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Note well that I will be on vacation and not reachable from October 2 – 17. If you need me, reach me before this event.

I. Remember Fidelity Magellan Fund?:

When I first began to assist individuals with their investments, one of the giant mutual fund winners was Fidelity's Magellan Fund. It had a marvelous record of providing returns to shareholders and it grew rapidly to be the largest mutual fund, and largest US stock mutual fund headquartered here in the USA. Managed by Peter Lynch between 1977 and 1990, it more than doubled the S&P 500 index for total investment return. Then, Mr. Lynch ceased being the fund manager, he retired, as I recall. His success had increased the size of Magellan from $18 million to $14 billion. At the time I thought charitably that it was nice, somehow, that he was going "out on the top." But, shortly there began to be speculation that the reason that he retired was that the large size of the fund prevented him from coming up with workable ideas in which to invest.

Let's revisit Magellan. According to one of the Morningstar publications, during the 10 years ended June 30, 2018, the fund has produced an annual rate of return which averaged 7.9% per year. The Vanguard Total Stock Market Index Fund, Admiral class, has produced an annual rate of return of 10.3% per year. In the ten years then ended, a $10,000 investment in Magellan would have grown to $21,390, the Vanguard fund would have grown to $26,536, or would have increased in value by $5,156 more than Magellan, a lead that is greater than 50% of the original investment in just the ten years under study.

Good or great actively managed (non-indexed) mutual funds often don't stay good or great. John Bogle, the founder of Vanguard, says that within investment results there is "reversion to the mean." That is there is a lot of momentum back down to average.

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 June 30, 2018	Clients	John Smartt
Money Market Funds	3.1	0.6%
Bond Funds	24.6	21.1%
Stock Funds	72.3	78.3%
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.

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 June 30, 2018	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**3.3%**	(14)	**13.3%**	(17)	**10.3%**	(14)
Tax-Managed Capital Appreciation Admiral	**2.7%**	(25)	**13.6%**	(7)	**10.3%**	(16)
Tax-Managed Small Capitalization	**9.3%**	(10)	**14.5%**	(3)	**12.2%**	(6)
REIT Index Admiral	**0.0%**	(72)	**7.9%**	(49)	**8.0%**	(29)
FTSE All-World ex-US Index Admiral	**-3.7%**	(70)	**6.3%**	(43)	**2.8%**	(39)
Balanced Index Admiral	**1.4%**	(14)	**8.8%**	(9)	**8.0%**	(13)
Total Bond Market Index Admiral	**-1.6%**	(50)	**2.2%**	(51)	**3.7%**	(65)
Interim-Term Investment-Grade Bond	**-2.2%**	(31)	**2.9%**	(75)	**4.8%**	(61)
High–Yield Corporate Bond	**-1.1%**	(83)	**5.0%**	(28)	**6.9%**	(37)

For comparison, here are several stock and bond benchmarks:

Periods ended June 30, 2018	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**2.5%**	**13.4%**	**10.1%**
Russell 2000 (small stocks)	**7.7%**	**12.6%**	**10.6%**
MSCI World Index	**0.4%**	**9.9%**	**6.3%**
BBgBarc US Aggregate Bond Index	**-1.6%**	**2.2%**	**3.3%**
ICE BofAML US High Yield Master II TR (bond index)	**0.1%**	**5.5%**	**8.0%**

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 <u>top 1/3 before taxes based on low cost</u>, and they <u>ought to be in the top 1/4 (stock funds) after income taxes</u>.

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 just over 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. Has the Growth of Index Investing Made Markets Less Efficient:

This from an article in the July 7, 2018 issue of the *Economist Magazine*, titled "The Index Fear."

"In the autumn of 1974 Paul Samuelson, a prominent economist and Nobel prizewinner issued a challenge. Most stockpickers should go out of business, he argued. Even the best of them could not always beat the market average. But there was a snag. 'If this advice to drop dead is good advice, it is obviously not counsel that will be eagerly followed.' An alternative was needed to set an example. Someone should set up a low-cost, low-turnover fund that simply tracked the S&P 500 index of stocks.

