ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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In This Issue

Vanguard Cuts Manager Count

On January 19, Vanguard announced it was removing subadvisers from its Explorer and Morgan Growth funds. Both of these funds could be seen as poster children for Vanguard's full embrace of a "more managers is better" philosophy for its actively managed offerings, one which Adviser Investments does not share. We think it's a step in the right direction for the funds, but whether it's a signal that Vanguard plans to change its multimanager ways remains to be seen.

In this latest round of subadviser musical chairs, Century Capital Management, which had been managing a piece of Explorer since 2008, was dropped from the fund and leaves the Vanguard fold entirely. Kalmar Investment Advisers (coincidentally) remains a manager on Explorer, but was shown the door at the $11.7 billion Morgan Growth after seven years on the fund.

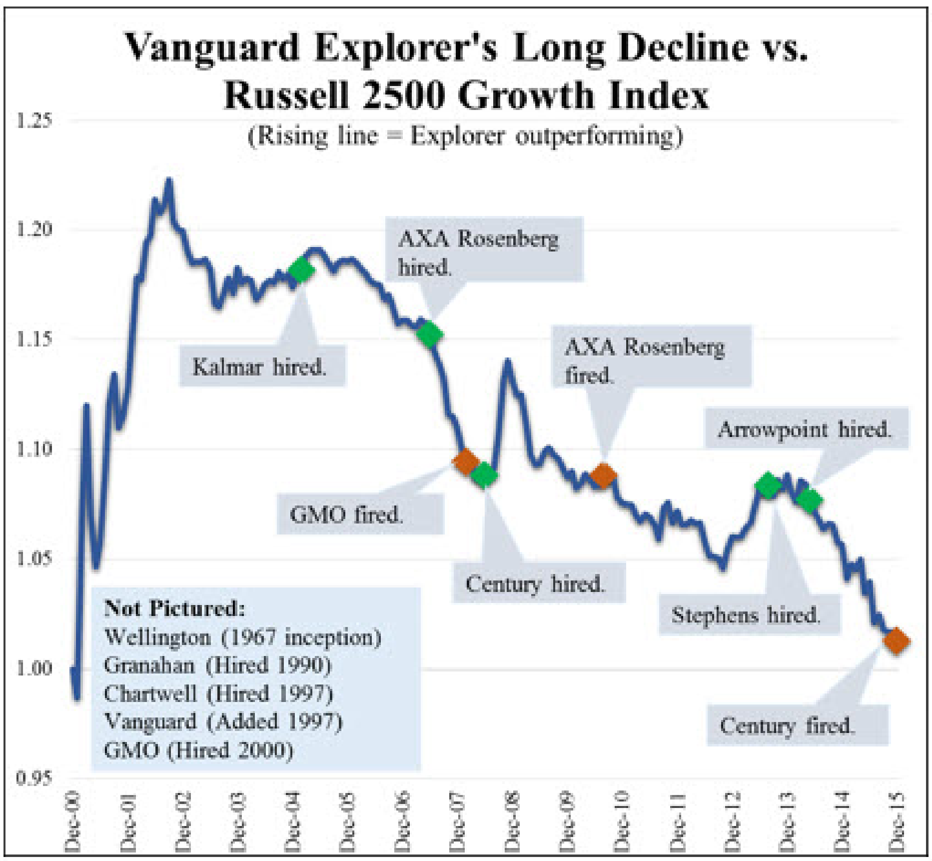
After the changes, the headcount on Explorer remains a very crowded field of seven management teams made up of 15 individual portfolio managers. The story is fairly similar at Morgan growth, with four subadvisers and eight named managers.

So why does Vanguard stack managers on funds? The firm's official stance on the multi-manager format, first adopted in 1987, is that it "can reduce portfolio volatility, provide potential for long-term performance and mitigate manager risk."

In theory that sounds nice, but in practice the risk and return aspects seem to have suffered at the expense of protecting against manager risk.

