Financial Common Sense

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Rockbridge Investment Management is a group of like-minded professionals working with a select group of clients with whom we can have a significant impact. Everything we do is focused on building and preserving wealth for our clients. We help remove complexity so clients can focus on the simple but difficult process of successful investing.

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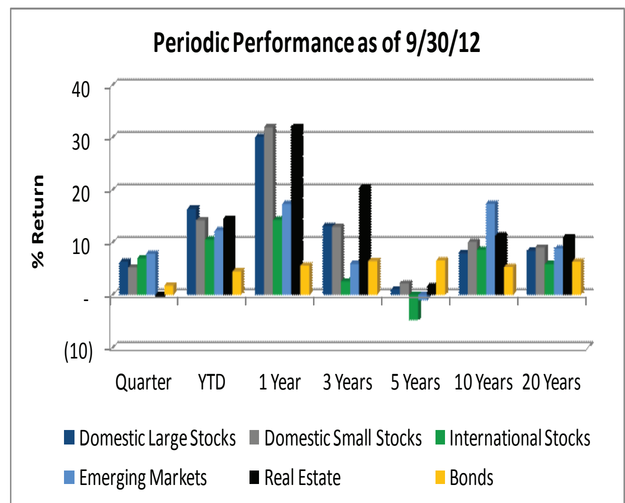
Market Commentary by Craig Buckhout

The equity markets finished a very strong quarter in September, erasing the losses of the second quarter, and more, pushing returns solidly into double-digit territory for the year.

If the S&P 500 could hold its 16% gain through the next quarter, it would be the third best annual result of the past decade, and above the historical average of 10%-12%.

Bonds also provided positive returns for the quarter. U.S. Treasury yields remained fairly constant for the period but interest rates paid by high-yield issuers (junk bonds) continued to fall, so increasing values boosted returns for bonds that are subject to credit risk.

In the chart at the right you will also see that Real Estate (REITs) had a poor quarter, allowing other parts of the equity market to catch up on a year-to-date-basis.



Some Things Cannot Last Forever
Herbert Stein was a distinguished academic and chairman of the President's Council of Economic Advisers in the 1970's. He formulated "Herbert Stein's Law," which he expressed as "If something cannot go on forever, it will stop."

One thing that cannot go on forever is high bond returns, resulting from falling interest rates. At some point, rates hit bottom, and if not there yet, we are getting close. Rates could fall more from current levels – we need only look to Japan for evidence of

(Continued on page 4)

401(k) Fee Disclosure Coming Soon. . . by Tony Farella

If you have a 401(k) account, your next statement may not look much different, but it will contain some very interesting and powerful information. During the last several years, increased focus has been given to the expenses and fees charged to retirement plan participants. The Department of Labor (DOL) recently published regulations under the Employee Retirement Income Security Act of 1974 (ERISA), as amended recently by Congress. The new regulations require retirement plan sponsors to disclose the fees associated with your retirement plan including all 401(k) plans.

The retirement savings landscape has changed dramatically over the last two decades. In 1983, 88% of workers were covered by a defined benefit pension plan. The 401(k) was a way for an employee to save additional funds for retirement in a tax-deferred account. When an employee retired they could maintain their living standard through a combination of fixed benefit payments from a pension and Social Security. Any additional savings were a bonus, but typically not required to fund daily living expenses.

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401(k) Fee Disclosure Coming Soon (cont.)

Today most employers have frozen or eliminated their defined benefit (DB) pension plans in favor of a defined contribution (401(k)) plan. Defined benefit plans are very costly for employers to manage and contribution requirements can vary widely from year to year. In a 401(k) plan, the employers' costs are fixed from year to year making it easier to budget. However, there is a major downside to moving from a defined benefit plan to a 401(k) plan as the primary retirement savings plan. Now the risk of accumulating enough assets to fund retirement has shifted from the employer (DB plans) to the employee (401(k) plans), and many employees are ill prepared to manage this risk effectively.

401(k) Plan Costs Vary Widely

All 401(k) plans are not created equally. Typically, large employers have better plans that include bigger matching or profit sharing contributions, better investment fund line-ups and lower overall costs.

There are 3 components of cost to a 401(k) plan:

1. Administration/record-keeping - A firm that keeps track of each employees' contributions and balances.
2. Investment options - The various mutual funds that are available in the plan.
3. Investment advisor - A firm or person who gives participants advice, reports to the employer on performance and handles employee communication/enrollment.

Often, larger employers have the resources to deliver a quality 401(k) plan and their size usually drives costs down for the participants. Small employers who do not have human resource departments or investment committees are often at the mercy of bundled product providers that include dramatically higher costs. In the past these costs were skillfully hidden. The new disclosure regulations were designed to shine a light on these deceptive practices and alert the individual participant to what they actually pay for services provided.

