ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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In This Issue

Vanguard Pushes Multimanager Button

On March 31, Vanguard pushed its multimanager button once again, adding a third sub-advisory team, Pzena Investment Management, to its Selected Value fund, bringing the total number of named managers on the portfolio to seven.

Pzena, which also manages a fund for non-U.S. investors and a portion of Vanguard's Windsor and Emerging Markets Select Stock funds, will initially build a portfolio from some of the fund's current 5.8% cash allocation and be handed "a portion of new cash flow over time." Firm Founder Richard Pzena will be joined by two co-managers, Eli Rabinowich and Manoj Tandon, in running the firm's sleeve of the fund, following a classic, fundamental research-driven approach to the mid-cap value space.

The new team's initial impact on the portfolio will be small, leaving the lion's share of Selected Value assets (about 70%) in the hands of original manager Barrow, Hanley, Mewhinney & Strauss, while Donald Smith & Co., added to the fund in 2005, will continue to oversee about 25% of assets. All told, Selected Value counts $8.5 billion in total assets, and is one of the few actively managed funds at Vanguard that has enjoyed consistent inflows over the last year, adding about $1.9 billion of net new cash in the past 12 months.

Vanguard touted Pzena's value investing experience and the additional diversification multiple management teams bring to a fund as the reasons for the move. While we don't think the addition is cause for immediate concern for investors, Adviser Investments does not share Vanguard's fondness for the multimanager approach. We'll be keeping a close eye on the fund, its portfolio and performance to see how the new structure is working.

Tax Efficiency: Fidelity and Vanguard Funds

In our last *Adviser Fund Update*, we discussed the effects of taxes on portfolio returns and covered some of the consensus thinking on asset placement. This week, we take a look at the tax efficiency of funds from Fidelity and Vanguard over the three years through March.

Before we get into the data, it's important to note that tax efficiency for funds is generally calculated in one of two ways. The first assumes you still own your shares at the end of the period, paying taxes on distributions along the way; this is the method we used to calculate the percentages you'll see below. The second assumes that you've sold all shares, meaning that it also accounts for any additional short- or long-term capital gains you've realized since you bought the fund (tax efficiency will generally be considerably lower using this method if your investment has gained value). Because of Adviser Investments' long-term investment philosophy, we think it's more useful to look at the tax efficiency of funds you plan to hold on to. (When our clients are drawing down their accounts with us, however, we do consider how taxes will come into play when deciding what to sell, and together work out a plan that best meets each client's needs.)

Fidelity: Most and Least Tax-Efficient Funds

Fund	Symbol	3-Year Return	Tax-Adjusted 3-Year Return	Tax Efficiency
Fifty	FFTYX	15.2%	15.1%	99.4%
Independence	FDFFX	13.9%	13.8%	99.2%
Growth Strategies	FDEGX	10.4%	10.3%	99.2%
Growth Discovery	FDSVX	14.7%	14.6%	98.9%
Select Electronics Portfolio	FSELX	12.2%	12.0%	98.7%
Select Biotechnology Portfolio	FBIOX	38.7%	38.1%	98.5%

Leveraged Company Stock	FLVCX	13.5%	13.2%	97.7%
Advisor Value Strategies	FSLSX	12.7%	12.4%	97.6%
Advisor Capital Development	FDETX	12.0%	11.7%	97.2%
Select IT Services Portfolio	FBSOX	19.1%	18.5%	97.0%
Total International Equity	FTIEX	5.2%	3.9%	75.2%
Real Estate Income	FRIFX	9.5%	7.1%	75.0%
Freedom 2000	FFFBX	4.1%	3.0%	74.8%
Freedom Income	FFFAX	4.1%	3.0%	74.7%
International Value	FIVLX	4.7%	3.5%	74.3%
China Region	FHKCX	5.2%	3.9%	74.2%
New Markets Income	FNMIX	7.5%	5.1%	67.8%
Global Strategies	FDYSX	4.2%	2.6%	61.9%
Select Energy Portfolio	FSENX	2.4%	1.1%	44.3%
Emerging Asia	FSEAX	0.7%	0.1%	7.5%

Source: Morningstar. Note: Three-year returns are annualized. After-tax returns assume the highest applicable tax rate for each distribution and reinvestment of whatever's left after taxes. Funds with losses over the period were excluded from the table.

