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I. <u>Index We Trust</u>

From an Article in *The Economist Magazine*, June 11, 2016 edition.

Subtitle is: "Vanguard has radically changed money management by being boring and cheap."

> "When John Bogle set up Vanguard Group 40 years ago, there was no shortage of skepticism. The firm was launching the first retail investment fund that aimed simply to mimic the performance of a stock index (the S&P 500, in this case) rather than to identify individual companies that seemed likely to outperform. Posters on Wall Street warned that index-tracking was 'un-American'; the chairman of Fidelity, a rival, said investors would never be satisfied with 'just average returns'; and the Securities and Exchange Commission (SEC), Wall Street's main regulator, opposed the firm's unusual ownership structure [mutual, not a stock company]. The firm attracted just $11m[illion] of the $150m Vanguard had been hoping for, and suffered net outflows for its first 83 months. 'We were conceived in hell and born in strife,' Mr. Bogle recalls.
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> Vanguard now manages over $3.5 trillion on behalf of some 20m investors. Every working day its coffers swell by another billion dollars or so. One dollar in every five invested in mutual or exchange-traded funds (ETFs) in America now goes to Vanguard, as does one in every two invested in passive, index-tracking funds, according to Morningstar, a data provider. Vanguard's shareholders own around 5% of every public company in American and about 1% of nearly every public company abroad. Although BlackRock, a rival, manages even more money, Vanguard had net retail inflows of $252 billion in 2015, more than any other asset manager.
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> Impressive as they are, however, these statistics still understate Vanguard's influence. By inventing index-tracking, and providing it at very low cost, the firm has forced changes on an industry known for its high margins and overcomplicated products. Delighted investors and disgruntled money managers speak of 'the Vanguard effect', the pressure that the giant's meagre fees put on others to cut costs. Some rivals now sell passive products priced specifically to match or undercut it.
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> Ask any employee for the secret of Vanguard's success, and they will point to its ownership structure. The firm is entirely owned by the investors in its funds. It has no shareholders to please (and remunerate), unlike the listed BlackRock or Fidelity, a privately owned rival. Instead of paying dividends, it cuts fees. Mr. Bogle's rationale for this set-up is simple: 'No man can serve two masters.'

The incentives of the firm and its customers are completely aligned, he says. Competitors implicitly agree. 'How are we supposed to compete when there's a non-profit disrupting the game?' complains one.

Bill McNabb, Vanguard's current CEO, says the ownership structure permits a virtuous cycle, whereby its low fees improve the net performance of its funds, which in turn attracts more investors to them, which increases the economies of scale, allowing further cuts in fees. Even as the assets Vanguard manages grew from $2 trillion to $3 trillion, its staff of 14,000 or so barely increased. Meanwhile, fees as a percentage of assets under management have dropped from 0.68% in 1983 to 0.12% today…This compares with an industry average of 0.61% (or 0.77%, when excluding Vanguard itself). Fees on its passive products, at 0.08% a year, are less than half the average of the industry of 0.18%. Its actively managed products are even more keenly priced, at 0.17% compared with an average of 0.78%.

The index-trackers account for over 70% of Vanguard's assets and over 90% of last year's growth. Investors are gradually absorbing the idea that, in the long run, beating the market consistently is impossible, Mr. McNabb says. That makes being cheap more important than being astute. Last year investors in America withdrew $145 billion from active funds of different kinds and put $398 billion into passive ones.

'In an industry with serious trust issues, Vanguard has proven an exception to the rule,' says Ben Johnson of Morningstar. Its investors stay with it roughly twice as long as the industry average. The firm actively shuns short-term 'hot money' because it brings extra trading costs."

Smartt comment:

I have been fortunate indeed. As a ten year old, I was awarded mutual fund shares for feeding my aunt's dog one summer. When I received my capital back from Price Waterhouse in 1989, I discovered Vanguard's first index fund and my investment management practice is very thoroughly built on Vanguard products.

If you know of anyone worried or dissatisfied with their investments, please recommend that they give me a call.

II. <u>What Are YOUR and MY Asset Allocations?</u>

Each of us has a different ability to live with uncertainty (risk) and so our investments will be different:

As of June 30, 2016	Clients	John Smartt
Money Market Funds	2.0	2.4%
Bond Funds	24.9	17.1%
Stock Funds	<u>73.1</u>	<u>80.5%</u>
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.

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, 2016	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**3.7%**	(28)	**11.6%**	(19)	**7.5%**	(14)
Tax-Managed Capital Appreciation Admiral	**3.4%**	(37)	**11.9%**	(13)	**7.5%**	(14)
Tax-Managed Small Capitalization	**5.8%**	(18)	**11.2%**	(2)	**7.9%**	(9)
REIT Index Admiral	**13.5%**	(5)	**12.4%**	(11)	**7.6%**	(14)
Total International Stock Index Admiral	**0.1%**	(15)	**0.6%**	(67)	**1.9%**	(33)
Balanced Index Admiral	**4.6%**	(22)	**8.6%**	(7)	**6.9%**	(10)
Total Bond Market Index Admiral	**5.5%**	(24)	**3.7%**	(48)	**5.1%**	(41)
Interim-Term Investment-Grade Bond	**6.1%**	(78)	**5.0%**	(55)	**6.1%**	(42)
High–Yield Corporate Bond	**5.7%**	(69)	**5.9%**	(10)	**6.5%**	(31)

For comparison, here are several stock and bond benchmarks:

Periods ended June 30, 2016	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**3.8%**	**12.0%**	**7.3%**
Russell 2000 (small stocks)	**2.4%**	**8.4%**	**6.3%**
MSCI World Index	**0.7%**	**6.6%**	**4.4%**
Barclays Aggregate Bond Index	**5.3%**	**3.7%**	**5.0%**
BofAML US High Yield Master II TR (bond index)	**9.3%**	**5.7%**	**7.4%**

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:

"The Collapse of Active Management"

This article appeared in the June/July, 2016 edition of the *Morningstar Advisor Magazine*. Subtitle of the article is, "Fiduciary Rule Accelerates a Trend that is Already Advanced and Inexorable."

> "Mutual fund management companies' revenues are simply [the] dollar value of the assets under management times the weighted average management fee. If a firm's active [e.g. not indexed] funds are redeemed and the money is reinvested in its index funds, the assets may be the same, but if 1% fees are replaced by 0.1% fees the effect on the income statement [of the mutual fund management company] is catastrophic. It gets even more catastrophic if the retirement fund's money is reinvested in Vanguard so that the assets are gone to a competitor.
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> As the revenue stream of the industry drops, companies that serve the mutual fund world will be hurt, such as Bloomberg, Lipper and Morningstar.
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> Most of the investment professionals in a fund company work on actively managed funds.
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> Active funds need a herd of CFAs [chartered financial analysts] to research stocks and a flock of portfolio managers to build portfolios. An index fund takes two people: one to look at the previous day's computer printouts, and a second person to wake up the first when it's time to go to lunch. We are talking about massive layoffs in the industry."
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> **Smartt comment:** I was struck by this as it appeared in one of Morningstar's own publications. It is true that an index fund is less expensive to run; an article in Forbes more than a decade ago talked about an old XP IBM personal computer which kept track of all of the daily orders for purchases and sales of stock within the Vanguard original S&P 500 index fund. Simple is lower cost and the virtuous cycle continues to gather momentum.

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