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**Client Newsletter Volume XIX Number 2 November 1, 2013**

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## I. <u>Where From Here?</u>

One could hardly wish for a hotter stock market this year. See section III below for rates of return on investment through the first nine months of the year. The Total Stock Market Index fund is up more than 21% for 9 months. This month, as this is being written, the average client account has posted gains of 3.9% *for the month*. The Federal Reserve will apparently continue to stimulate the economy by purchasing more bonds every month, no "taper" of their efforts is in sight, though the current speculation is that the Fed might begin reducing their bond purchases sometime next spring, not stopping the stimulative bond purchases, just decreasing the amount of such purchases.

Stock Markets:

One of the Barron's magazine websites reports that the S&P 500 average of large US stocks was, at the end of last week, selling for 19.3 times earnings. That is, if you wish to purchase $1 of earning power of the average large US corporation (as measured by earnings reported for the most recent year period) you would have to pay about $19.30 for its stock. We would rather pay less, but often in the last five years when this price/earnings ("P/E") ratio was significantly less, the financial and economic news was so bad that we would hesitate before investing more of our money in the stock market. This is the way investing is, when the news is good other investors have already bid up the price of what we wish to purchase and vice versa.

Jeremy Siegel, my principal stock "guru", a Wharton School finance professor and author of <u>Stocks for the Long Run</u>, my favorite investment book, says that the average P/E ratio for the market is about 19. At 19 times earnings stocks are reasonably priced. So, I conclude, that it is all right for a long-term investor (and urge each of you to be a long-term investor) to add more money into the stock market. Please note that the stock market is subject to significant fluctuations, negative as well as positive. We much appreciate the fine increases in value so far this year; we enjoy positive fluctuations.

We are stressed by negative fluctuations, we tend toward panic (e.g. "This is my retirement, what if this trend continues?"). Being a long-term investor is not without stress, but stress is reduced by remembering that if we need money from our investments, and the stock market has declined in value, we can sell bonds for several years to obtain the funds we need, most of us have five years of probable withdrawals invested in bonds for this purpose.

If negative stock market fluctuations were stress-free, more people and institutions would invest a higher percentage of their money in stocks, and stock would, as a result, not be as good an investment buy. So, no free lunch, but stock continues to be the better, long-term investment. We should be prepared for the

possibility that any $1.00 we invest in the stock market today or tomorrow might be worth 80 cents the next day, the fluctuations can be rapid and breathtakingly large. This should not deter us, but should require that our investments contain a mix of stock, bonds, and money market balances.

We invest in stock because it has such a superior long-term, after-inflation, historical rate of return, not because it is stress-free.

Bond Markets:

As this is written, the Vanguard Total Bond Market Index fund is down more than 2% for the year. Bonds have been a great long-term investment over the last 30 plus years, a period that began with very high, double digit, inflation and high interest rates, and now is characterized by record low interest rates and lower than average inflation. Short-term bond rates of interest payment on bonds are below the rate of inflation (a negative, real, after-inflation rate of return). The prospects for bonds are not very good as there is a high probability that interest rates will increase sometime in the future (and when interest rates increase, the value of the bonds which we already own goes down).

Yet we should continue to own some bonds within our investments, for two principal reasons: first, as mentioned above, for those of us withdrawing from our investments to finance our life, bonds help protect us from negative fluctuations in the stock market (while still providing some interest income). Second, when those bad days of large, negative fluctuations in the stock market come, bonds help us sleep nights as they do not fluctuate as much in value as does stock. In fact, when stock goes down in value, bonds *may* increase in value. This makes bonds a good counterweight to stock, a good diversification.

Money Market Funds:

These funds are now paying only 0.1% 0.2% interest per year. They appear to be a bad investment, but are a store of value, the value of which is expected to be stable until we spend them. We need to invest in money market funds if we have upcoming cash needs.

Stability of Government:

Few of us are happy with Congress and the Executive branches of government right now. They did not solve the impasse on Federal government spending, taxation, or the national debt; the can was just kicked down the road one more time. Political uncertainty just adds to our worries, and political uncertainty tends to increase the extent of financial market fluctuations in value.

