lower cost is a function of the S&P 500 index itself. Periodically, the Standard & Poors committee must replace a few of the stocks in the 500 index with others, to keep it both the index of the largest publicly traded stocks in the US. When that happens the followers of that large capitalization stock index incur trading costs as they sell the old "500 members" and buy the new ones. TSMIF owns all of the largest 1,800 stocks in the US and so need do no trading when the S&P 500 index changes.

Note that if, 20 years ago, you had set out to find a US stock mutual fund, you would have had only a 9% chance of finding a fund which actually has done better than TSMIF has done. Note too that Vanguard's international index funds are similarly both very low cost and broadly diversified and thus by the time they are 20 years old, there is a good chance that they will be in the top 1/10th of funds as to performance.

To summarize, it is possible that the chance of being able to pick a better US stock fund and a better international stock fund, both, is approximately one in one hundred!

If you know anyone who has not made this realization, please give me a chance to assist them too.

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 March 31, 2014	Clients	The Smartts
Money Market Funds	1.8	0.7%
Bond Funds	26.2	4.1%
Stock Funds	72.0	95.2%
Totals	100.0%	100.0%

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

Over long years stock investments generally perform much better than bonds. But when the financial news is bad we can be afraid to purchase stock investments, and when the news is good, stocks are so high in price that they may not be quite as good an investment.

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

III. <u>Vanguard Rates of Return (through Latest Quarter End)</u>

Performance percentages are per ***Morningstar.*** Amounts in parentheses are percentile rankings (1= best and 100= worst) within category.

Periods ended June 30, 2014	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**7.0%**	(32)	**19.4%**	(11)	**8.4%**	(16)
Tax-Managed Capital Appreciation Admiral	**7.3%**	(24)	**19.2%**	(13)	**8.3%**	(18)
Tax-Managed Small Capitalization	**3.3%**	(57)	**23.8%**	(16)	**9.9%**	(20)
REIT Index Admiral	**17.7%**	(19)	**28.7%**	(18)	**9.8%**	(30)
Total International Stock Index Admiral	**5.9%**	(15)	**11.0%**	(57)	**7.4%**	(31)
Balanced Index Admiral	**5.8%**	(31)	**13.7%**	(25)	**7.6%**	(12)
Total Bond Market Index Admiral	**3.9%**	(61)	**4.7%**	(79)	**4.9%**	(46)
Interim-Term Investment-Grade Bond	**4.5%**	(86)	**7.8%**	(71)	**5.8%**	(49)
High–Yield Corporate Bond	**2.7%**	(49)	**14.5%**	(79)	**6.9%**	(68)

For comparison, here are several stock and bond benchmarks:

Periods ended June 30, 2014	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**7.1%**	**18.7%**	**7.7%**
Russell 2000 (small stocks)	**3.3%**	**20.2%**	**8.7%**
MSCI World Index	**6.2%**	**15.0%**	**7.2%**
Barclays Aggregate Bond Index	**3.8%**	**4.5%**	**4.7%**
BofAML US High Yield Master II TR (bond index)	**5.6%**	**13.9%**	**8.9%**

Vanguard mutual funds and ETFs (exchange-traded funds) continue to perform as expected. I expect each Vanguard fund or ETF, for each ten-year period to be in the <u>top 1/3 before taxes based on low cost</u>, and they <u>ought to be in the top 1/4 (stock funds) after income taxes</u>. Note in the *Financial Times* article how the fund and ETF which are most often used by clients (Total Stock Market Index fund/ETF) has done even better over a 20 year period.

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, 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 exactly because it takes significantly less risk than the average high-yield fund. Note that for the 10 year period above, the high yield bond benchmark index performed 4.2% better, per year, than the good quality bond index (see the last 2 benchmarks listed above, i.e. 8.9% minus 4.7%). Of that 4.4% difference, the Vanguard fund captured approximately half of the high yield out performance (e.g. it did 2.2% better than the good quality bond index (6.9% vs 4.7%).

For the last several years, in an atmosphere of very low interest rates, the managers of many actively managed bond mutual funds have been betting that higher risk bonds will have higher returns. This has increased both the relative return of their funds, as well as the risk. Vanguard bond funds have a reasonably narrow range of investments and are both lower cost and more predictable as to rate of return.

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

IV. <u>401(k) Investors Saving on Fund Fees</u>

In a July 21st article in *Investment News*, a study finds that investors paid less in 2013 for their mutual funds within 401(k) plans than they did in the prior year. The average annual expense ratio on stock funds used declined from 0.63% in 2012 to 0.58%. The average expense ratio for bond funds declined from 0.58% to 0.50% over the same period.

The decline in costs is, I believe, large attributed to the US Department of Labor beginning to require that all 401(k) plan costs be reported to participants. A continuing series of lawsuits by participants suing their 401(k) trustees for providing a selection of only higher cost funds may have had some effect as well.

I assist with clients, without further charge, to select low cost alternatives within their 401(k) plans. Having found the lowest cost alternatives, we "diversify around" these fund choices so that the individual and/or family's investments are a broadly diversified, very low-cost, integrated whole.

If you or other members of your family have questions about 401(k) plan alternatives, I would be pleased to assist. Note, per the study quoted within the same *Investment News* article, that not all 401(k) plans are worth using (for purposes other than gaining the employer match):

> "A substantial portion of 401(k) plans have poorly designed menus that offer participants [high fee] funds," wrote the researchers, Ian Ayres, a professor of Yale Law School and the Yale School of Management, and Quinn Curtis of the University of Virginia School of Law. "The problem of excess fees is sufficiently severe that in 16% of the plans, young participants would do better to forgo the tax benefits of 401(k) saving and invest any unmatched contributions in low-cost stand-along investments."
>
> After the…study was released, Morningstar Inc.'s ETF research team issued a tweet: "Active funds have a long way to go to catch up to index funds.

V. <u>Other News and Notes:</u>

Here is another item of interest noted in a quarter full of reading:

In an article titled, "Clients Should Know About All Fees They Pay," in the June 16th edition of *Investment News*, a survey found that for 159 investment advisors surveyed, the average total cost clients actually pay is 1.83% of assets. My clients pay close to one-third of this level of costs. If you think you, one of your friends, or someone in your family might be paying too much, please contact me, I'd be pleased to assist.

John M. Smartt, Jr., CPA	Phone: (865) 588-4159
2001 Partridge Run Lane	E-mail: johnsmarttcpa@yahoo.com
Knoxville, TN 37919-8967	Website: www.johnsmarttcpa.com