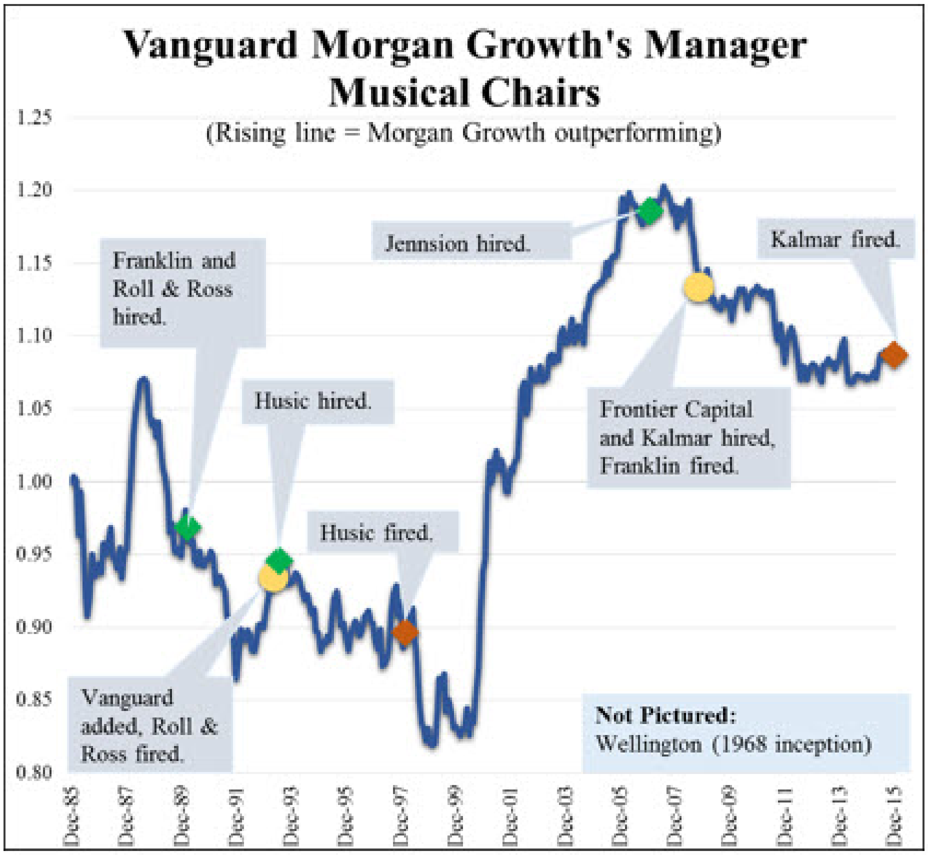
If you're unfamiliar with the term, "manager risk" refers to the chance you take that a single fund manager greatly underperforms or leaves a void when they depart a fund, which in turn negatively impacts shareholder investments and portfolios. We think this risk is a valid concern to an extent, but it can be tempered with diversification within a portfolio, by thoroughly researching a manager beforehand and always having an alternative fund ready. While this may sound similar to Vanguard's take, the difference is that when the fund giant amalgamates a pack of subadvisers, shareholders have no way of knowing to what extent each manager is helping or harming performance at any given time or what their performance has been like over their tenure (Vanguard does not publicly disclose this information). If you observe a collection of active managers each running individual funds, winners and losers are far more apparent.

Examining the relative performance of Explorer and Morgan Growth under the yoke of multiple managers, it's questionable how much shareholders have benefited. In the chart below, which compares the performance of Vanguard Explorer against its Russell 2500 Growth Index benchmark, you can see that the addition of new teams has done little to help performance. After some terrific relative returns in the early 2000s, the fund has been on a decade-plus-long decline when compared against its benchmark. (Note, relative performance charts compare the returns of two funds or indexes directly, combining them into a single line—when the line is rising, the fund is putting up positive relative performance, while a falling line shows underperformance against the given benchmark.)



Sources: Adviser Investments, Morningstar.

