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I. Why Fees are So Important—a Morningstar Update

From an Article in the *Morningstar FundInvestor*, April 2016 edition by Russell Kinnel, Editor.

"The expense ratio is the most proven predictor of future fund returns. I find that it is a dependable predictor when I run the data. That's also what academics, fund companies, and of course, Jack Bogle [Vanguard's founder] find when they run the data. That's what I mean when I say most proven.

How We Ran the Test

To begin any test of predictive power, you have to go back to historical data so that you are using the data that investors would have had access to at the time. That includes funds that no longer exist. In fact, that's a key part of the story because higher-cost funds are much more likely to fail and be merged away [e.g. merged into other existing funds with better records]. So, if you do not factor them in, you will see better performance from higher-cost funds than was the reality, as those that survived naturally are more likely to have produced better performance while so many failures have been culled.

…We calculated a success ratio for all…measures, my way to factoring in mutual funds which were merged away or liquidated over the ensuing time period…But the success ratio asks, What percentage of funds survived and outperformed? Only funds that did both count toward the success ratio, as it is hard to argue that funds that no longer exist or underperformed were successful.

Finally, there's the matter of time period. I looked at the five years ended December 2015, the four years ended 2015, and so on.

The Answer: Costs really Are Good Predictors of Success

Using expense ratios to choose funds helped in every asset class and in every quintile [e.g each 1/5 of funds sorted by annual cost of the fund] from 2010 to 2015. For example, in U.S. equity funds, the cheapest quintile had a total-return success rate of 62% compared with 48% for the second-cheapest quintile, then 39% for the middle quintile, 30% for the second-priciest quintile, and 20% for the priciest quintile. So, the cheaper the quintile, the better your chances. All told, cheapest-quintile funds were 4 times as likely to succeed as the priciest quintile. (If you are wondering why only one quintile had a success ratio above 50%, it's because so many funds did not survive the time period. If no funds were

merged away, then the overall success rates would average something close to 50%.) As it was about 20% of the funds were merged away, making 40% the average success ratio point.

The pattern was pretty similar in other asset classes. Balanced funds had a 54% success rate for the cheapest quintile compared with 24% for the priciest. Taxable-bond funds were even more striking, as the cheapest quintile delivered a 59% success rate versus just 17% for the priciest quintile.

Smartt comment:

Complicated language but another study, the seventh or eighth I've run across in the last couple of decades, which proves the efficacy of low cost, diversified, mutual fund (and ETF) investing.

II. What Are YOUR and MY 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, 2016	Clients	John Smartt
Money Market Funds	1.7	0.6%
Bond Funds	25.3	8.6%
Stock Funds	73.0	90.8%
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.

I contemplate withdrawing more from my IRA in the future (in order to make qualified charitable contributions) and I therefore increased my allocation to bonds late in 2015.

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 March 31, 2016	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**0.9%**	(40)	**11.0%**	(24)	**7.0%**	(15)
Tax-Managed Capital Appreciation Admiral	**0.9%**	(41)	**11.3%**	(14)	**7.1%**	(14)
Tax-Managed Small Capitalization	**2.4%**	(22)	**10.4%**	(3)	**7.0%**	(10)
REIT Index Admiral	**6.3%**	(7)	**11.8%**	(18)	**6.7%**	(19)
Total International Stock Index Admiral	**-0.2%**	(21)	**0.7%**	(76)	**1.9%**	(35)
Balanced Index Admiral	**2.0%**	(18)	**8.3%**	(6)	**6.5%**	(10)
Total Bond Market Index Admiral	**3.1%**	(12)	**3.7%**	(41)	**4.9%**	(39)
Interim-Term Investment-Grade Bond	**3.5%**	(42)	**5.0%**	(41)	**5.8%**	(38)

High–Yield Corporate Bond	**2.3%**	(50)	**5.5%**	(8)	**6.1%**	(31)

For comparison, here are several stock and bond benchmarks:

