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I. Searching for Income from Your Investments

Inflation in the US is running around 2% per year, a rate which is not expected to change very much in the next year or so.

Bonds:

The interest income being paid presently on ten-year US treasury bonds is less than 2%. So if one is relying on government bond interest income, one is falling behind inflation; net of inflation, there is no investment income left to spend. And, unless the bonds are owned in a tax-deferred account (an IRA or 401(k)), there is income tax to pay too, even though there is, after inflation, no net income on the bonds.

Intermediate-term, investment grade corporate bonds are paying about 2.5 to 3% interest, better than government bonds but not the "inflation plus 2% to 2.5%" that we expect bonds to provide over long periods of years.

Stock:

As I write this, the stock market, represented by the dividend yield on VTI, the Vanguard Total Stock Market Index ETF (exchange-traded fund), is yielding a dividend rate of 2.13%. So, stock, as represented solely by its current income, its dividend, is not helping provide income which would run much ahead of inflation, is it?

High-yield Bonds:

When confronted with this situation, many are tempted by products which promise higher rates of return. For several years we have seen advertisements for annuities with guaranteed interest rates, say of 5% or 6% per year. These rates are generally offered not forever, but for periods of three to six months. Again, not much of a solution, especially because once purchased, such "guaranteed" annuities have a high exit cost, often 6% to 10%. The anticipation is that the "guaranteed rate" will last only a few months and then a rate of interest will be provided which is "bond-like."

So many investors have been purchasing high yield ("junk") bonds that the Vanguard fund, which many of us own, has been closed to new investors since May, 2012. Vanguard closes its mutual funds when there are more demands from new investors than Vanguard believes are available for fulfillment; that is, the managers of the mutual fund cannot find enough reasonably priced bonds to buy in relation to investors requesting to purchase new shares of the fund. For new clients in the interim, until the fund reopens, I have been using a junk bond ETF which takes more risk than the Vanguard fund and which was chosen for its relatively low cost of operation. When the Vanguard fund re-opens, the ETF will be sold and the Vanguard fund purchased.

Income through a widened perspective:

"Never dip into principal," is an invest adage many of use have heard. If we never dipped into principal, we could not have been living on our investments for the last several years, years in which interest rates have been kept artificially low by governments in order to attempt to stimulate the economy and encourage increases in business activity. Dipping into bond principal really does not work long term, but may be a short term solution.

I believe that as investors we must widen our view. The stock market's return on investment is comprised of both the dividend income paid and on anticipated, but not guaranteed, increases in the value of our investments. To live on our investments, it is allowed to spend part of the principal of our investments in stock, because that principal, long term, grows in value. So we don't just spend interest and dividend income, we also spend some of the gains we have realized from owning investments which are based on common stock.

How much can we spend?

I believe that spending 4% of the value of our investments each year provides assurance, but not a guarantee, that we will be able to spend more dollars but the same percentage next year in order to keep up with inflation. There is no guarantee of this, but it is a rule of thumb which has been reasonably reliable in the past.

So, owning investments and receiving part of our income from our investments requires both (a) a wider perspective of what is permissible to spend, income includes capital gain income, and (b) owning stock as a significant part of our investments.

If we spend less than 4%, we can have more confidence that our investments are growing in their ability to provide future income; if we spend more than 4%, we can have less confidence.

II. <u>What Are OUR and THEIR Asset Allocations?</u>

Each of us has a different ability to live with uncertainty (risk) and so our investments will be different:

