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ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investment Management

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Vanguard's New Funds Blitz

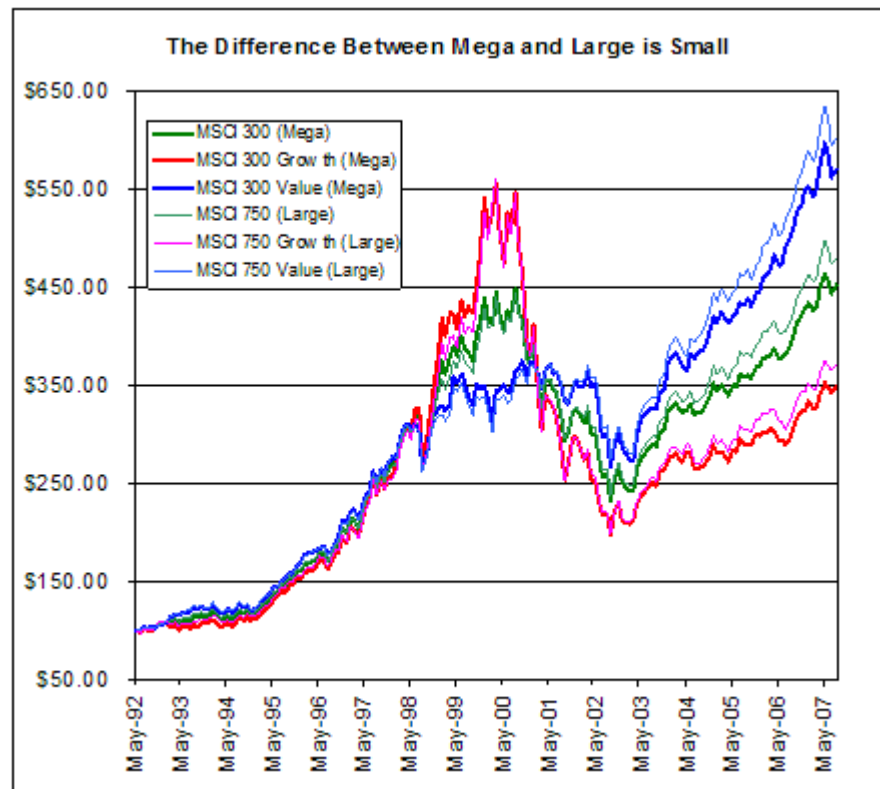
Vanguard revealed plans for six new funds in September, three of which are aimed at retirees and the other three expand their index and ETF roster.

Mega Indexes

Vanguard has the small-, mid- and large-cap segments of the market well covered, offering three index funds (as well as a number of managed funds) in each of those categories, now the firm is looking to tackle the very largest of the large—mega-caps. MegaCap 300 Index, MegaCap 300 Growth Index and MegaCap 300 Value Index will track subsets of the index benchmarks already used by LargeCap Index, Growth Index and Value Index. The three new mega indexes will be attempting to match the performance of the MSCI Large Cap 300 Index, as well as its growth and value sub-indexes, which in turn are derived from the MSCI Prime Market 750 indexes tracked by the aforementioned large-cap index funds. (Yes, the fact that MSCI refers to the index as "Large" as opposed to "Mega" could be the cause of some confusion, but it is what it is.)

The timing of Vanguard's announcement seems auspicious, as larger-cap companies seem to be coming back into style on Wall Street, but we don't expect to see the new funds open to investors until the end of the year. When they do make their debut, the investor shares are slated to have a 0.20% expense ratio, while the ETF shares will come with a minimal 0.08% in expenses (there will be institutional shares available as well, but there are no plans for Admiral shares at this time).

Of course, the first thing we looked at once we knew of these new funds was the comparative performance of their bogeys—would they offer something new and unique? The answer to that question at this point seems to be no. Using 15 years worth of MSCI's back-tested data, we found that there was not a significant difference in performance between MSCI's mega-cap indexes (represented by the MSCI Large Cap 300 indexes) and their large-cap indexes (represented by the Prime Market 750 series), as can be seen in the graph below (the thicker, darker lines represent the mega-caps, the thinner, lighter lines the large-caps). Over the full 15-year period, the large-cap indexes showed slight outperformance, although the mega-caps lead the way by a thin margin through 1998. After March 1999, when some of the smaller companies included in the large-cap indexes prospered, they took the performance edge over their mega brethren.



We also looked at the six indexes' rolling returns and maximum cumulative losses (MCLs) and these numbers followed the same pattern. As you can see in the table below, while the mega-caps showed greater outperformance in their best periods, they also lost more in their worst periods, and had a slightly lower average performance during one-, three- and five-year periods over the past 15 years. The MCLs for the mega-caps were all also slightly to moderately larger than they were for the large-caps.