Why Costs Matter

Costs can vary widely among plans. For instance, the Thrift Savings Plan (a 401(k) style plan for federal workers) has rock bottom costs of about .025% per year. I've seen small private employer plans with costs that exceed 2.5% per year. Private sector employees in high cost plans are paying anywhere from 10 - 100 times the fees that others pay. The chart below illustrates the impact of high costs on the retirement lifestyle of a person working and saving for 40 years until retirement.

The bottom line – you can expect to give up 11% to 29% of your retirement account to Wall Street for no additional value. In addition, mutual funds that under-perform their benchmarks could further reduce the amount you accumulate.

At Rockbridge, we have been advising employers on their retirement plans since 1993. Just as we do for all clients, we have a relentless focus on costs and seek to eliminate all fees that do not add value. We welcome the changes in the 401(k) marketplace and will use it as an opportunity to educate employers on the value of full fee disclosure. If you have a 401(k) account, please take a close look at your statement arriving this month. We would be happy to review your holdings and fees and make suggestions on ways to reduce costs in your own 401(k) plan.◆

Annual fees as a share of assets in percent	Expected assets accumulated (today's dollars)	Reduction in assets accumulated (percent)	Expected annual income from savings (today's dollars)
0.5%	$423,000	--	$28,113
1.0%	$377,000	-11%	$25,071
1.5%	$337,000	-20%	$22,411
2.0%	$302,000	-29%	$20,084

* Example saving $5,000/year for 40 years in a retirement plan account starting at age 25 and earning a real rate of 4%.

** Expected annual income based on ability to annuitize the total accumulated savings at age 65.

Controlling Costs – A Financial Recipe for Success by Patrick Rohe

Patrick E. Rohe
CFP®

I have seen people drive miles out of their way for the cheapest gas, shop at multiple grocery stores for the best prices, and even wake up at uncanny hours to receive the best deals on holiday presents! As consumers we are always looking for a good deal, and price is one of the largest factors in determining if we have succeeded!

Fortunately for the everyday investor, investment companies are now starting to compete on cost as well.

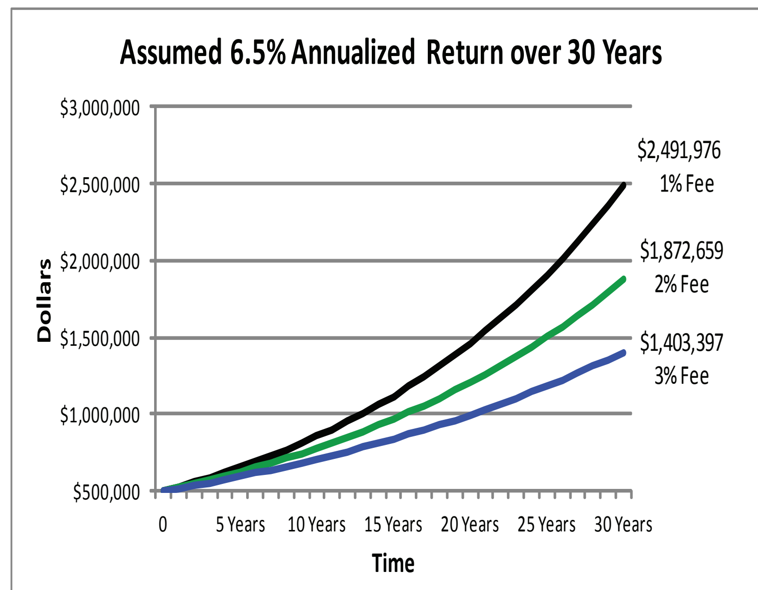
- 9/21/12: Schwab announces that is has the lowest expenses among ETF providers.
- 9/26/12: Vanguard rebuts with its article, Low Costs: Part of our DNA. In this article Vanguard explains that they have adhered to this low cost philosophy with its funds since the founding of the company.

Competition among investment companies can help price similar products efficiently for the everyday investor. Also, Schwab and Vanguard are seeing more assets flow into their ETF's and index funds as of late because "it's becoming more and more clear that it's difficult for a manager to consistently outperform [their respective index]" says Mike Rawson, an ETF analyst for Morningstar, in a recent *Investment News* article.

With market returns being below historical averages over the past decade, investors seem to be "tightening the belt" and focusing their attention on the bottom line. Rawson also stated that "costs matter more when expected returns are low. If you're expecting only a 2% or 3% return, a 1% fee seems a lot more expensive."

Rawson is right. However at Rockbridge, we think that price ALWAYS matters, thus why it is important to control the controllable. In a low return environment, giving up one third of your overall investment return to fees is not a recipe for success!

