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

Client Newsletter Volume XXIV Number 2 November 1, 2018

I. Socially Responsible Investing Reconsidered
II. What are YOUR and MY Asset Allocations?
III. Vanguard Rates of Return (through Latest Quarter End)
IV. Fidelity's No-Fee Mutual Funds

I. Socially Responsible Investing Reconsidered:

Socially responsible investing, e.g. the consideration of factors other than future growth and profit in ones investments, is a trend of long standing. To date my response has been to suggest that investors maximize their profits by minimizing investment costs; and then take some of the profits and make targeted contributions to reduce or eliminate the world's ills. I am in the process of changing my mind on this. I was prompted to change by two events. First, to complete some of my annual CPA and registered investment advisor continuing education, I attended the annual Morningstar conference (remotely, online). One of the sessions featured Jeremy Grantham. His address noted that climate change threatens not us but it does threaten our grandchildren. The effects of climate change could make it much more difficult to feed the world.

The second event is that Vanguard, which has had a socially responsible index fund since 2000, has recently introduced two ESG (environmental, social and governance) ETFs. Both are broadly diversified. One owns US stocks, the other owns non-US stocks. Whereas the Vanguard Total Stock Market Index ETF (and Admiral class mutual fund), the current basis of most of our investments in US stocks, costs 4/100% per year of fund cost, the new Vanguard ESG US ETF will initially cost 12/100% per year.

Quoting Vanguard:

> "These ETFs can be core components of a portfolio for investors who wish to invest in accordance with their social objectives.
>
> The indexes exclude the stocks of companies producing adult entertainment, alcohol and tobacco products, conventional and controversial weapons (including civilian firearms), fossil fuels, gambling activities, and nuclear power. The indexes also exclude the stocks of companies that do not meet certain diversity criteria, as well as the labor, human rights, anti-corruption, and environmental standards defined by the Ten Principles of the United Nations Global Compact.
>
> With thousands of stocks in each portfolio, the ESG ETFs at their outset will be the most diversified across all capitalizations [e.g. will contain large, medium and small capitalization stocks]. Both ETFs are among the very few that offer all-cap exposure to their markets, after applying the ESG screens, the ETFs will cover more than 80% and nearly 70% of the U.S. and international equity market capitalization, respectively."

To highlight the effect of the presently projected higher costs, assume $100,000 is invested at a 6% annual rate of return for a decade. The result, with no costs would be $179, 085. A 4/100% annual cost would

reduce the result by $675 to $178,410. If instead a 12/100% annual cost (the initial cost of the US ESG ETF) was applied, the result would be $177,068, a further difference of $1,342.

Personally, that is a difference that I can live with because I believe that, just when as other Vanguard funds have grown in size, Vanguard reduces their cost, so the ESG fund will probably cost less in future.

There are small conversion costs. TDAmeritrade, our custodian, now charges a brokerage charge when Vanguard ETFs or mutual funds are bought or sold. The amount of the commission is lower for larger accounts. Further, when an ETF is purchased or sold, the bid/asked spread of prices acts to increase the cost of each transaction.

The bid/asked spread is generally only one to five pennies per share, but this is for Vanguard ETFs which have been trading for a while. So we should be in no hurry to make the change.

When converting from a mutual fund to an ETF there is an additional conversion risk because mutual funds are priced once per day, as the New York Stock Exchange closes at 4 PM Monday through Friday. The prices of ETFs change throughout the day as they are traded from 9:30 AM to 4 PM each day. One cannot sell one and buy the other at prices which are determined the same instant. So some change in value, some gain or loss, generally quite small, will occur.

For accounts other than IRAs, Roths, and 401(k)s, that is for taxable accounts, there can be a more significant cost, the payment of income taxes on capital gains realized on the sale of the originally held, appreciated security. And so, personally, I am going to convert to the new ESG ETF for the US market, but only within my IRA. I believe that global warming is a threat to the future but, as you will recognize, I do not wish to pay income taxes to change that part of my investments.

And, yes, I can be charged with not being totally consistent, and not true to my principles, but I am comfortable with this stance. For my stock investments in my regular, currently taxable account, I am not reinvesting dividends so I will not be making any new investments in "non ESG" funds.

Note that no mutual fund can tailor its investments exactly to meet all of any individual's ESG concerns. I believe in clean air (as an asthmatic of seven decades standing) and consider nuclear power as a positive. I believe this new set of ETFs meets most of my concerns. It's a compromise, one that I can live with.

I will be pleased to assist you in conversion if you have an interest.

