



ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments



August 3, 2012

Vanguard Fires Manager

On August 2nd, Vanguard officially parted ways with AllianceBernstein, which had been sub-advising three of the firm's funds: Global Equity, International Value and Windsor.

While Vanguard was not specific about the reasons behind AllianceBernstein's dismissal, the firm's performance on the portions of the funds it ran was likely the deciding factor. Vanguard doesn't break out individual manager performance on multimanaged funds, but by looking at AllianceBernstein's reported track record on similar strategies, it was clear that their management teams haven't been delivering for investors.

AllianceBernstein's portion of Global Equity will be reallocated to Baillie Gifford, which will now manage about 19% of the fund's assets. Marathon Asset Management (44% of assets) and Acadian Asset Management (33%) will continue to manage a majority of the portfolio.

At International Value, Vanguard is bringing aboard ARGA Investment Management, a newcomer to the firm's sub-advisory ranks that initially will be handed a 21% portion of the fund's assets. ARGA joins existing managers Lazard Asset Management, Edinburgh Partners and Hansberger Global Investors.

Over at Windsor, Pzena Investment Management is replacing AllianceBernstein, taking over an approximate 28% of the fund's assets. Pzena already manages a piece of Emerging Markets Select Stock and a domestic-focused value fund available only to non-U.S. investors for Vanguard. Wellington Management will continue to handle the majority of Windsor's assets.

We've never been thrilled by Vanguard's infatuation with the multimanager concept, since we believe, in most cases, it dilutes performance. That said, the axing of AllianceBernstein, which we've long felt was a drag on performance at these three funds, could be a positive for investors.

Fidelity's About-Face(book)

Fidelity, a big buyer of Facebook's stock during the IPO in May,

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did an about-face in June, with 21 of the firm's funds selling more than 1.9 million shares of the social network's stock. Sixteen of those funds sold more than 25% of their overall stake, according to Morningstar.

Big sellers included Fidelity's Puritan, Dividend Growth, Disciplined Equity and Magellan funds. Fidelity was actually a net purchaser of Facebook in June, with 13 funds buying 2.2 million shares; however, more than half of that was for passively-managed index funds, where trades are determined by the underlying benchmark's composition.

While the numbers tilt toward the positive and represent a small portion of the firm's overall Facebook stock ownership, such a quick pullback doesn't seem to fit with the long-term objectives of Fidelity's mutual funds. Clearly the managers responsible for the selling had their reasons for doing so, but the rapid turnaround is noteworthy.

Is Vanguard Finally Opening a TIPS ETF?

Over the past couple of years, concerns about runaway inflation have taken a back seat to concerns about sluggish economic growth, high unemployment and a weak housing market. But with the Federal Reserve maintaining its "easy money" posture, higher inflation remains a risk, especially if the economy does eventually regain some momentum.

Investors who are concerned about inflation may want to investigate a new fund that Vanguard plans to launch this fall. Vanguard Short-Term Inflation-Protected Securities Index will, as its name suggests, invest in Treasury Inflation-Protected Securities (TIPS). The principal amount on TIPS is adjusted to correspond with changes in the Consumer Price Index, the most commonly used measure of inflation. Therefore, as prices rise, the income generated from TIPS may also rise. If inflation were to rise substantially from its recent annual rate of around 2.0%, investors who own TIPS or TIPS funds should have some measure of protection.

Vanguard will offer three retail share classes:

Share Class	Estimated Expense Ratio	Minimum Initial Investment
Investor Shares	0.20%	\$3,000
Admiral Shares	0.10%	\$10,000
ETF Shares	0.10%	None

Source: Vanguard

In addition to the management fees, mutual fund shares will be subject to a 0.25% front-end load and ETFs will be subject to

brokerage commissions (Vanguard Brokerage clients can trade the firm's ETFs commission free up to a certain limit, however). The benchmark for the new fund is the Barclays U.S. Treasury Inflation-Protected Securities 0-5 Year Index.

While Vanguard has offered a TIPS fund (Inflation-Protected Securities) since 2000, the new fund will be different in two notable ways. First, the new fund's benchmark tracks TIPS that mature in five years or less, rather than 10 years or less. With a shorter "duration," the fund will suffer less if interest rates rise.

Duration is a measure of how much a bond will fluctuate in response to interest-rate changes. For example, a fund with an average duration of 2.5 years would generally lose 2.5% of its value if interest rates rise 1.0%. The duration of Vanguard's new fund will be approximately 2.5 years, while the existing fund (Inflation-Protected Securities) had a duration of 8.6 years as of June 30.

Second, unlike Inflation-Protected Securities, the new fund is index-based and not actively managed. That means Vanguard can offer an ETF share class with an expense ratio of just 0.10%. That's half the expense ratio of the iShares Barclays 0-5 Years TIPS Bond ETF (STIP) which, with more than \$352 million in assets, is currently the largest TIPS ETF in this space.

With most money market funds currently yielding anywhere from 0.1% to 0.2%, some investors may view Vanguard's new TIPS fund and ETF as alternatives to money market funds. Why? Because the inflation protection adjustment on the underlying TIPS alone will net a higher return than a money market fund can deliver in today's low-rate environment. However, if interest rates begin to rise, TIPS, like any other bonds, will decline in value. Those declines could more than offset the inflation protection adjustments and could leave investors with short-term losses. At the same time, higher interest rates would allow money market funds to deliver higher yields, but with no significant risk to principal since they maintain a stable net asset value of \$1.00.

Vanguard intends for Short-Term Inflation-Protected Securities Index to provide protection against higher inflation. By targeting shorter maturities, its net asset value should be less volatile than funds that invest in longer-maturity TIPS. And, with lower costs to investors, we expect Vanguard will capture market share from higher-priced options already on the market. That said, investors should understand that TIPS funds are not immune to the effects of rising interest rates and could suffer capital losses.

Of course, this entire discussion will be moot if Vanguard follows the trend it's set over the last few years of announcing new bond funds but never actually bringing them to market (we're still waiting on three muni bond index funds originally slated to open in 2011 and two international bond funds that were supposedly set to go early this year). We'll have to wait to see if the firm

delivers on its promise this time.

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