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

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I. <u>Indexing and Its Logical Limit</u>

I still smile, three months later, at one of the findings of the Morningstar (largest provider of mutual fund and ETF data) 2015 Fee Study. Here, again, is what is making me smile:

> Investors are choosing low-cost funds. Over the past decade, 95% of all flows (net new money invested in mutual funds and ETFs) have gone into funds in the lowest-cost quintile. Passive funds have benefitted disproportionately.

Each day some investors make changes in the amount of the mutual funds and ETFs that they own. Mutual fund ownership changes occur once per day at the market prices which prevail at the end of the previous stock/bond market trading day. ETF prices change each instant during each market trading day. Some investors lower their number of shares, receiving back the value of all or part of their investment. Others make new investments. "Net new money" is the excess of new purchases over redemptions.

The Morningstar finding is that 95% of the net new money is not being spread among all mutual funds and ETFs; it is going into the funds and ETFs which are the 20% lowest in cost. Again, 95% of the net new money is going into the funds and ETFs which are the 20% cheapest.

Truly, indexing is winning and has been winning big for the period 2010-2014. But, what if the trend continues, what if more and more investors (or their investment advisers) wake up and discover that, not every day, but over most all longer periods of time *indexing wins*? Can the markets function if everyone indexes? The answer is no, there must be some investors who own individual stocks and individual bonds for the market to function adequately/efficiently.

An article which attempted to address this question appeared in a Canadian publication more than 10 years ago. The occasion was the collapse of Northern Telecom which became too hot a stock in the tech boom of the 1990s and came to comprise some very high percentage of all of the value of the Canadian stock market. This happenstance occurred when technology stocks became a value bubble, they increased in value very rapidly, and then, as always with bubbles, the bubble burst.

The article estimated that a stock market can function if at least 15% of the securities are not owned by index funds. The estimated extent of the preference for indexing can reach 85%. Is this correct? No one knows.

The Morningstar study found that, at the end of 2014, indexing comprised almost 37% of the market. I predict that indexing will increase in popularity and that there will begin to be concerns about whether markets can work correctly/efficiently with too much indexed investing going on. It is a concern, but not a big one because, I believe, there are a number of investors who will continue to maintain an active, individual stock and individual bond market.

For instance, many employees now have stock options. The purchasing and selling of shares incident to these options is trading that occurs outside of indexed mutual funds. So called “day traders,” investors who own stocks for less than a day, rapidly purchasing and selling in order to attempt to realize very quick profits, also assist in maintaining financial markets. Day trading will continue as long as individuals like to gamble for a living, a livelihood which has been around for centuries.

Another investor class maintaining an active market are traders who buy stock in order to seek control of a corporation. Such corporate raiders buy some of the stock then try to get management to change course in order to increase the value of the stock in the short run. This practice, too, will continue.

Then there are individuals who have this basic belief that they can “beat the market.” I continue to run in to many of them. Some will persist.

Yours truly uses some non-indexed investments. For clients with tax-deferred accounts (IRAs, 401(k)s, etc.) I recommend using high yield (“junk”) bonds as one of the asset classes. Although there are indexed junk bond funds and ETFs, I use a Vanguard actively managed mutual fund for all investments for this asset class. We too are helping the active bond market continue to function.

So, for the foreseeable future, I don’t think that index funds and ETF’s will crowd out other market participants enough for their presence to be a problem.

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, 2015	Clients	The Smartts
Money Market Funds	1.7	1.6%
Bond Funds	25.4	7.2%
Stock Funds	72.9	91.2%
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. 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, 2015	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**1.9%**	(33)	**17.6%**	(15)	**8.3%**	(15)
Tax-Managed Capital Appreciation Admiral	**2.4%**	(25)	**17.7%**	(12)	**8.4%**	(17)
Tax-Managed Small Capitalization	**4.1%**	(43)	**18.4%**	(15)	**9.3%**	(16)
REIT Index Admiral	**4.7%**	(39)	**15.8%**	(17)	**9.9%**	(24)
Total International Stock Index Admiral	**-6.2%**	(72)	**14.2%**	(23)	**7.2%**	(29)
Balanced Index Admiral	**1.1%**	(65)	**11.9%**	(15)	**7.1%**	(13)
Total Bond Market Index Admiral	**1.6%**	(39)	**4.4%**	(62)	**4.9%**	(43)
Interim-Term Investment-Grade Bond	**0.6%**	(11)	**4.9%**	(66)	**5.7%**	(47)
High–Yield Corporate Bond	**1.8%**	(79)	**8.2%**	(27)	**6.6%**	(48)

For comparison, here are several stock and bond benchmarks:

Periods ended June 30, 2015	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**1.2%**	**17.3%**	**7.8%**
Russell 2000 (small stocks)	**4.7%**	**17.1%**	**8.4%**
MSCI World Index	**2.6%**	**13.1%**	**6.4%**
Barclays Aggregate Bond Index	**-0.3%**	**3.1%**	**4.2%**
BofAML US High Yield Master II TR (bond index)	**2.5%**	**8.4%**	**7.8%**

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>.

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. **SOME Index Funds Vulnerable to "Front-running"**

A July 13, 2015 article in the *Investment News* speaks to a problem which some index funds, particularly S&P 500 index funds have. Only a few times per year is the S&P 500 index of corporations changed. There are investors who figure out, before the Standard and Poors investment panel announces, which corporations will be added to the index and which will be replaced. "Front-running" is other investors' attempts to buy the new S&P 500 companies in advance of the official announcement and sell the exiting companies.

It works so well that it may cost, according to two estimates in the article 0.20% to 0.28% per year for S&P 500 index funds. Vanguard believes that it is mitigating this problem:

> "Managers at The Vanguard Group Inc., which oversees $3 trillion, 'mitigate a good portion' of the risk by gradually building positions over time in stocks that are scheduled to be added, said Doug Yones, Vanguard's head of domestic equity indexing and ETF product management.
>
> 'It just comes down to being smart with your trades,' he said. 'It's a big enough deal that index manager are aware and spend time and energy making sure there isn't an impact."

Smartt comment: Vanguard has a mutual fund and an ETF which own stock sizef just below the S&P 500. When one of the "500" slips out of the index, it is sold by the S&P 500 fund to this fund, the Extended Market fund, and vice versa. The front-running mal-effect is not eliminated but is minimized a bit.

A better solution is to own an investment which covers the entire stock market so that no swapping, no trading is required. Such an investment is Vanguard's Total Stock Market Index Fund and ETF. The problem of front-running is one of the reasons why this investment is better than an S&P 500 fund/ETF and why I have used it personally for more than a quarter century. This is the largest single holding, by far, for clients as well as personally.

Most 401(k) plans have an S&P 500 mutual fund as one of the investment alternatives, few have a total stock market fund as alternative. Employees would be better served if the total fund was included in the roster of permissible investments.

V. **Other News and Notes:**

The July 22, 2015 edition of The Wall Street Journal, in an article by fellows at the Brookings Institution and the Progressive Policy Institute, estimates that the cost of depriving clients of personalized, human advice during a future market correction (nice word for "market crash") could be as much as $80 billion. The authors believe that so called "robo financial advice" is inadequate in keeping investors invested during periods of high market uncertainty.

> "Expecting robots to safeguard the investment security of small savers is the kind of policy hubris that could only come after a six-year bull market, when officials have forgotten that what goes up can also come crashing down."
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> As research from Vanguard has shown, brokers and advisers perform a vital service by keeping clients invested for the long-term, rather than trying to time the market. The decision to stay invested swamps all other factors affecting retirement savings."

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