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Client Newsletter Volume XXII Number 2 November 1, 2016

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I. The Battle of Costs vs. Performance

From the lead article in *The Morningstar FundInvestor*, October, 2016 edition. The author is Russel Kinnel, Director of Market Research for Morningstar and the editor of the magazine:

"Who cares what a fund charges? If a fund has great returns, then I know it was able to overcome its fee." I see comments like this one just about every time I write about the predictive power of fees. There's a certain logic to it, but the problem is one of persistence. Fund expense ratios don't tend to change much, whereas performance changes a lot. I've shown how fees predict success, but this time I wanted to go one step further and look at the combination of expenses and past performance. Would you rather own a low-cost fund with poor past performance or a high-cost fund with great past performance? Novice investors would typically say the latter, but the former is the better choice. Hands down.

I went back 10 years and grouped funds into expense ratio quartiles relative to category and trailing five year-return quartile by category. (I used the past five years because that's the time period investors seem to rely on most.) Then I combined the data so that I had fee quartiles grouped by past returns. That left me with 16 groups of funds: the cheapest funds divided into quartiles by return, the second-cheapest in return quartiles, and so on…

At the end of 2005, the U.S. equity funds in the cheapest quartile but with returns in the worst quartile had an expense ratio of 0.73% and an average five-year return of negative 1.92% annualized. The funds in the priciest quartile but with top-quartile performance had an expense ratio averaging 2.17%, but returns were a robust annualized 6.95%. So, how did the next 10 years go? The funds that started with low costs and poor returns went on to enjoy a 7.41% annualized return compared with 5.46% for those formerly high-performing pricey funds. In fact, the cheap laggards produced the highest returns of any of the 16 groups, while the pricey sports cars had the worst of any group.

The return figures actually understate the difference because high-cost failures were more likely to be liquidated by the parent company because of subsequent periods of poor performance. This is why I use success ratios in conjunction with returns.

Take-Aways

Needless to say, expense ratios are the place to start for mutual funds. Look for funds with strong managers, good strategies, good stewardship, and good performance over the manager's entire tenure, too. You want to understand past performance, but don't read too much into recent returns."

Smartt comment:

A good article which shows that even if a low cost fund was to have a bad set of returns for some period (five years here), its future long term (ten years here) outlook at that point would still be better than average due to its persistence (e.g. continuing) to be low cost.

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 September 30, 2016	Clients	John Smartt
Money Market Funds	1.8	3.1%
Bond Funds	24.6	17.6%
Stock Funds	73.6	79.3%
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), increased my allocation to bonds late in 2015 and further increased it in 2016. I continue to make 401(k) contributions, invested in Vanguard's High Yield Corporate Bond Fund.

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, 2016	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**8.2%**	(17)	**16.3%**	(12)	**7.5%**	(12)
Tax-Managed Capital Appreciation Admiral	**7.5%**	(28)	**16.5%**	(9)	**7.5%**	(14)
Tax-Managed Small Capitalization	**13.2%**	(16)	**17.7%**	(6)	**8.8%**	(8)
REIT Index Admiral	**11.8%**	(9)	**15.7%**	(14)	**6.5%**	(20)
Total International Stock Index Admiral	**6.7%**	(14)	**6.8%**	(62)	**2.2%**	(31)
Balanced Index Admiral	**7.5%**	(21)	**11.0%**	(13)	**6.8%**	(10)

Total Bond Market Index Admiral	**6.0%**	(48)	**3.0%**	(70)	**4.8%**	(44)
Interim-Term Investment-Grade Bond	**7.0%**	(84)	**4.7%**	(64)	**5.7%**	(48)
High–Yield Corporate Bond	**10.4%**	(74)	**7.6%**	(30)	**6.6%**	(33)

For comparison, here are several stock and bond benchmarks:

