ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Vanguard to Change Benchmark Indexes

The ongoing price war among the leading providers of index funds and ETFs spurred Vanguard to find new, lower-priced benchmark indexes for 22 of its index funds and ETFs. The changes, which affect signature funds such as Total Stock Market Index and Emerging Markets Index, will take place over several months and are not expected to be completed until well into 2013 (a list of affected funds appears below).

For 16 domestic funds and ETFs, Vanguard is dropping MSCI indexes in favor of indexes developed by the Center for Research in Security Prices (CRSP), a research department at the University of Chicago Booth School. Approximately $367 billion in assets will be affected (MSCI's stock dropped 27% on the news).

While CRSP data is well known among academic researchers, this is their first foray into actual index product development. We have reviewed some back-tested data from CRSP and our initial findings show that the MSCI and CRSP indexes have had very similar performance.

For the six international index funds and ETFs affected, Vanguard is exchanging MSCI in favor of London-based FTSE. This change will affect $170 billion in assets under management at Vanguard.

One notable difference here is that MSCI classifies South Korea as an emerging market while FTSE considers it to be a developed country. As of the end of August, South Korea was the second-largest country allocation in Emerging Markets Index at 15.5% of the portfolio, so the difference is significant, and investors will likely see a change in the fund's composition as a result.

Funds Switching to a CRSP Benchmark

Fund	Current Benchmark	New Benchmark
Total Stock Market Index	MSCI US Broad Market	CRSP US Total Market
Institutional Total Stock Market Index	MSCI US Broad Market	CRSP US Total Market
Balanced Index (stock portion)*	MSCI US Broad Market	CRSP US Total Market
MegaCap 300 ETF	MSCI US Large Cap 300	CRSP US Mega Cap
MegaCap 300 Growth ETF	MSCI US Large Cap Growth	CRSP US Mega Cap Growth
MegaCap 300 Value ETF	MSCI US Large Cap Value	CRSP US Mega Cap Value
LargeCap Index	MSCI US Prime Market 750	CRSP US Large Cap
Growth Index	MSCI US Prime Market Growth	CRSP US Large Cap Growth
Value Index	MSCI US Prime Market Value	CRSP US Large Cap Value
MidCap Index	MSCI US Mid Cap 450	CRSP US Mid Cap
MidCap Growth Index	MSCI US Mid Cap Growth	CRSP US Mid Cap Growth
MidCap Value Index	MSCI US Mid Cap Value	CRSP US Mid Cap Value
SmallCap Index	MSCI US Small Cap 1750	CRSP US Small Cap
SmallCap Growth Index	MSCI US Small Cap Growth	CRSP US Small Cap Growth
SmallCap Value Index	MSCI US Small Cap Value	CRSP US Small Cap Value
MidCap Index Annuity	MSCI US Mid Cap 450	CRSP US Mid Cap

*Balanced Index's 40% bond allocation will remain benchmarked to the Barclays U.S. Aggregate Bond Index. Source: Vanguard.

Funds Switching to a FTSE Benchmark

Fund	Current Benchmark	New Benchmark
European Stock Index	MSCI Europe	FTSE Developed Europe
Pacific Stock Index	MSCI Pacific	FTSE Developed Asia Pacific
Emerging Markets Index	MSCI Emerging Markets	FTSE Emerging
Total International Index	MSCI ACWI ex USA IMI	FTSE Global All Cap ex US
Developed Markets Index	MSCI EAFE	FTSE Developed ex North America
Admiral Tax-Managed International Index	MSCI EAFE	FTSE Developed ex North America

Source: Vanguard

Index providers such as MSCI and FTSE are responsible for deciding which companies are included in their various benchmarks and how their stocks are weighted. They earn licensing fees from mutual fund companies and ETF providers, typically a small percentage of assets under management. Vanguard was able to negotiate a lower price for licensing the various indexes from FTSE and the CRSP, which should translate into lower operating costs for its index funds and ETFs.

Comparison Shopping

Vanguard has shopped index providers in search of a better deal before. In April 2003, it began transitioning funds that tracked S&P indexes to the MSCI indexes it is now dumping. At that time, Vanguard's Gus Sauter said, "As the leading manager of index mutual funds for more than 25 years, we have formulated certain views of what makes for optimal index construction. The MSCI indexes incorporate most of the best practices we seek..." When announcing the recent shift away from MSCI, Sauter said that the new indexes from FTSE and CRSP "...meet Vanguard's 'best practice' standards for market benchmarks."

Are the new indexes any better? It depends how you define "better" but we don't find any compelling advantages held by the CRSP or FTSE indexes over those from MSCI. But they are definitely cheaper--or at least the costs to license the indexes will be cheaper. Faced with its first real competitive threat from the likes of Charles Schwab, which recently lowered index fund costs below Vanguard's already-low prices, Vanguard is not going to let another company seize the mantle of "lowest cost provider" from its shoulders.

Vanguard says that the changes should not result in capital gains for current shareholders. With the exception of Emerging Markets Index, we do not believe that investors in the funds will notice much of a difference as the changeover occurs. While the moves are not directly related to improving performance, once the lower expense ratios are instated, investors will get to keep more of their earnings (if only a fractional amount). This kind of investor-friendly, cost-saving move is something that we like to see at Adviser Investments and is part of what has kept Vanguard a leader in the mutual fund marketplace.

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 2,400 clients and over $2 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.

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