

Joseph Wealth Counsel Journal

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Stewardship. Objective, Trusted Advice

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Welcome to the Joseph Wealth Counsel Journal. This publication is a supplement to Joseph Capital Management’s Quarterly Capital Markets Commentary. Regular editions of the Joseph Wealth Counsel Journal contain an article which explores investment theory, and its application, in some detail. The Joseph Wealth Counsel Journal also contains various historical data, presented in several formats, which may be of interest to our clients. *This data is presented for educational purposes only.* If you have any questions regarding the content of this publication, please feel free to give me a call. Thank you.

- Ron A. Rhoades, Director of Research

Feature Article: The “Fatal Flaws” of Many Index Funds and Exchange-Traded Funds

In this article we’ll explore why most traditional “index funds” and “ETFs” do not meet our criteria as “best-in-class” investments within a particular stock asset class. For years we have been studying traditional index funds and exchange-traded funds (ETFs). While we generally favor *passive* investment strategies, and traditional index funds (and ETFs which track traditional indices) are passively managed, that does not mean that such mutual funds and ETFs are always “best-in-class investments.” In fact, only two index funds or ETFs meet our criteria for “best-in-class” investments in their asset classes at this time. (We have 11 different approved stock asset classes we may utilize in the construction of an investment portfolio, and we have both taxable and tax-managed fund choices in most of these asset classes. So, in essence, “index funds” or ETFs only constitute about 10% of our choices as “best-in-class” in the stock asset classes.)

-cont. The “Fatal Flaws” of Traditional Index Funds and ETFs

Why don't most index funds and ETFs make the cut? It's because of four words: “*hidden costs and taxes.*”

The “Expense Ratio” Is Only Part of A Mutual Fund's Total Cost. A fund's “expense ratio,” which most investors are familiar with, is a very incomplete picture of a fund's expenses. By leaving out items such as transaction costs and opportunity costs, the “disclosed” expense ratio does not permit investors to compare the true costs of one fund against another. These “undisclosed” or “hidden” costs, which are not included in a fund's expense ratio, include “opportunity costs,” “commissions,” “market impact” and “bid-ask spreads.”

The “Hidden” Costs of Stock Mutual Funds: Bid-Asked Spreads and Market Impact. Transaction costs result from stock mutual fund and ETF purchases and sales of stocks within the fund. These transaction costs include “bid-ask spreads” and “market impact.” The “bid-ask spread” is the difference between what a buyer is willing to pay (bid) for a security and the seller's asking price (ask), and can be low for large U.S. company stocks (perhaps 0.1-0.2% per trade) or quite large for some U.S. small company and international stocks (perhaps as high as 2-5% per trade, in some instances). “Market impact” is the rise or fall in the price of a stock which occurs when a stock mutual fund (or other large holder of the stock) seeks to purchase a lot of stock or sell a lot of stock in a specific company. Both of these costs do not show up in the fund's expense ratio, but they often dramatically impact the net return of an investor.

“Reconstitution” Forces “Turnover.” High costs from bid-ask spreads and market impact can result from the “reconstitution” of the underlying indices which an index fund seeks to track. This reconstitution, which occurs periodically (sometimes once a year, sometimes more often) on pre-announced dates, is necessary because underlying stocks cease to meet the index's criteria for inclusion, or because of major corporate events such as mergers, liquidations, bankruptcy, or delistings from an exchange. As a result, a “forced turnover” of stocks within the fund occurs.

“Turnover Rate.” Turnover rate is a measure of the trading of stocks or bonds within a mutual fund or an investment portfolio. Applied to a stock mutual fund, turnover rate gives an indication of how transaction costs could affect the fund's future returns. In general, the greater the buying and selling of stocks by the funds (i.e., the higher the turnover rate), the greater the impact commissions, spreads, and market impact will have upon the fund's net return to investors. Additionally, stock mutual funds with higher turnover usually are less tax-efficient, in that they report out realized capital gains more frequently and many of the capital gains are “short-term” and taxed as ordinary income (in lieu of being taxed at far more favorable “long term” capital gains rates). As of December 31, 2002, the average turnover rate for all domestic (U.S.) stock mutual funds was 111%, according to Morningstar, Inc. *However*, the turnover rate reported by Morningstar is the *lesser* of the purchases or sales in the stock mutual fund, and hence the *true turnover rate* is often much higher. At Joseph Capital Management, LLC we “dig deep” to find the *true turnover rate* by seeking data on actual purchase and sale volume, then using both sets of data to estimate the true turnover rate.

Index fund average turnover rates are estimated to be quite low for the S&P 500 index (4.6% annually, for 1998-2003) but quite high for other indices over the same time period, as follows:

S&P 500 / Barra Value:	26.1%
Russell 2000:	47.6%
Russell 2000 Value:	41.7%

The consequences of so many mutual funds (tracking the same index, in many cases) being forced to buy and sell certain identified stocks, all within a short period of time, can be quite dramatic. This is because of the vast amounts of monies now tied to specific indices. It was estimated in 2002 that more than 10% of the market cap of the S&P 500 companies was held by S&P 500 index funds, while 6% of the market cap of the companies in the Russell 2000 index was held by funds tied to that index.