Rolling Returns and MCLs Tell the Tale

	MSCI 300 (Mega)	MSCI 750 (Large)	MSCI 300 Growth (Mega)	MSCI 750 Growth (Large)	MSCI 300 Value (Mega)	MSCI 750 Value (Large)
	one-year	one-year	one-year	one-year	one-year	one-year
max	53.0%	50.8%	58.9%	55.9%	47.2%	46.9%
avg	12.0%	12.3%	11.2%	11.5%	13.2%	13.5%
min	-30.6%	-30.1%	-48.3%	-48.8%	-25.0%	-24.4%
	3-year	3-year	3-year	3-year	3-year	3-year
max	33.8%	32.5%	42.1%	42.3%	32.2%	31.8%
avg	11.4%	11.7%	10.4%	10.5%	12.5%	12.9%
min	-18.1%	-17.3%	-27.4%	-27.4%	-7.5%	-5.8%
	5-year	5-year	5-year	5-year	5-year	5-year
max	30.4%	29.3%	37.1%	35.7%	24.9%	24.0%
avg	10.1%	10.4%	8.9%	9.0%	11.3%	11.7%
min	-5.0%	-3.8%	-13.1%	-12.4%	-2.4%	-1.9%
MTL	25	25	30	30	23	16
MCL	-48.4%	-46.7%	-64.8%	-64.6%	-29.1%	-26.5%
MTR	55	50	N/A	N/A	16	15

Note: "MTL" stands for "months to loss" and "MTR" stands for "months to recovery."

After reviewing the data, it's hard to say that one set of indexes offers a

clear advantage over the other in the long-term. At times mega-caps have outperformed large-caps, at other times the opposite is true. What we can say for certain is that there is no need to own both of the funds in either the broad, growth or value categories. Beyond that, it will be for individual investors to decide whether they think they can gain more of an advantage in their portfolio with the large- or mega-caps—or if either are appropriate at all.

Managed Payout

Following close on the heels of Vanguard's press release introducing the mega-cap funds, the firm unveiled its plan for the Managed Payout series of funds, each offering a different level of risk: Managed Payout Real Growth, Managed Payout Moderate Growth and Managed Payout Capital Preservation. The idea behind these three funds is that retired investors will want a strategy that allows them to maintain the value of their investments while spending only the income generated. These funds are Vanguard's answer to that strategy.

What we know about the funds so far is that they will attempt to make equal monthly distributions while preserving capital. The 12 mid-month payments will be determined each January, based on the prior three years' performance (when the funds are first introduced, this number will have to be estimated, most likely based on back-tested results), and there will be the possibility of a 13th payout near year-end if necessary to avoid additional taxes on the funds.

These funds do bring something new to the Vanguard investment universe, in that they will invest in market neutral strategies and commodities (alongside stocks, bonds, cash, REITs and inflation bonds). But a majority of the Managed Payout funds' assets will be invested in other Vanguard funds.

Vanguard's goals for two of the funds are tied to inflation, while Managed Payout Capital Preservation's goal is to produce a 7% distribution rate. According to their preliminary filing with the SEC, both the Growth and Moderate Growth funds' goals are to exceed inflation by 5%. But the Moderate Growth fund's goal is to distribute 5% per annum while the Growth option distributes 3%.

The idea here is that the Growth option will have the lowest payout but will provide the greatest opportunity for capital appreciation while the Moderate Growth option will temper growth and produce a higher payout. Obviously, the Capital Preservation option is not concerned with growing capital but, instead, paying out lots of income.

The funds will attempt to fulfill their goals with core investments in Total Stock Market Index and World ex-U.S. Index. Market Neutral, Inflation-Protected Securities, REIT Index and Total Bond Market Index will serve as additional investments, with investments in commodities rounding out the stable of investment options. The allocations to these various options will not be static, and Vanguard says it has created an investment committee to make decisions on allocation. The firm has said it may also look for additional "absolute return" strategies to add to the portfolios. Vanguard's quant group is working on such strategies and will be using a version when it begins managing its portion of Market Neutral.

Vanguard hopes the funds will become available before the end of the year and expenses are expected to be 0.34%, which is a bit high for a Vanguard fund of funds. By comparison, the STAR LifeStrategy funds and

Target Retirement funds run expenses well below 0.30%, though Diversified Equity, which is a fund of managed funds (with a higher expense ratio as a result), runs about 0.41%.

The Managed Payout funds seem to follow Vanguard's pattern of attempting to appeal to investors who want a simple, one fund strategy to follow in their retirement (much as the STAR LifeStrategy and Target Retirement funds attempt to do for investors saving for retirement and beyond). At Adviser Investment Management, we're wary of the "one size fits all" approach to investing, and until we see how they perform, we'd be hard pressed to recommend the Managed Payout funds.

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.

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

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