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, 2018	Clients	John Smartt
Money Market Funds	2.7	0.6%
Bond Funds	27.0	21.2%
Stock Funds	70.3	78.2%
Totals	100.0%	100.0%

Remember each of us has different goals and needs and our asset allocation should fit us and our family. If you have questions about your asset allocation, or your retirement plan investments, I'd be pleased to assist.

If you have questions, don't hesitate to contact me.

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, 2018	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**10.6%**	(17)	**13.4%**	(23)	**12.1%**	(15)
Tax-Managed Capital Appreciation Admiral	**10.3%**	(30)	**13.8%**	(11)	**12.2%**	(11)
Tax-Managed Small Capitalization	**14.3%**	(6)	**13.2%**	(3)	**12.8%**	(8)
REIT Index Admiral	**0.5%**	(71)	**8.7%**	(51)	**7.5%**	(36)
Total Int'l Stock Index Admiral	**-3.1%**	(68)	**4.5%**	(37)	**5.2%**	(42)
Balanced Index Admiral	**5.7%**	(13)	**8.9%**	(11)	**9.0%**	(15)
Total Bond Market Index Admiral	**-1.6%**	(57)	**2.1%**	(50)	**3.7%**	(72)
Interim-Term Investment-Grade Bond	**-1.6%**	(38)	**2.8%**	(81)	**5.5%**	(64)
High–Yield Corporate Bond	**1.5%**	(68)	**5.1%**	(20)	**7.9%**	(43)

For comparison, here are several stock and bond benchmarks:

Periods ended September 30, 2018	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**10.4%**	**13.9%**	**11.8%**
Russell 2000 (small stocks)	**11.5%**	**11.1%**	**11.1%**
MSCI World Index	**5.4%**	**9.3%**	**8.6%**
BBgBarc US Aggregate Bond Index	**-1.7%**	**2.1%**	**3.6%**
ICE BofAML US High Yield Master II TR (bond index)	**2.5%**	**5.5%**	**9.4%**

As this is being written in the early morning of October 31st, Vanguard's Total Stock Market Index ETF ("VTI") is up, on a price basis, 1.23% for the year to date. The market decline in recent weeks has wiped out most stock gains for the year based largely on fears of a trade war, principally between the US and China.

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 reasonably highly in the rankings over the last ten year period. When the more risky portions of the "junk bond" investment sector are under stress, the Vanguard fund shines. Over the last ten years the Vanguard fund has captured almost 75% of the excess of junk bond returns over good quality bond returns—meeting my

expectation. I continue to believe that, for tax deferred accounts, this fund is a reasonable, additional diversification and comprises more than 50% of my personal bond holdings.

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

IV. Fidelity's No-Fee Mutual Funds:

This quarter has seen the ultimate in the mutual fund industry's trend of cost reduction. Led largely by Vanguard, mutual fund (and their cousin ETFs) costs have declined as index funds gain in popularity and as more and more investors realize that higher costs generally lead to lower net returns on investments. Fidelity, another large mutual fund company, announced two zero fee funds in August and two more in September. The most fundamental question is, "How can they do that?" If you are not charging investors for the mutual fund you are providing, how do you make any money?

The answer is that mutual funds have two streams of income. The more obvious one is the annual expense ratio, the amount that the fund takes from us, little by little each trading day, to run the mutual fund. We understand this and we have been seeking to minimize this by using Vanguard broadly based index and other mutual funds and ETFs.

Fidelity's CEO Abigail Johnson says that the objective is to get more people to try Fidelity. And many have. The first two new funds attracted nearly $1 billion in their first few weeks of existence. But Fidelity is not "just making it up on volume."

The second income stream of mutual funds (and ETFs) is that the managing company lends out part of the assets of the fund overnight. This is not something secret, though few investors realize it. The assets are returned each morning and a small fee is earned for the transaction. Why do such transactions occur? There are investors who "sell short," that is they sell a stock that they do not own and then, hoping that when the price goes down, they can purchase the security, cancel their short position and earn a profit. They are charged a fee for having sold the securities that they do not own. Complicated but it works. The mutual fund companies are a major source of the overnight positions in these securities.

And so, Vanguard is no longer, at least at this writing, the lowest cost. It is my belief that Vanguard's costs of doing business are at least as low as Fidelity's. If this works for Fidelity, it is my opinion that Vanguard will offer either no fee or lower than current fee products in the future. Vanguard is a larger enterprise and has a longer history of concern for its owner/investors (that's us). Thus I am not changing from Vanguard. I recommend that you stay with Vanguard too.

John M. Smartt, Jr., CPA
3039 Kingston Pike, Apartment # 5
Knoxville, TN 37919-4615
Phone: (865) 525-9793
E-mail: johnsmarttcpa@yahoo.com
Website: www.johnsmarttcpa.com