Our motto here at Rockbridge is "Building Wealth with Simple Disciplines" and we have been doing that for clients since the early 1990's. It seems that the financial industry may be catching onto some of our beliefs, which is a good thing for investors everywhere. However, if this is just another one of Wall Street's short fads, I can promise you one thing – Rockbridge won't be abandoning ship!◆



- *Fees matter.*
- *Over long time periods, high management fees and related expenses can be a significant drag on wealth creation.*
- *Passive investments generally maintain lower fees than the average actively managed investment by minimizing trading costs and eliminating the costs of researching stocks.*

Market Commentary (cont.)

that possibility. However, the Federal Reserve is now taking extraordinary measures to avoid the Japanese spiral of deflation that seems to be a big part of their problems.

Treasury Inflation Protected Securities (TIPS) have also benefited from falling rates in recent years, particularly the decline in real interest rates (the rate received net of inflation). The total return for TIPS this year is 6% and the annual return for the past five years is 7.6%, far ahead of the S&P 500, which gained only 1.1% over the past five years.

Some may think these returns will continue. Vanguard reports that in the past three years, TIPS funds garnered about $42 billion in net cash flow, representing just under 50% of the net cash flow received by TIPS funds in the ten years through June 2012.

Yet anyone investing in TIPS based on recent returns is very likely to be disappointed. The current pricing on TIPS reflects a market expectation that returns will just offset inflation over the next decade – an expected nominal return of 2%-2.5%, and a real return of 0%.

TIPS are also risky. TIPS funds are sensitive to changes in real interest rates and short-term returns can be volatile. Since 1997 when TIPS were first issued, there has been at least one 12-month period where TIPS lost 7.5% and another where they gained almost 20%.

So, why own TIPS at all, if expected returns are poor, and risk is significant? Well, they are still the most effective way to protect against an unexpected rise in inflation. If inflation averages more than 2%-2.5% over the next ten years, TIPS will provide a greater return to help offset the effect of inflation, so they can still provide valuable diversification.

TIPS can still play a role in a diversified portfolio, but investors should keep their expectations realistic – they will not provide the kind of returns we have seen in the past five years. An increase in real interest rates will have a negative impact on TIPS returns. A more detailed discussion of this topic is available in a research report written by Vanguard in September 2012, at https://personal.vanguard.com/pdf/icrtips.pdf. ◆

Returns from Various Markets

The following table shows the returns from various markets over periods ending September 30, 2012:

Market/Asset Class	Quarter	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
Money Market	0.0%	0.1%	0.1%	0.1%	0.7%	1.8%	3.2%
Bond Market	1.7%	4.4%	5.7%	6.5%	6.6%	5.4%	6.4%
Large-Cap Stock Market	6.4%	16.4%	30.2%	13.2%	1.1%	8.0%	8.5%
Small-Cap Stock Market	5.3%	14.2%	31.9%	13.0%	2.2%	10.2%	9.1%
International Equity Market	7.0%	10.6%	14.3%	2.6%	-4.8%	8.7%	5.9%
Emerging Markets	7.9%	12.3%	17.3%	6.0%	-1.0%	17.4%	8.9%
Real Estate	-0.4%	14.5%	32.1%	20.5%	1.6%	11.3%	11.0%
Inflation	0.2%	2.1%	1.7%	2.2%	2.1%	2.5%	2.5%

Market Benchmark Portfolios

The following table shows returns from our market benchmarks over periods ending September 30, 2012:

Benchmark	Quarter	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
Capital Preservation	1.5%	3.5%	5.0%	4.1%	3.5%	4.2%	5.1%
Conservative	2.7%	6.3%	9.8%	6.2%	3.6%	5.6%	6.4%
Moderate	4.0%	9.0%	14.6%	8.1%	3.4%	7.0%	7.5%
Aggressive	4.9%	10.8%	18.3%	8.5%	1.8%	7.6%	7.7%
All Equity	6.1%	13.0%	23.1%	8.5%	-0.8%	8.3%	7.7%

Note: These results were developed by simulating past returns in the various markets included in each benchmark, assuming the reinvestment of dividends and other earnings and deductions of costs totaling 0.20%. The money market is represented by 90-Day Treasury Bills; the bond market by the Barclays Capital Government/Credit Bond Index; the domestic large cap market by the S&P 500; the domestic small cap market by the Russell 2000 Index; the emerging markets by MSCI Emerging Markets Index; the real estate market by Dow Jones US Select REIT Index; and the international equity market by the EAFE Index. This data is presented to show the long-term relationship between returns at various levels of investment risk. It is not intended to present performance results experienced by clients of Rockbridge Investment Management, but is intended to provide a benchmark against which actual performance might be judged. Also, readers should recognize that future investments would be made under different economic conditions. It should not be assumed that future investors would experience returns, if any, comparable to those shown above. The information given is historic and should not be taken as any indication of future investment results.