ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Vanguard Gets Active Abroad

Last week, Vanguard launched four actively managed exchange-traded funds (ETFs) in England. Is this a sign of things to come on our shores? Our hunch is that Vanguard is using the smaller U.K. market as a testing ground to see what kind of reception the funds get to help decide whether or not to offer actively managed ETFs on the much larger U.S. market.

To review, an ETF is similar to a mutual fund in that it is a basket of stocks or bonds grouped into a portfolio for investment. Where an ETF differs is in how it is traded—unlike mutual funds, which are priced once a day, ETFs are priced throughout the day based on the value of the underlying portfolio and what investors are willing to pay for the ETF—so like an individual stock or bond, there is a bid price and ask price. A majority of ETFs operate similarly to index mutual funds by tracking a set benchmark, owning a portfolio that is essentially identical and seeking to match the index's performance minus operating expenses. Actively managed ETFs are a newer wrinkle, and like an actively managed mutual fund, there is a portfolio manager making investment decisions for the portfolio.

The four ETFs Vanguard is launching in the U.K.—all carrying a 0.22% expense ratio—would probably fall under the rubric of "smart beta" or "factor" ETFs if they were available in the U.S. The strategies, managed by Vanguard's quantitative equity group, are global and look to capture different "factors" in the market. (For comparison, the PowerShares FTSE RAFI US 100 ETF, what could be considered the original "smart beta" ETF in the U.S, charges 0.39%.)

"Smart beta" funds function with one foot in both active and passive investment management. These index funds differ from the cap-weighted market indexes that Vanguard's current ETF family is built on, but are rules-based on factors other than price—sales growth, dividend payouts, price momentum, low valuations—and quantitatively driven. This introduces the "active" element, as the returns seek to be differentiated from existing market benchmarks, and the quantitative models underlying the strategies will be tweaked by their portfolio managers over time.

Let’s look at the new funds—and the “smart beta” strategies—available to investors in the U.K. Global Value Factor UCITS ETF focuses on “cheap” stocks—those with lower price-to-earnings or price-to-book ratios. Global Momentum Factor UCITS ETF seeks to capture momentum by buying stocks that have done well recently. Global Liquidity Factor UCITS ETF buys less liquid stocks that don’t trade as often as other stocks. Finally, Global Minimum Volatility UCITS ETF—like Vanguard’s Global Minimum Volatility fund in the U.S.—builds a portfolio of stocks with lower volatility than the broad market and hedge the currency risk back to the U.S. dollar. (You read that correctly; even U.K.-based investors will see the currency hedged back to the dollar to “further reduce the overall volatility of the portfolio.”)

It remains to be seen whether investors will be able to stick with the strategies over time or will jump around chasing performance. History suggests the latter is likely, as investors tend to be their own worst enemies, whether using active ETFs or passive ones.

We expect that active ETFs from Vanguard will be available to U.S. investors at some point, though it’s unlikely that actively managed mutual funds like Capital Opportunity or Dividend Growth will come in ETF format. Vanguard has already taken the first step to bring active ETFs to the U.S. through filings with the Securities and Exchange Commission seeking permission to do so.

One certainty: When Vanguard enters an investment space, expense ratios come down. That’s a win for investors any way you slice it.

Portfolio Renovation for 2016

With just a few weeks left in the year, time is running out to make year-end tax-harvesting moves. While it can be difficult to focus on tax preparation during the hectic holiday season, the seven steps outlined below could pay dividends in 2016 and beyond.

1. Consider Rebalancing

At the start of each year, the financial press and mutual fund providers will talk a lot about rebalancing. We have a different take.

First, a refresher: Rebalancing involves selling shares of those stocks, bonds or funds in your portfolio that have had gains and reinvesting the proceeds in assets that are currently underweighted in your portfolio. For example, consider a hypothetical portfolio comprised of three mutual funds a year ago, with one-third in a large-cap domestic fund, one-third in an international stock fund and one-third in a U.S. Treasury bond fund.

Due to variations in the performance of these funds over the past year, the investor’s asset allocation today would be noticeably different, as Treasury bonds have slightly outperformed stocks, while U.S. stocks have outperformed international stocks. The conventional wisdom for this investor would be to rebalance back to the original asset allocation. For someone focused on a specific risk profile or keeping a strict asset mix, rebalancing could be a valid practice.

At Adviser Investments, we contend that unless a portfolio has seriously diverged from the original allocation, rebalancing is often unnecessary or of little benefit. In looking at the effects of portfolio rebalancing at various regular intervals versus the effects of rarely or never doing so, we've found that there is little to no performance advantage to automatically resetting a portfolio's allocation every year. Plus, those who regularly rebalance may be burdening themselves with taxes on gains and any fees generated by the necessary transactions.