One thing that you might notice in the tables is that a handful of funds from each family have achieved excellent tax efficiency, but that their after-tax returns over the period were weaker than some of the funds that were less efficient. The starkest example of this is Vanguard Market Neutral, which let investors keep 99.4% of their gains after taxes on distributions, making it the firm's most tax-efficient fund over the period. But unfortunately for investors, it only generated a 4.4% average gain per year while doing so. Compare that to the balanced Wellesley Income fund, which at 84.5% tax efficiency was one of the firm's lower ranking funds. However, it still gained 8.1% a year after taxes, nearly twice Market Neutral's return.

Vanguard: Most and Least Tax-Efficient Funds

Fund	Symbol	3-Year Return	Tax-Adjusted 3-Year Return	Tax Efficiency
Market Neutral	VMNFX	4.4%	4.4%	99.4%
U.S. Growth	VWUSX	14.8%	14.7%	99.2%
SmallCap Growth Index	VISGX	13.6%	13.4%	98.8%
MidCap Growth Index	VMGIX	11.5%	11.3%	98.3%
Admiral Tax-Managed SmallCap	VTMSX	15.8%	15.6%	98.2%
Strategic Equity	VSEQX	17.2%	16.8%	97.9%
Growth Index	VIGRX	14.7%	14.4%	97.8%
Windsor	VWNDX	15.4%	15.0%	97.7%
Extended Market Idx	VEXMX	14.2%	13.9%	97.6%
FTSE Social Index	VFTSX	16.3%	15.9%	97.6%
Wellesley Income	VWINX	9.6%	8.1%	84.5%
Pacific Stock Index	VPACX	5.1%	4.3%	84.3%
FTSE All-World ex-U.S. SmallCap Index	VFSVX	4.9%	3.9%	80.8%
Total Intl Stock Index	VGTSX	4.3%	3.5%	79.5%
FTSE All-World ex-U.S. Index	VFWIX	4.1%	3.2%	79.1%
LifeStrategy Income	VASIX	4.7%	3.6%	75.6%
Global ex-U.S. Real Estate Index	VGXRX	6.6%	5.0%	75.4%
Managed Payout	VPGDX	8.2%	5.9%	71.9%
Convertible Securities	VCVSX	7.9%	5.6%	70.9%
Energy	VGENX	2.0%	1.0%	49.4%

Source: Morningstar. Note: Three-year returns are annualized. After-tax returns assume the highest applicable tax rate for each distribution and reinvestment of whatever's left after taxes. Funds with losses over the period were excluded from the table.

You might also notice that there are no funds with negative returns listed. This is not because there weren't any funds from the two firms that lost money over the period. (At Fidelity, seven funds were in negative territory over the three years through March: Select Natural Resources, Canada, EMEA, Emerging Markets, Global Commodity Stock, Latin America and Select Gold;

while there were two from Vanguard: Emerging Markets Stock Index and Precious Metals and Mining.) We left these funds off of the list because investors had nothing to show at the end of the period, even though in every case they were stuck paying taxes on distributions, which resulted in negative tax efficiency. (A fund can also have negative tax efficiency if it has a positive pre-tax return that becomes a loss after taxes, though this did not happen at either fund family over the period covered in this update.)

Looking at the numbers for both family's stock funds over the last three years, on the whole, they have been remarkably tax efficient. More than 50% of the Fidelity funds we included in our calculations (79 of 156) had a tax efficiency of 90% or better, while two-thirds of Vanguard's funds (52 of 78) surpassed that mark. That's pretty good, but those numbers may go down in the coming years as gains accumulated during the markets' strong recovery since the market bottomed in March 2009 are realized and the funds have fewer losses on the books with which to offset them.

If you own a fund not included in either of these tables and would like to see its after-tax returns, both Fidelity and Vanguard publish this information on their websites for a handful of different periods. You can find it by going to an individual fund's "performance" page—both firms show after-tax returns before and after the sale of shares. To calculate tax efficiency, divide the after-tax return by the pre-tax return for a given period and multiply by 100. For example, if a fund has a 10.0% return before taxes and an 8.5% return after taxes, it was 85% tax efficient over that period.

Tax efficiency is important, but it is just one consideration of many when selecting funds and managers to invest with. After a long period of gains, you may owe (or have paid) a sizeable amount in taxes, but in our experience, most investors are happier with more money in their pockets after taxes than holding onto tax-efficient investments that leave them with less after all is said and done.

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. With 2,400 clients and more than $2.5 billion under management, Adviser Investments is one of the nation's largest mutual fund research and money management firms. Our investment professionals focus on helping individual investors, trusts, foundations and institutions meet their investment goals. Our minimum account size is $350,000. Adviser Investments was recently named to *Barron's* list of the top 100 independent financial advisers nationwide and its list of the top advisory firms in Massachusetts.

For more information, please visit www.adviserinvestments.com or call 800-492-6868.