ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Vanguard Postpones Muni ETF Launch

In January, Vanguard announced plans to launch a new municipal bond index fund and ETF, Tax-Exempt Bond Index, on May 15 (you can read [our coverage here]). But the scheduled debut has come and gone without the fund—at the last minute, Vanguard filed with the Securities and Exchange Commission to put off Tax-Exempt Bond Index's introduction for at least another month.

The delay adds to a curious pattern of postponements and cancellations in Vanguard's attempts to bring bond funds to market over the last five years. In June 2010, Vanguard filed an SEC proposal to offer short-, intermediate- and long-term bond index funds before withdrawing the plan in early 2011. And the introductions of Vanguard's two international bond funds also saw two delays in 2012 ahead of their eventual May 2013 opening.

It's not like there isn't a ready market for this product. Tax-Exempt Bond Index—which will have an expense ratio of 20 basis points for Investor class shares and 12 basis points for Admiral class and ETF shares, with a 50 basis-point front-end load on the open-end shares—will undoubtedly see most flows go into the ETF share class (assuming it eventually launches).

That's stiff competition for the comparable iShares National AMT-Free Muni Bond ETF, which currently has about $4.9 billion in assets and, at 25 basis points in operating expenses, costs more than twice Vanguard's planned addition.

Vanguard says Tax-Exempt Bond Index will now debut on June 12. Given its track record, we'll take a wait-and-see approach.

Tax Efficiency: Fidelity and Vanguard Funds

Now that the sting of paying 2014 taxes is behind us, we thought it might be useful to look at ways to minimize tax bills in the years ahead. Here at Adviser Investments, we feel the main goal of investing isn't to avoid taxes, but to maximize wealth. That said, careful consideration of tax burdens should be part of any investment decisions.

In an *Adviser Fund Update* last year, we discussed the effects of taxes on portfolio returns and some of the consensus thinking on asset placement. This week, we thought it'd be useful to look at the tax efficiency of funds from Fidelity and Vanguard over the three years through April.

Before we dig 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	14.2%	14.2%	99.6%
Growth Discovery	FDSVX	15.6%	15.5%	99.4%
Growth Strategies	FDEGX	18.3%	18.2%	99.2%
Leveraged Company Stock	FLVCX	18.8%	18.5%	98.4%
Value Strategies	FSLSX	17.3%	16.9%	97.8%
Independence	FDFFX	18.4%	17.9%	96.9%
Nasdaq Composite Index	FNCMX	18.8%	18.2%	96.9%
Select Air Transportation	FSAIX	25.2%	24.4%	96.8%
Value	FDVLX	19.5%	18.9%	96.8%
International Growth	FIGFX	10.9%	10.5%	96.7%
Select Consumer Finance	FSVLX	17.6%	12.9%	73.3%

Capital & Income	FAGIX	9.3%	6.8%	72.7%
Asset Manager 20%	FASIX	4.7%	3.4%	71.9%
Global Balanced	FGBLX	6.9%	5.0%	71.7%
Freedom 2000	FFFBX	4.5%	3.2%	71.4%
Export & Multinational	FEXPX	13.8%	9.8%	71.3%
Canada	FICDX	5.0%	3.6%	71.0%
Global Strategies	FDYSX	6.7%	4.3%	64.1%
Select Energy	FSENX	5.6%	3.5%	62.5%
EMEA	FEMEX	2.2%	1.3%	58.0%

Source: Morningstar. Note: Three-year returns are annualized through April 2015. 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 99.3% 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 3.5% average gain per year while doing so. Compare that to the small-cap Explorer fund, which was one of the 10 worst funds for tax-efficiency due to a couple of big capital gains distributions, but still gained 14.2% a year after taxes, more than quadrupling 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	3.5%	3.5%	99.3%
Mid-Cap Growth Index	VMGIX	16.6%	16.3%	98.4%
Small-Cap Growth Index	VISGX	15.8%	15.5%	98.2%
Tax-Managed Small Cap	VTMSX	16.9%	16.5%	97.6%
Mid-Cap Index	VIMSX	17.8%	17.4%	97.5%
Extended Market Index	VEXMX	17.1%	16.6%	97.2%
Growth Index	VIGRX	16.4%	15.9%	97.2%
FTSE Social Index	VFTSX	19.2%	18.7%	97.2%

Small-Cap Index	NAESX	17.1%	16.6%	96.8%
Tax-Managed Capital Appreciation	VTCLX	17.0%	16.3%	96.3%
Explorer	VEXPX	16.8%	14.2%	84.4%
Wellington	VWELX	12.0%	10.1%	84.4%
Global ex-U.S. Real Estate Index	VGXRX	12.2%	10.2%	84.0%
Capital Value	VCVLX	20.0%	16.7%	83.4%
LifeStrategy Conservative Growth	VSCGX	7.4%	6.2%	83.2%
Mid-Cap Growth	VMGRX	15.7%	12.9%	82.1%
Emerging Markets Stock Index	VEIEX	3.5%	2.6%	74.6%
Managed Payout	VPGDX	9.4%	6.9%	73.5%
Convertible Securities	VCVSX	10.9%	7.9%	72.9%
Energy	VGENX	3.2%	1.8%	58.2%

Source: Morningstar. Note: Three-year returns are annualized through April 2015. 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, three stock funds were in negative territory over the three years through April: Global Commodity Stock, Latin America and Select Gold; while there was one from Vanguard: 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 tax efficiency of both family's stock funds over the last three years, on the whole, investors have not lost too much to taxes. Nearly 40% of the Fidelity funds we included in our calculations (62 of 168) had a tax efficiency of 90% or better, while more than 60% of Vanguard's funds (49 of 82) surpassed that mark. Not bad, especially as gains accumulated during the markets' sustained bull run since the market bottomed in March 2009 have largely been 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 the information 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, simply divide the after-tax return by the pre-tax return for a given period.

Tax efficiency is important, but it is just one consideration of many we use 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.

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 2,600 clients and more than $3 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. In 2014, Adviser Investments was named to *Barron's* list of the top 100 independent financial advisers nationwide and its list of the top advisory firms in Massachusetts for the second time in 2015. We are also recognized on the *Financial Times* 300 Top Registered Investment Advisers list.

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