2. Know Your Funds' Distribution Dates to Avoid Taxable Income

We mentioned this in the November 20 issue of the *Adviser Fund Update*, which included distribution calendars for Fidelity and Vanguard, but a review of year-end investing wouldn't be complete without it: If you are planning to make any additional purchases in 2015, it's important to know when your funds will be making their December distributions.

Why? Taxes. If you buy shares of a fund prior to its "ex-dividend" date (the date on which the fund's price is reduced by the amount of the dividend or capital gain), you will have to pay taxes on additional distributions on those shares, even though you didn't own the shares when that income was "earned." Buying shares just prior to the ex-dividend date is often referred to as "buying the distribution," and it's something we avoid whenever possible for our clients.

3. Should You Take a Loss?

If you have a loss in a fund you own in a taxable account, it may make sense to sell your shares to avoid a distribution, rather than have the distribution add to your tax bill. However, you'll need to consider the size of the distribution, the size of your loss and any fees that may be incurred in the sale before doing so. If you own the fund in a tax-deferred account, distributions will not affect your taxes.

As you consider your tax-planning options, however, be aware of the "wash-sale" rule. This rule is designed to prevent investors from temporarily selling shares to gain a tax advantage and then repurchasing them a short time later.

Under the wash-sale rule, you lose the ability to claim a tax loss if you make a purchase of the same fund (or a substantially similar fund) 30 days prior to or 30 days after a sale. Therefore, if you sold 100 shares of XYZ fund on December 22 at a loss and bought the shares back on January 5, 2016, you could not claim a capital loss. The same rule would apply if you bought shares November 16 and sold them on December 14. These rules apply whether you made a direct purchase or reinvested a fund distribution.

Assuming you abide by the wash-sale rule, harvesting tax losses can be a cost-saving aspect of your investment strategy. You should also be careful not to sell shares of a fund you won't be able to replace. For example, if a fund is closed to new investors and you sell all of your shares, you won't be able to buy back in.

As always when it comes to tax planning, our best advice is to speak to a trusted tax professional to help you come up with a course of action that works best for you.

4. Think About Whether to Opt Out of Automatic Reinvestment
One strategy that we employ for a number of our clients is to have their income and capital gains distributions deposited into a money market fund rather than automatically reinvesting the proceeds in the fund that generated them. This provides the flexibility of reinvesting in the fund at a later date or, as part of a rebalancing strategy, using the cash to add to other funds that may have underperformed recently.

5. Maximize Opportunities for Tax-Deferred Growth
It's a well-known fact that 401(k)s, IRAs and other retirement accounts are a great way to keep assets growing tax-deferred. Therefore, consider contributing the maximum amounts allowable to each account every year. Depending on your employer's plan, you may be able to defer up to $18,000 in earnings to a 401(k) or 403(b) plan in 2015 (the same limit is in place for 2016). If you will turn 50 before December. 31, 2015, and your plan allows it, you can contribute an additional $6,000 (and unchanged for 2016). For IRAs, the maximum contribution in 2015 and 2016 is $5,500, plus a $1,000 "catch-up contribution" for those who turn 50 during either calendar year. You have until April 15, 2016, to make your 2015 contributions, but if you do it now, your money can enjoy the benefits of tax-deferral and compound interest sooner rather than later.

6. Don't Forget Your Required Minimum Distributions (RMDs)
If you have tax-deferred accounts, you will be required to withdraw a minimum percentage each year after reaching a certain age. The RMD rule exists to make sure that savings in retirement accounts are actually used for retirement and not just passed on to heirs.

You generally have until April 1 of the year following the calendar year in which you turn 70½ to take your first RMD (in subsequent years, there is a December 31 deadline). These rules apply to any retirement account in which you contributed tax-deferred assets or had tax-deferred earnings, such as Traditional IRAs, Rollover IRAs, SEP-IRAs, 401(k) and 403(b) plans. Note that Roth IRAs are not subject to RMD rules.

The RMD is calculated (in most cases) by dividing the adjusted market value of your tax-deferred retirement account as of December 31 of the prior year by an applicable factor taken from the IRS life expectancy tables. If you fail to take your RMD from your retirement account, you will be assessed a penalty equal to 50% of the amount you should have withdrawn, in addition to normal income taxes. These are heavy penalties, so clearly it's in your best interests to take these RMDs, something we help our clients with each year.

7. Focus and Finish
While taxes are one of the last things you may want to think about during the holiday season, taking the time to fine tune your portfolio now may help prevent bigger headaches and tax bills come April. That said, restructuring a portfolio and moving assets in an attempt to avoid distributions can be tricky, which is why we recommend you consult with a professional tax or investment adviser before doing so.

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 more than 2,500 clients and over $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 2015, Adviser Investments was named to *Barron's* list of the top 100 independent financial advisers nationwide for the third consecutive year and its list of the top advisory firms in Massachusetts for the second time. We have also been recognized on the *Financial Times* 300 Top Registered Investment Advisers list in 2014 and 2015.

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