Periods ended September 30, 2016	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**7.8%**	**16.4%**	**7.2%**
Russell 2000 (small stocks)	**11.5%**	**15.8%**	**7.1%**
MSCI World Index	**5.6%**	**11.6%**	**4.5%**
Barclays Aggregate Bond Index	**5.8%**	**3.1%**	**4.8%**
BofAML US High Yield Master II TR (bond index)	**15.3%**	**8.2%**	**7.6%**

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 approximately 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. Reverse Mortgage—A Retirement Tool

"Reverse Mortgage"

This article appeared in the June 13, 2016 edition of *InvestmentNews*. Subtitle of the article is, "Prominent Researchers are Embracing the Home Equity Product as a Key Retirement Planning Tool. Will Advisers Follow?"

> "Carolyn Dayton had achieved a major goal of many retirees. She owned her home [in the San Francisco Bay area] free and clear with no monthly mortgage to erode her retirement income.
>
> But after retiring from her job…more than a year ago [she] watched nervously as the investments in her individual retirement account rose and fell amid a volatile market. Meanwhile the value of her home…steadily increased.
>
> 'My investments haven't been doing great, but I have a whole pile of money tied up in my house,' said Ms. Dayton who paid $600,000 for her home 12 years ago. Today it is worth $900,000. 'Rather than take money out of my IRA when it is low, I thought I could take money out of my house when it is high.'

Without realizing it, Ms. Dayton had stumbled onto one of the most innovative—and controversial—ideas in financial planning today: How to incorporate home equity into a retirement income strategy.

'Having a buffer asset can help manage sequence of returns better and make a retirement income plan more efficient,' said…Wayne Pfau, a professor of retirement income at the American College of Financial Services…'A reverse mortgage can reduce the risk of client outliving their savings by allowing them to use loan proceeds during down markets rather than tap a shrinking nest egg.'

Great value

Mr. Pfau analyzed several recent studies on how to use a reverse mortgage as part of a comprehensive retirement income strategy. His conclusion: There is great value for clients in opening a reverse mortgage line of credit at the earliest possible age, particularly in a low-interest rate environment like today.

Once established, the available line of credit continues to grow each year, even if the underlying value of the house does not appreciate. In addition to serving as a hedge against portfolio depletion, a standby reverse mortgage line of credit can serve as long-term care insurance or a deferred annuity, using the home as collateral instead of paying insurance premiums.

Reverse mortgages allow older homeowners to convert the equity in their primary residence into a liquid, usable resource. Borrower must be 62 or older and must either own their home outright or use the proceeds of the reverse mortgage to pay off the balance of their existing mortgage. They retain ownership of the home and must continue to maintain it and pay their property taxes and homeowner's insurance.

Distributions are tax-free and can be taken as monthly payments for a fixed period of time, as long as the borrower remains in the house, as a line of credit or as a combination of payout options. Interest accrues monthly only on the amount borrowed, not on unused lines of credit. No repayment is required until the last borrower sells the house, moves out permanently or dies. Because it is a nonrecourse loan, the borrower or heirs can never owe more than the home is worth, even if that value is less than the loan balance.

It's undeniable that the reverse mortgage industry has been plagued with a sleazy image thanks to its outdated celebrity pitchmen, aggressive sales tactics and occasional horror stories of widows being forced out of their homes. But the industry landscape has changed dramatically over the past few years. Reform of the federally insured Home Equity Conversion Mortgage program has increased consumer protection, introduced underwriting to weed out unsuitable candidates and significantly lowered costs."

Smartt comment: I have discussed reverse mortgages with most of my clients as they reach the decade before retirement. The initial closing costs of the product deter most everyone. One of the significant costs is an insurance policy which holds the bank or holder of the mortgage harmless if the house declines in value. Clients generally are put off by this significant cost (a cost which has declined in recent years as markets obtain additional experience with reverse mortgages). The above article suggests just opening a line of credit, in advance of current need. If you have an interest in this, please contact me.

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