When things are not going well for our government, when the branches have a hard time agreeing and conducting business, it is harder to be an investor, but just as necessary and, potentially, just as rewarding. I look forward to opportunities to assist you as you negotiate future financial markets. Please do not hesitate to give me a call or send me an email if you have questions.

I am grateful that several individuals and families have, this year, chosen me to begin to assist them with their investments. I welcome others. When you hear others complain about stock markets, bonds, or government, please help them connect with me. Many of you, similarly, acted on a referral. Thank you.

## 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, 2013 | Clients | The Smartts |
|---|---|---|
| **Money Market Funds** | 2.0 | 0.7% |
| **Bond Funds** | 28.7 | 6.7% |
| **Stock Funds** | 69.3 | 92.6% |
| **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, 2013 | Yr.-to-date | | 5 Years | | 10 Years | |
|---|---|---|---|---|---|---|
| **Total Stock Market Index Admiral** | **21.3%** | (30) | **10.7%** | (15) | **8.3%** | (18) |
| **Tax-Managed Capital Appreciation Admiral** | **21.0%** | (33) | **10.7%** | (16) | **8.1%** | (21) |
| **Tax-Managed Small Capitalization** | **28.5%** | (21) | **12.4%** | (28) | **11.2%** | (14) |
| **REIT Index Admiral** | **3.1%** | (20) | **6.3%** | (27) | **9.6%** | (33) |
| **Tax-Managed International Admiral** | **15.6%** | (17) | **6.2%** | (39) | **8.2%** | (34) |
| **Balanced Index Admiral** | **11.6%** | (36) | **9.1%** | (25) | **7.2%** | (21) |
| **Total Bond Market Index Admiral** | **-2.0%** | (55) | **5.3%** | (75) | **4.6%** | (45) |
| **Interim-Term Investment-Grade Bond** | **-1.9%** | (51) | **8.4%** | (14) | **5.3%** | (20) |
| **High–Yield Corporate Bond** | **1.3%** | (96) | **10.8%** | (57) | **7.0%** | (71) |

For comparison, here are several stock and bond benchmarks:

| Periods ended September 30, 2013 | Yr.-to-date | 5 Years | 10 Years |
|---|---|---|---|
| **S & P 500 (large stocks)** | **19.8%** | **10.0%** | **7.6%** |
| **Russell 2000 (small stocks)** | **27.7%** | **11.2%** | **9.6%** |
| **MSCI World Index** | **17.3%** | **7.8%** | **7.6%** |
| **Barclays Aggregate Bond Index** | **-1.9%** | **5.4%** | **4.6%** |
| **BofAML US High Yield Master II TR (bond index)** | **3.8%** | **13.4%** | **8.7%** |

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 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.

This fund has closed since May, 2012. Until it reopens several are using a low cost, non-Vanguard ETF, pending reopening of the Vanguard fund. This ETF, with the symbol "JNK" costs 0.40% per year, significantly less than the average junk bond mutual fund (which costs 1.12% per year per Morningstar) but significantly more than the Vanguard mutual fund (which costs 0.23% per year).

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

## IV. Financial Origami (a Book Review)

The subtitle of the book is: "How the Wall Street Model Broke." I found this book in early October at one of the exhibitor stalls when attending the national conference of my fee-only advisors association (NAPFA, the National Association of Personal Financial Advisors). A short book, it is a fine summary of how changes in regulation and changes in ownership of the Wall Street financial firms caused the 2007-2009 financial crisis. The author, Brendan Moynihan, is an editor-at-large for Bloomberg News.

He posits that for decades the model for ownership of the major Wall Street investment banks was the partnership form. If there were losses, the partners bore the losses, same for gains. Now, such firms are almost all corporations; gains and losses are shared with shareholders and there is no ultimate, personal liability for employees if things go wrong. He believes this has made financial markets more volatile.

He believes that Wall Street's primary purpose is the transfer of risk. When there is not enough risk on which to profit, Wall Street invents other products which transfer risk. Regulation is a tough act since Wall Street types are very, very creative.

A good book, very short, only about 150 pages (plus footnotes). Unlike the dozens of other books about the financial crisis, this one has no descriptions of what various leaders thought or were experiencing during the crisis, just step by step detail of what has happened and how changes, sometimes decades before, led to the crisis.


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