It's a similar story for Morgan Growth. While it has been holding its own against the Russell 3000 Growth lately, index-like performance is not a good goal for an actively managed fund—unless it is achieving it with lower risk. Unfortunately that is not the case for either of these funds.



Sources: Adviser Investments, Morningstar.

One of the risk measures we look to most often is a fund's maximum cumulative loss, or maximum drawdown. This gauge gives investors an idea of the worst loss they would have experienced as shareholders, how quickly that loss took place and how long it took to recover. During the financial crisis, Explorer investors experienced a 52.4% loss over 16 months ending in February 2009—a hit that took the fund's managers 24 months to recover from. The Russell 2500 Growth Index suffered a 52.8% loss over the same period and recovered in 22 months (this is not a completely fair comparison, as you can't invest in indexes, and their performance is not impacted by expenses, however, looking to Vanguard's Small-Cap Growth Index fund, it fell 53.5% over the same period and recovered in the same 22 months as the Russell 2500 Growth). Those results count as a strike against Explorer's so-called risk management, as its drawdown was nearly as large as the index and took longer for shareholders to recover from.

The same holds for Morgan Growth, which lost 50.3% over that same 16 months and took 37 months to fully recover. Its Russell 3000 Growth Index benchmark fell 48.3% over the same stretch, but recovered far sooner (24 months). Once again, the benefits of multi-management do not make themselves apparent from a risk perspective.

If we take the risk and return stats into account and revisit the idea of manager risk, it may seem natural to wonder if there is such a thing as "too many managers risk." In the case of these two funds, it certainly seems so.

Vanguard has clearly been able to identify and attract a handful of top active managers over the last 30-plus years—that fact, plus the fund company's commitment to low costs, has made us happy investors since Adviser Investments' 1994 founding—but it's a more recent development that grouping them together three, four, five or eight at a time has become standard practice. Explorer and Morgan Growth are two prime examples of why we disagree with the approach. Hopefully, the trimming of the ranks on these funds represents, if not a return to the one manager, one fund days, at least a reining in of the philosophy carried out to the extreme. We'll be watching.

Vanguard Reopens Treasury Money Market to Investors
Last Wednesday, Vanguard reopened its $9.1 billion Treasury Money Market fund to all investors, the second time in less than a year that the firm has reopened a U.S. government money market fund.

In June 2015, Vanguard reopened its Federal Money Market fund—which invests mainly in U.S. agency debt—to all investors. Since then, it's grown in size by $2 billion to $4.5 billion.

Vanguard had closed both funds in 2009 out of concerns that their yields would be diluted by a massive influx of new investors burned by the financial crisis and looking for the safe haven of U.S. government money-market funds. Citing improving market conditions and changes in the interest-rate environment, Vanguard sees the reopening of the funds to be "in the best interest of shareholders."

Both funds invest more than 99.5% of total assets in U.S. government securities or repurchase agreements, in accordance with new SEC rules defining U.S. government funds as those with no more than 0.5% of assets not collateralized solely by government security funds or cash.

Treasury Money Market currently has a 0.16% SEC yield, while Federal Money Market yields 0.27%. Paltry yields to be sure, but far improved from the 0.01% yields both funds sported for years before finally rising in the second half of 2015.

Coming Up
In our next edition, we'll continue our look at portfolio rebalancing —addressing some questions from readers and discussing issues related to costs, risks and taxes.

About Adviser Investments
Adviser Investments and its subsidiaries operate as an independent, professional money management firm with particular expertise in Fidelity and Vanguard mutual funds. We advise more than 2,500 clients and have over $3 billion under management.

Our investment professionals focus on helping individual investors, trusts, foundations and institutions meet their investment goals. Our minimum account size is $350,000. In 2015, Adviser Investments was named to *Barron's* list of the top 100 independent financial advisers nationwide for the third consecutive year and its list of the top advisory firms in Massachusetts for the second time. We have also been recognized on the *Financial Times* 300 Top Registered Investment Advisers list in 2014 and 2015.

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