The following year Vanguard, then a fledgling firm, took up Samuelson's challenge and launched an index fund for retail investors…

Samuelson's case for an indexed fund rested on the idea that stockmarkets are 'efficient", in that any relevant news about a company's prospects is quickly reflected in its share price. If there were obvious bargains, a little effort would bring riches at the expense of slothful investors. Yet if more people are buying the index, might the market become less efficient? And might that, in turn, create opportunities for the very stockpickers who Samuelson thought should cease trading? In fact, the opposite is more probable. If index investing has displaced bad stockpickers, as seems likely, it will have made the market more efficient, not less…

Passive aggressive?

A low-cost index fund looks like a sounder bet. As more investors come to that conclusion, what is the effect on market prices? These are set by trades between informed active managers with differing opinions. Index funds are passive. Yet a concern that is often heard is that index investing helps to inflate bubbles, because index funds are forced to put more money into fashionable stocks even as they become more expensive. This rather misses the logic of indexing as a passive strategy. The index weighs each stock by its value. If a stock's price rises rapidly, its weight in the index increases. But its value in the indexed portfolio also increases. No buying is needed.

A more valid concern is what happens when capital moves to an indexed fund from an active manager who has trailed the market average by shunning fast-rising stocks. The more pension-fund mandates that such 'fundamental' investors lose to index-trackers, the greater the chance that bubbles will inflate. Yet it is worth thinking about what would happen if index funds did not exist. One hypothetical pension-fund trustee might instead switch funds to another active investor, who had done well by betting on recent winners. That would make a bubble far more likely.

Perhaps the growth of indexing has robbed the world of outstanding stockpickers. But it seems more likely that it has put a lot of bad managers out of business just as Samuelson hoped. And it is not as if the buying and selling of stocks by informed investors with opinions has ceased. The turnover of stocks has actually increased over time. Active investors are more active than ever.

Why do they bother? If the rise of index investing means less dumb money, then it is harder to beat the market. Yet it goes against human nature for people to think of themselves as mediocre or settling for the average. People will try, even though failure is more likely than success. Imagine, wrote Samuelson, that a think-tank discovered that one in 20 alcoholics can learn to become moderate drinkers. Even if the finding was well grounded, he argued, the wise clinician should still act as if it were false—'for you will never identify that one in twenty, and in the attempt, five in twenty will be ruined.' "

V. The Sunk Cost Fallacy

Article is from the *Economist Magazine*, June 2, 2018 edition, subtitled "Another's wasted investment is as disturbing as one's own."

> "That human beings often tend to pour money into bad projects because they have already invested in them and cannot bring themselves to lose that investment is well known. Indeed the sunk cost fallacy, as this phenomenon is called is frequently cited as an example of people failing to behave in a 'rational' way that classical economics suggests they should.
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> Though the exact psychological underpinning of the sunk cost fallacy is debated, it might reasonably be expected to apply only when the person displaying it also made the original investment. However a study published recently in *Psychological Science*, by Christopher Olivola of Carnegie Melon University suggests this is not true. In making decisions, people may also take into account the sunk costs of others.
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> Dr. Olivola was led into his investigation by a thought experiment of the sort sometimes conducted by physicists. His imagined experimental subject had just received, as a present from a well-intentioned aunt, a gaudy and uncomfortable jumper. He asked himself whether the putative subject would be more likely to wear the jumper if he also knew that his aunt made significant sacrifices to buy it and he suspected that the answer would be 'yes'...
>
> **Oooo! It's lovely!**
>
> A possible explanation of these results…is that social signaling is involved. [T]he gift was supposed to come from a close social connection, …so part of the act of using it was to show appreciation for its receipt. The costlier the gift, the more appreciation a donor might expect to be demonstrated, which was consistent with what he found.
>
> To double check the role of social connection, however, he decided to conduct one final round of experiments. In these the putative gift was supposed to come not from a bosom buddy but rather from a casual acquaintance or a stranger. To his surprise, the effect was often stronger with these people than it was with friends and relatives.
>
> What is going on here is obscure. Perhaps exaggerated gratitude towards acquaintances and strangers is a way of turning them into friends. All told, however, Dr. Olivola believes he has demonstrated that the sunk cost phenomenon shapes human behavior more broadly than was previously thought. Yet more evidence then that *Homo sapiens* and *Homo economicus* are different species."

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