ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

May 13, 2011

Vanguard Selects Dozens to Manage New Emerging Markets Fund

Attempting to capitalize on the success and popularity of emerging markets investments over the last several years, Vanguard announced plans to launch Emerging Markets Select Stock in mid-June. This actively managed fund will face stiff competition from Vanguard's already successful Emerging Markets Index, especially considering that Vanguard is saddling the fund with dozens of managers, which is rarely a recipe for outstanding performance.

Emerging Markets Select Stock will have a $3,000 investment minimum, a 2% back-end load for shares held less than 60 days and an expense ratio of 0.95% ($9.50 for every $1,000 invested). The fund's assets will initially be split equally between four teams, including:

- A team of 39 global industry analysts led by Cheryl Duckworth from Wellington Management.
- M&G Investment Management's Matthew Vaight and Michael Godfrey.
- Oaktree Capital Management's Tim Jensen and Frank Carroll.
- Pzena Investment Management's John Goetz, Caroline Cai and Allison Fisch.

Researching Vanguard's selections, we found that several of these firms and managers have limited or mediocre track records in the emerging markets space. This begs the question: Why has Vanguard chosen this lineup?

In a nutshell, it's because emerging markets funds have been so successful in recent years (hence the genesis of this fund). That success attracted strong inflows of new money from both institutional and retail investors. Because emerging markets managers feel there is a limit to the amount of money they can manage efficiently in this space, many are no longer accepting new assets. This narrowed the field of available sub-advisors to which Vanguard could outsource portfolio management and may have doomed Emerging Markets Select Stock to a future of index-like performance--something often experienced by multi-managed funds.

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A deeper examination of these four firms raises additional concerns. For example, Pzena Investment Management's penchant for deep-value investing got crushed during the financial crisis. Oaktree Emerging Markets Absolute Return, a hedge fund run by the aforementioned team of Tim Jensen and Frank Carroll, returned 3.7% in 2010, significantly trailing Emerging Markets Index's gain of 18.9% over the same period. While an absolute return fund has a different mandate than a traditional mutual fund, we are not encouraged by these results.

All told, there will be at least 47 analysts and portfolio managers contributing ideas to Emerging Markets Select Stock. Can a meal prepared by so many cooks provide a tasty treat for investors? In our view, it's an unwieldy number of managers, one that could result in bland returns. With an operating expense headwind of 0.95% (73 basis points higher than Vanguard's Emerging Markets ETF), investors will be paying a high price, one that will be hard to justify without market-beating performance. We'll keep an eye on this new fund's performance, as we do invest in the emerging markets space in many of our clients' portfolios, but our initial take on Emerging Markets Select Stock is not a positive one. We suggest taking a wait-and-see approach.

Does Anyone Need a Tax-Managed Fund?

Effective May 13th, Vanguard has made several changes to reduce expenses for its family of tax-managed funds. In short, Vanguard has converted all five funds to Admiral-class shares (formerly, only two of the five had Admiral shares), set the minimum initial investment for the funds to $10,000 (the two with Admiral shares previously had $100,000 minimums) and eliminated the five-year, 1% back-end load on all but Tax-Managed International.

Why is Vanguard making these investor-friendly moves? Most likely, they are trying to stem outflows from the funds, which began in the summer of 2008 and accelerated in recent months. It seems that investors have figured out they can get the same tax advantages through low-cost ETFs at a fraction of the cost and with no investment minimums. In fact, the only thing that may have been preventing some shareholders from cashing out earlier was the 1% back-end load. Now that it has been eliminated, the tide of redemptions could swell further.

We've never seen much of a point to Vanguard's tax-managed lineup, and we've been taking advantage of the tax-efficiency of ETFs for our clients, where appropriate, for years now. But even before the ETF boom, our philosophy was that a well-diversified portfolio should consider tax efficiency as a part of the whole strategy, but not to let that one aspect of portfolio construction outweigh the advantages of investing with high-quality managers or in funds with the best long-term prospects for success.

There is little point to a highly tax-efficient portfolio if you can't meet your investment goals by investing in it, and Vanguard's tax-managed funds are nowhere near the firm's best options, even after factoring in their solid record of dodging big tax bills. We'd advise investors to seek their fortunes elsewhere.

Vanguard Slashes Fund Minimums

Vanguard has taken its low-cost mantra one step further by dropping minimums for the Investor share class on a slew of funds, effective immediately. The changes affect 15 of Vanguard's actively managed funds, which have seen their price of entry drop from $25,000 or $10,000 to $3,000, while the firm's 12 Target Retirement funds have had their minimums reduced from $3,000 to $1,000.

This move should be a great boon to lower-income or first-time investors and, as such, we applaud the increased accessibility. We're especially pleased to see minimums reduced for funds like Health Care and Selected Value, two of Vanguard's best offerings. The $1,000 minimum on the Target Retirement funds could help younger investors get a start on investing. However, we would hope that, as their investments grow, they will move into some of Vanguard's better funds. While lifecycle funds have become an increasingly popular choice for investors who buy into the one-size-fits-all approach they represent, we believe that proper portfolio construction hinges on more than just a projected retirement date.

You can see a list of all new minimums in the table below.

Vanguard's New Investor Share Minimums

Minimum Reduced from:	Funds
$25,000 to $3,000	Capital Opportunity*, Energy, Health Care, International Explorer, PRIMECAP*, Selected Value
$10,000 to $3,000	Convertible Securities, Explorer Value, Growth Equity, MidCap Growth, Precious Metals & Mining, PRIMECAP Core*, Strategic Equity, Wellington, Windsor II
$3,000 to $1,000	Target Retirement funds

*Closed to new investors.

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