Periods ended March 31, 2016	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**1.4%**	**11.5%**	**6.9%**
Russell 2000 (small stocks)	**-1.5%**	**7.2%**	**5.3%**
MSCI World Index	**-0.3%**	**6.5%**	**4.3%**
Barclays Aggregate Bond Index	**3.0%**	**3.8%**	**4.7%**
BofAML US High Yield Master II TR (bond index)	**3.2%**	**4.7%**	**6.8%**

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 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. The Vanguard fund, which takes less risk, continues to rank very highly in the rankings over the last five and ten year periods. When the more risky portions of the "junk bond" are stressed, the Vanguard fund shines. Over the last ten years the Vanguard fund has captured 2/3 of the excess of junk bond returns over good quality bond returns—in accord with my expectation. I continue to believe that, for tax deferred accounts, this fund is a reasonable, additional diversification.

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

IV. Other News and Notes:

A. Study "finds extensive misconduct:"

The subtitle of this article from the March 7, 2016 issue of the *Investment News* is "Nearly 20% of advisers at Oppenheimer have been disciplined."

> "There's a phrase no one wants to read in a sweeping report about the financial advisers who handle their savings: economy-wide misconduct.
>
> A new working paper by business school professors at the University of Chicago and the University of Minnesota found that 7% of financial advisers have been disciplined for misconduct that ranges from putting clients in unsuitable investments to trading on client accounts without permission. That's a troubling mark for an industry that relies on the trust of clients.
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> **Smartt comment:** I recently receive my "all clear" letter from a limited exam performed by the State of Tennessee regulators to whom I answer as a Tennessee registered investment adviser. Most of the examination seemed aimed at unearthing the extent to which employees were paid commissions for various types of sales and sales contests. Much of the exam was "n/a" to me.
>
> Percentage of advisors disciplined for several other large firms: Wells Fargo Advisors – 15.3%; UBS Financial Services – 15.1% and Raymond James Financial Inc. -13.7%.

B. “Most fund managers are not hot shots.” This appeared in the Money section of the March 13, 2016 issue of *USA Today*:

> “That hot-shot mutual fund manager you’re banking on to make you rich might be generating returns that fall far short of the benchmark stock index the fund tracks.
>
> Last year, for example, when the Standard & Poor’s 500-stock index posted a paltry total return of 1.4% with dividends included, 66% of ‘actively managed’ large company stock funds posted even smaller returns, according to the SPIVA U.S. Scorecard released…by S&P Dow Jones Indices. In Wall Street speak, that means that two out of three fund managers ‘underperformed’ the stock benchmark they are measured against.
>
> …Higher fees for actively managed funds also played a role.
>
> ‘Fees explain a lot of the long-term underperformance’ of actively-managed funds said [a financial advisor, Thomas Lee].

C. “Things to know about the new rules for retirement advisers” is the title of an article from the April 10, 2016 issue of the *Knoxville News Sentinel*, by Jim Puzzanghera of the *Los Angeles Times*:

> “You might think the people you hired to help arrange your retirement finances have to put your best interests first. That’s not always the case.
>
> So the Obama administration has taken a controversial step to try to protect Americans from being ripped off.
>
> The new rules unveiled…by the Labor Department are designed to prevent consumers from being steered toward IRAs and other retirement investments with higher fees or lower returns that benefit the advisor recommending or selling them.
>
> The White House estimated that those conflicts of interest cost Americans $17 billion a year.
>
> Consumer advocates, Democrats and retiree groups such as the AARP cheered the administration’s move…
>
> For decades, many investment advisers have been required under federal law to put the best interest of their clients first. That makes the advisers, who usually are paid a flat fee, into what are known as fiduciaries.
>
> But other retirement advisers, such as brokers and insurance agents, have had a lower standard…
>
> This has become a bigger issue as Americans have shifted from pension plans administered by their employer to 401(k) and other retirement plans that they manage themselves.
>
> The new rules make all retirement investment advisers into fiduciaries, meaning they must put the client’s best interest above their own.

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