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I. Stay Away from Hedge Funds

An article titled "Can't Pay, Won't Pay" authored by one of the long time staff writers for *The Economist*, appeared in the September 20, 2014 edition of the magazine.

> "Investing in hedge funds requires one to believe three things. The first, which is plausible, is that there are anomalies in the market which a shrewd fund manager can exploit. One example is momentum, the tendency for assets that have recently risen in price to continue to do so. The second requirement is to identify such outperforming managers, but the average life of a hedge fund is less than five years, indicating that many managers have to give up for lack of clients or because of poor performance. In addition, half of all current funds are less than five years old.
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> Even if one can successfully identify smart managers, one must then believe that the excess returns will be sufficient to outweigh their high fees. Not all managers charge the "two-and-twenty" of legend (a 2% annual fee plus 20% of the return over a given benchmark) but enough do to make this a very high hurdle to overcome. And investors who use a consultant (or a fund of funds) to help with the selection process have to pay an extra layer of fees.
>
> The evidence for stellar hedge fund performance is not convincing. Of the last ten calendar years, only one (2005) has seen the average hedge fund outperform a portfolio of 60% equities (the S&P 500 index) and 40% government bonds. Far from being masters of the universe, the mangers have been mastered by the market.
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> One could argue that hedge funds offer a different type of return—less volatile and thus offering a better trade-off between risk and return. But the example of 2008, when the average hedge fund made a loss of 28%, makes that a harder case to argue."

Smartt comment: Much research, in most markets, reveals that the supposed excess gains from "momentum plays," after deducting brokerage commissions and the income taxes on higher levels of trading, are small or non-existent.

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, 2014	Clients	The Smartts
Money Market Funds	1.8	0.2%
Bond Funds	26.2	6.8%
Stock Funds	72.0	93.0%
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. 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, 2014	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**7.0%**	(45)	**15.8%**	(14)	**8.6%**	(15)
Tax-Managed Capital Appreciation Admiral	**7.6%**	(33)	**15.9%**	(13)	**8.6%**	(15)
Tax-Managed Small Capitalization	**-3.5%**	(54)	**16.1%**	(16)	**9.3%**	(18)
REIT Index Admiral	**14.0%**	(24)	**15.9%**	(13)	**8.6%**	(31)
Total International Stock Index Admiral	**0.0%**	(19)	**5.9%**	(62)	**6.8%**	(34)
Balanced Index Admiral	**5.8%**	(19)	**11.3%**	(16)	**7.3%**	(15)
Total Bond Market Index Admiral	**4.1%**	(49)	**4.0%**	(74)	**4.6%**	(45)
Interim-Term Investment-Grade Bond	**4.5%**	(74)	**6.3%**	(66)	**5.4%**	(49)
High–Yield Corporate Bond	**3.5%**	(19)	**9.4%**	(51)	**6.7%**	(65)

For comparison, here are several stock and bond benchmarks:

Periods ended September 30, 2014	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**8.3%**	**15.6%**	**8.1%**
Russell 2000 (small stocks)	**-4.3%**	**14.3%**	**8.2%**
MSCI World Index	**3.9%**	**10.9%**	**7.1%**
Barclays Aggregate Bond Index	**4.0%**	**3.8%**	**4.4%**
BofAML US High Yield Master II TR (bond index)	**3.6%**	**10.4%**	**8.2%**

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 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 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.

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 long-term, clearly stated 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. "Gross and Net Returns" – Bill Gross Leaves PIMCO

In an October 4th article in *The Economist*, the magazine comments on the lessons from a star money manager's exit:

> "The departure of Bill Gross, the world's best known fund manager, from PIMCO, the investment firm he helped to found, has many potential lessons. At its simplest it can be portrayed as a Shakespearean drama; the ageing king who refused to loosen his grip on power. Eventually, his subordinates rebelled and overthrew him…
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> The Securities and Exchange Commission, an American regulator, recently announced an investigation into pricing at the Total Return fund, the main outlet for Mr. Gross's talents, creating the potential for damage to his reputation…
>
> A second lesson concerns whether investment firms are wise to rely on the reputation of a "star" fund manager…Mr. Gross's occasionally eccentric pronouncements (he once devoted a section of his newsletter to the death of his pet cat) were avidly watched by other investors.
>
> In recent years, he made some big calls on the bond market. Four years ago, he talked of the British bond market resting on a bed of nitroglycerine; three years ago, he worried that yields would rise when the Federal Reserve ended its second round of quantitative easing. Neither bet on bonds paid off and the Total Return fund suffered a slump in performance; its return is below the average for similar bond funds over the past five years.

V. VTI – "The Total Package"

In an article titled, "The Total Package" subtitled "This ETF is the most efficient way to get exposure to the entire U.S. Stock Market," the *Morningstar Advisor Magazine* states:

> "Vanguard Total Stock Market ETF VTI covers the entire U.S. stock market for a razor-thin 0.05% expense ratio. It is a quintessential core stock holding, providing investors with an excellent choice

for passive exposure to U.S. stocks. Paired with an appropriate fixed-income investment, this fund could serve as the foundation for a diversified portfolio.

The index this fund tracks represents the dollar-weighted average of all investors' U.S. stock holdings. Therefore, its performance should be similar to the average investor's, before fees. However, its 0.05% expense ratio [annual cost] gives it a nearly 1% cost advantage relative to the average large-blend fund. As a result, over the last past 10 years, the fund outpaced more than 80% of all large-blend funds that survived the period.

For passive investors looking to establish a core allocation to U.S. equities, using a total stock market fund such as this one is more efficient that using separate market cap segment funds. Dedicated small cap funds are more expensive that the best total stock market index funds. Since this Vanguard fund contains an allocation to small caps and charges just 5 basis points, investors are obtaining their small cap exposure at a lower cost.

A total stock market fund is also more efficient than separate market cap segment funds because it should result in lower turnover. When a small cap stock appreciates in size, it will migrate from the small cap index to a large cap index resulting in turnover for both the large cap and small cap funds. But that same stock will remain part of a total stock market index naturally and without incurring additional turnover. Turnover leads to tax inefficiency and trading costs."

Smartt comments: Morningstar is the largest provider of mutual fund information. If investors ever "wised up" and dropped their interest in actively-managed funds in favor of index funds, Morningstar's business would probably decline. Thus their recommendation, "For passive investors." I believe all investors should be passive investors, unless no suitable, low cost alternative is available.

The article well portrays the advantages of a total stock market fund, a lesson most 401(k) plans have not learned. They include only an S&P 500 index fund, not a total stock market index fund. As a result the plan's participant employees suffer higher costs and are less diversified in their stock market holdings.

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

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

An article from Marketwatch.com, online, titled: "We're Flying Blind Investing for Retirement" is subtitled: "If you're in the dark about your holdings, get professional help.

"Hearts & Wallets, a financial services market research firm, just held focus groups with 72 men and women age 40 to 64 with at least $250,000 in investible assets and found that very few of them knew which investment products were in their retirement portfolio and why.

The study "echoes one from benefits consultant Towers Watson in 2012 where only one in five large companies said they believed their employees generally made informed decisions about retirement savings."

Smartt comment: I provide 401(k) investment advice to continuing investment management clients because (1) I believe that low costs are a winner in the investment scene and (2) this way, each family's investments can be formed into an integrated whole.

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