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Fidelity Attempts to Enhance Indexing

On Tuesday, May 1st, Fidelity announced the opening of three new “enhanced” index funds: Large Cap Value Enhanced Index, Large Cap Core Enhanced Index, and Large Cap Growth Enhanced Index.

The concept behind Fidelity’s enhanced index funds (and others that have been on the market for a decade or more) is a fairly simple one—combine the “low” risk of an index fund with the benefits of active management, which, in theory, will provide market-beating returns with the same amount of risk. For its three funds, Fidelity is using a market-cap weighted version of the S&P 500 as well as the Russell 1000 Growth and Russell 1000 Value indexes as the starting points and will then employ computer-driven, quantitative analysis of a number of factors, including historical valuation, growth and profitability in narrowing the field to choose the three funds’ components. The funds are required to invest at least 80% of assets in their benchmarks and can venture into overseas markets at the manager’s discretion.

All three of these funds carry expense ratios of 0.45% (significantly higher than most of Fidelity’s other index funds), require a minimum investment of \$10,000, and they will also be subject to a fee of \$10 a year on accounts with balances less than \$10,000. Geode Capital Management, which is the sub-advisor to Fidelity’s index fund lineup, has been appointed manager. Geode knows the ins and outs of indexing like no one else’s business—except Vanguard’s. Both firms are masters of indexing, and hence they truly only compete on expenses and product differentiation.

Fittingly enough, one need look no farther than Vanguard’s Growth & Income fund for an ideal example of an enhanced index fund that follows a large-cap mandate (although the firm purposefully steered away from the “enhanced index” label, according to Vanguard, because “it implies no greater risk, but extra return,” which, ironically, it has provided, more or less). It’s benchmarked to the S&P 500, with the goal of exceeding the index’s returns, and uses active management to select around 120 stocks towards that end. Over the last 10 years, Growth & Income has outperformed Vanguard’s 500 Index fund (8.7% annualized for Growth & Income versus 500 Index’s 8.0% through April), with just about the same risk.

It’s clear that Fidelity has something similar in mind with the introduction of these three funds—how well it is able to deliver on the

strategy remains to be seen.

Vanguard Simplifies Fees

For years, Vanguard has exacted a number of pesky \$10 fees on various account types that fell below certain minimum balances. As of June, these \$10 fees will be eliminated, and replaced with a single \$20 fee for each fund account. While it may seem that this will increase what investors pay per year on their accounts, Vanguard has given all investors, no matter the account size, an easy way to avoid these fees altogether.

Currently, Vanguard charges a \$10 fee on the following account types that fail to meet the required balance:

- IRA and SEP-IRA accounts with less than \$5,000
- Index fund accounts with less than \$10,000
- Education Savings Accounts with less than \$5,000
- All general accounts with less than \$2,500

Under the new system, the \$20 fee will be charged to any account, of any type, with a balance under \$10,000. However, there are three ways to completely escape the fee:

1. Create an account through Vanguard.com and go paperless, getting your statements, reports and prospectuses delivered electronically
2. Keep all of your account balances over \$10,000 (which may not be very practical and may fly in the face of a well-diversified investment plan)
3. If you have more than \$100,000 invested in Vanguard funds

For most investors, the first option will be the most practical, but we'd urge anyone with an account at Vanguard to look into one of the three choices, as a \$20 annual fee for each small account, while seemingly insignificant, can add up over time and eat into your profits. You have until June to make the necessary adjustments, but why not do it today?

About Adviser Investment Management, Inc.

Adviser Investment Management, Inc. is an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 1,400 clients and \$1 billion dollars under management, Adviser is one of the nation's largest mutual fund research and money management firms. Our staff of 27 investment professionals focuses on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is \$350,000.

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