Measuring the Negative Impact. So what is the negative impact on investors? One academic study found that the adverse impact to investors from reconstitution of indexes was 0.10% annually for funds tied to the S&P 500 index (an index of U.S. large company stocks) and a very high 1.84% annually for funds tied to the Russell 2000 index (an index of U.S. small company stocks). Another recent academic study found higher annual costs for funds which track the S&P 500 index of 0.70% to 0.85% annually, and costs ranging from 1.10% to 2.11% for funds which track the Russell 2000 index.

The First "Fatal Flaw" of Index Funds - Hidden Costs Resulting from Forced Reconstitution. In summary, the first "fatal flaw" of many index funds, as to keeping investor costs down (and returns higher), is the forced reconstitution at the same time other funds (with the same holdings) are forced to buy and sell. This causes an often-substantial "hidden cost" of investing. This cost (along with other "hidden costs," such as opportunity costs and commissions paid in connection with stock trading by the mutual fund or ETF) is not reflected in the "disclosed" annual expense ratio. For some index stock mutual funds these "hidden costs" may drive the total costs of the fund even higher than that of some similar actively managed stock mutual funds!

Minimizing Market Impact and Bid-Ask Spreads: Stock Mutual Funds Which Track a "Secret" Index. The best way for a passive mutual fund to invest and track an asset class is to have a "secret" index, known only to the fund itself. The "secret index" inclusion rules should permit the mutual fund to trade patiently (to limit market impact), seek best pricing through the use of multiple brokers (in order to limit commissions paid in association with stock trading, and to minimize bid-ask spreads), and permit "hold" ranges to further limit turnover of the stocks held by the fund.

Other techniques can be utilized by mutual fund managers to reduce transaction costs, such as engaging in "block purchases" of stock at discounts (effected through a different type of "market" for such block sales and purchases). Block purchases can work extremely well when utilized to purchase small cap and micro cap companies. However, traditional index funds seldom are able to utilize this technique.

In essence, a “best-in-class” stock mutual fund should be designed so that it is not forced to trade by changes in a commercial index. Rather, it should be designed to limit the impact of all costs to the investor due to trading (while still maintaining the fund within its "style" category). The result - a stock mutual fund with “hidden costs” which are often *far below* the “hidden costs” of traditional index funds.

Joseph Capital Management, LLC seeks out these low-cost (both low as to “disclosed costs” and low as to “hidden costs”) funds, and after undertaking an extensive due diligence process, provides access to such funds (which are often “institutional-style”) to our clients. Many of these funds are from Dimensional Funds Advisors, a mutual fund company that does very little advertising but which has \$65 billion under management (at last count) in about 35 different stock mutual funds. The results speak for themselves. We invite you to compare the 10-year returns of the DFA funds versus the 10-year returns of the indices, in each asset class, in the tables contained in this publication.

The Second “Fatal Flaw” - Taxes. While many index funds are more “tax-efficient” than actively managed funds, these mutual funds are not *specifically designed* nor *specifically managed* to reduce the tax drag upon investors’ returns. In taxable accounts reduction of the tax drag is extremely important - it’s not just what you make, it’s what you keep!

For example, compare the 5-year “before-tax” and “after-tax” (on distributions, not redemption of fund shares) returns of a traditional stock index fund, the Vanguard Small Cap Index Fund (Investors Shares) with the “before-tax” and “after-tax” returns of the DFA Tax-Managed U.S. Small Cap Index Fund (as of 12/31/04):

	Before-Tax 5-Year Avg. <u>Annual Return</u>	After-Tax 5-year Avg. <u>Annual Return</u>
Vanguard Fund:	6.98%	5.90%
DFA Fund	9.63%	9.57%

Calculations of after-tax returns are based on the highest individual federal income tax and capital gains tax rates in effect at the times of the distributions. State and local taxes were not considered. After-tax returns reflect the reduced tax rates on ordinary income (including qualified dividend income) and long-term capital gains which became effective in 2003. Past performance is not a guarantee of future results.

As seen, the Vanguard index fund lost over 1% annually to “tax drag,” while the DFA fund in the same asset class lost only 0.06%. This difference can really add up over time - perhaps causing a loss of 25% or more of potential long-term returns over a period of 20 years or longer!!! This “tax drag” upon investment returns, for stock index funds held in taxable accounts, is the second “fatal flaw” of many index funds.

We will continue to analyze the investment landscape for you, to seek out the very “best-in-class” investment products for you. *Enjoy all that life has to offer.*

- Ron Rhoades, Director of Research



Utilizing a sophisticated approach to analyzing risks and returns in the capital markets, and employing in-house proprietary research and applying academic research from researchers at major universities, we seek to assist our clients in navigating this complex financial world. In essence, we seek to “build a better ship” to get you from here, to there, with room to spare. Our ongoing trimming of the sails, in reaction to shifting economic and market winds, and our calm hand on the wheel, assists our clients in navigating through inevitable storms.