As of December 31, 2012	Clients	The Smartts
Money Market Funds	2.3	0.9%
Bond Funds	31.9	4.3%
Stock Funds	<u>65.8</u>	<u>94.8%</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 December 31, 2012	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**16.4%**	(27)	**2.3%**	(16)	**7.9%**	(14)
Tax-Managed Capital Appreciation Admiral	**16.4%**	(28)	**2.0%**	(22)	**7.8%**	(16)
Tax-Managed Small Capitalization	**16.0%**	(40)	**5.2%**	(20)	**10.5%**	(20)
REIT Index Admiral	**17.7%**	(29)	**6.1%**	(23)	**11.7%**	(35)
Tax-Managed International Admiral	**18.6%**	(42)	**-3.3%**	(43)	**8.5%**	(35)
Balanced Index Admiral	**11.5%**	(62)	**4.3%**	(7)	**7.2%**	(25)
Total Bond Market Index Admiral	**4.2%**	(83)	**5.9%**	(57)	**5.2%**	(46)
Interim-Term Investment-Grade Bond	**9.1%**	(21)	**7.4%**	(18)	**6.1%**	(18)
High–Yield Corporate Bond	**14.4%**	(57)	**8.6%**	(36)	**8.1%**	(79)

For comparison, here are several stock and bond benchmarks:

Periods ended December 31, 2012	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**16.0%**	**1.7%**	**7.1%**
Russell 2000 (small stocks)	**16.4%**	**3.6%**	**9.7%**
MSCI EAFE Index	**17.3%**	**-3.7%**	**8.2%**
Barclays Aggregate Bond Index	**4.2%**	**6.0%**	**5.2%**
BofAML US High Yield Master II TR (bond index)	**15.6%**	**10.0%**	**10.4%**

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 Balanced Index mutual fund is comprised of approximated 60% stock, the same investments as the Total Stock Market Index fund, and approx. 40% bonds, the same bonds as the Total Bond Market Index fund. This 60/40 allocation is very close to the average client allocation, see Section II., above. When compared with other "Allocation funds" (Morningstar's caption for balanced <stock and bond> funds), the Balanced Index fund ranks at the top 1/4, before income taxes, a bit better than expected.

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 exactly because it takes significantly less risk than the average high-yield fund.

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

IV. The Tax Advantage of Broadly Based Index Funds

The last ten years have seen tremendous fluctuations in the value of the stock market. Much of the focus of the financial media has been on these changes in value. The income taxation of investments has taken a back seat during most of this decade. However, significant increases in the value of stocks since the February, 2009 low point in the stock market should remind investors that, in regular, currently taxed accounts, there is another cost of investing, the cost of income taxes. Income taxes are generally levied on both the dividend income paid by stock and the realized net capital gains of mutual funds.

The March/April, 2012 issue of *The Journal of Indexing* is subtitled "**The Bogle Issue**." John Bogle, the founder of Vanguard and a pioneer in indexed fund investing is on the cover, testifying at one of the Congressional Committees. In an article titled: "The Case for Indexing, Revisiting the Foundations of Passive Investment," one of Vanguards senior analysts, Christopher Phillips, summarizes the case for the income tax advantage of index funds:

> "From an after-tax prospective, broad index funds and ETFs may provide an additional advantage over actively managed funds. Because of the way index funds are managed, they rarely realize and distribute capital gains to shareholders.
>
> According to Bergstresser and Poterba (2002), the typical mutual fund distributed, on average, 50 percent of its annual price appreciation in the form of capital gains. It should be noted that very few conventional broad index funds or broad ETFs have distributed capital gains in past bull and bear market cycles. Historically, approximately one-third of the distributions from actively managed funds have been in the form of short-term gains and two-thirds in the form of long-term gains. Index funds, on the other hand, distribute far less (an estimated 0.50 percent) as long-term gains, primarily because selling occurs only when the composition of the market index changes. This can result in return advantages over the long term because the majority of the investment compounds over time instead of being lost to taxes.'

When the stock market is diving, no one cares about taxable capital gains, but when the stock market has gone up in value, rather strongly and rather consistently for several years, then regular, actively-managed mutual fund owners begin to be hit by "the December Surprise," distribution, late in the tax year, of net gains. Shareholders can do little to reduce the income taxes on such distributions.

We who are largely index fund investors have far less worry about income taxes. Generally, the broader the index fund owned, the less worry about taxable capital gains. <u>Not no worry, but far less worry</u>.

If your Form 1099 from your mutual fund contains taxable capital gains distributions, I'd be pleased to discuss with you how to change your investments so that this problem is minimized in future years.

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