ADVISER FUND UPDATE

ADVISER INVESTMENTS

Market Summary and Commentary for Individual Investors from Adviser Investments

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Vanguard to Add Global Bond Portfolio
Vanguard is planning to offer its first global bond portfolio to U.S. investors this fall, but as a variable annuity, not an open-end mutual fund—diminishing its appeal for most.

Seeking to bolster the foreign stock and bond offerings in its annuity program, Vanguard has filed plans with the Securities and Exchange Commission to launch Global Bond Index Annuity, the fund giant's first global bond fund of any type to be rolled out in the U.S. (a similar fund launched for investors overseas in 2015). Vanguard is also planning to offer a foreign-stock index portfolio; until now, it only offered a clone of its actively managed International Growth fund for annuity investors who wanted to add overseas stocks to their portfolios.

The new Total International Stock Market Index Annuity will share the same benchmark index as Vanguard Total International Stock Index, but rather than buying the 6,100-plus individual stocks in the mutual fund's portfolio (a pricy proposition for a new annuity like this), it will invest in as many as six existing Vanguard funds—including Developed Markets Index, Emerging Markets Stock Index, European Stock Index, FTSE All-World ex-U.S. Index, FTSE All-World ex.-U.S. SmallCap Index and Pacific Stock Index.

Vanguard estimates a total cost of 0.11%, or 11 basis points, for the underlying portfolio, which suggests that it will be comprised mainly of Admiral or Institutional shares of the funds it holds. Note that the investment fee does not include the additional annuity charges investors will be subject to.

On the fixed-income side, Global Bond Index Annuity is also a portfolio of funds rather than individual bonds. It will allocate 70% of assets to Vanguard's Total Bond Market Annuity and 30% to the firm's Total International Bond Index mutual fund. The new annuity will cost 0.14% before additional annuity expenses.

Vanguard has set a launch date for the annuities in September this year, but the firm's track record bringing new products to market on schedule has been mixed in recent years. We're circling the date in pencil, not permanent ink.

Are Variable Annuities for You?
Before getting too excited about the prospects of a low-cost global bond index fund from Vanguard, remember that we're talking about a variable annuity portfolio—not an open-end mutual fund or exchange-traded fund—which comes with added features, limitations and expenses, and as a result may not be a good fit for your objectives or situation.

So what do you need to know about variable annuities? Some might consider them investments, but in reality they are insurance products geared toward investors looking for a guaranteed stream of income in retirement. When you buy one, you sign a contract, and other than a short "free-look" period early on when you can back out without penalty, you are bound to the terms of that contract until it expires.

The "variable" part of the name covers the investment aspect—you pick funds within your annuity portfolio and your account value fluctuates based upon the performance of the underlying investments.

The insurance piece is where the term "annuity" comes in—by paying extra fees on top of the cost of the investment, an insurance provider gives some level of guarantee on the value of your account and its future income potential. This contract also can limit or restrict your penalty-free access to your money for a period of years. Because these are considered retirement accounts, they are generally governed by the same rules on withdrawals as individual retirement accounts (IRAs) and 401(k)s—"non-qualified distributions" taken before age 59½ are subject to a 10% penalty and income taxes; "qualified distributions" after that age are subject to income taxes (more on this below).

Vanguard's annuities have a handful of different options once you're ready to begin receiving income in retirement that are fairly standard among competitors.

One is to "annuitize" the portfolio, which means you give up control of the investments, but get a guaranteed stream of income for a set period or the rest of your days based on your life expectancy and the value of the annuity. Once you annuitize, all choices on the payment period, the payment type, the amount of income you will receive and any other optional benefits are final. It's also worth noting that by annuitizing, you end up paying income tax rates on any gains in value, not the lower capital gains tax rate. The portion of income considered a "return of premium" (i.e. your contributions) won't be taxed, however.

You can also maintain control of how your money is invested and draw down the portfolio as needed. Qualified withdrawals in retirement are subject to income taxes on gains, while the portion considered a return of premium is tax-free. These types of withdrawals are typically taxed on a last-in, first-out basis, meaning that initial distributions will be considered as coming from earnings (thus taxed); once the annuity's value drops below the level of the premiums paid, future withdrawals will be viewed by the IRS as a return of premium (thus tax-free). Note that while Vanguard doesn't have withdrawal penalties or surrender charges on its annuities, many providers will take fees of up to 5% or 7% of withdrawals made within the first 10 or so years after you sign the contract. Unlike when you annuitize, this scenario means that your account could lose value when you're depending on it for income.

The other insurance aspect of Vanguard's variable annuities is an optional death benefit rider; for an extra fee, investors can make sure that their heirs receive some portion of the account's value when they die. This is also a common feature of variable annuities from other providers.

In concept—guaranteed income in retirement and a chance to grow your assets over time—variable annuities may have appeal, but the expenses and taxes on withdrawals can add up, cutting into your account's returns significantly over time, even at a low-cost shop like Vanguard. They also come in many different permutations with a confusing array of choices—if you chose poorly or your financial circumstances change after you've signed a contract, you may not get the best value for your money. For this reason, the common advice for most investors is to pair a more traditional retirement savings account with a separate life insurance policy. For investors interested in annuities, the typical rule of thumb is to max out employee-sponsored plans and IRAs before buying one. An even better rule of thumb is to consult with a trusted investment adviser, financial planner or retirement specialist *before* signing an annuity contract to make sure you're on the right path.

If you're considering an annuity or are looking for means of generating income in retirement and would like to speak with one of our investment professionals, please give us a call at 800-492-6868 and we'd be happy to discuss your options with you.

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

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Adviser Investments 85 Wells Avenue Newton, MA 02459 USA

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