ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Fidelity Returns Fire in Fee Wars

On August 1, Fidelity reduced fees on its higher-minimum premium share class for 14 index funds, undercutting rival Vanguard on expenses charged on comparable funds' Admiral share class, which share a $10,000 minimum initial investment. This is another blow in the fee war that's been ongoing in the index mutual fund space for over a decade now—though after all the fee cuts, each advance gains the combatants less and less territory.

For example, the average expenses for Fidelity's index-based funds are 0.099% following the move, down 0.011% from before the reductions. Clearly this is a tiny amount—just an average of an 11-cent reduction in fees on every $1,000 invested, but in the race to zero in the competitive index fund space, Fidelity is seeking to stand out from the pack.

Fidelity introduced the fee cuts with a big ad in *The Wall Street Journal* and launched an unsubtle web page, "www.fidelity.com/beatsvanguard," that presents a head-to-head comparison of its index and sector ETF products against similar funds at Vanguard. Fidelity's fee cuts made all 28 of its index funds and each of its 11 sector ETFs cheaper than comparable funds offered by its main competitor.

Fidelity Fund (Premium Share Class*)	**Former Fidelity Expense Ratio**	**Current Fidelity Expense Ratio**	**Current Vanguard Expense Ratio**	**Vanguard Fund (Admiral Share Class*)**
500 Index	.045%	.035%	.040%	500 Index
International Index	.080%	.060%	.070%	Developed Markets Index
Total Market Index	.045%	.035%	.040%	Total Stock Market Index
U.S. Bond Index	.050%	.045%	.050%	Total Bond Market Index
Large Cap Value Index	.070%	.050%	.060%	Value Index

Large Cap Growth Index	.070%	.050%	.060%	Growth Index
Mid Cap Index	.070%	.050%	.060%	Mid Cap Index
Small Cap Index	.070%	.050%	.060%	Small Cap Index
Total International Index	.110%	.100%	.110%	Total International Stock Index
Global ex.-U.S. Index	.080%	.060%	.110%	FTSE All-World ex.-US Index
Emerging Markets Index	.140%	.130%	.140%	Emerging Markets Stock Index
Short-Term Treasury Bond Index	.090%	.060%	.070%	Short-Term Government Bond Index
Interm.-Term Treasury Bond Index	.090%	.060%	.070%	Interm.-Term Government Bond Index
Long-Term Treasury Bond Index	.090%	.060%	.070%	Long-Term Government Bond Index

*Premium and Admiral share classes both have a $10,000 minimum initial investment. Expense ratios as of 8/1/2017 (Fidelity) and 7/31/2017 (Vanguard). Sources: Fidelity Investments, The Vanguard Group.

If you're wondering why Fidelity, Vanguard and other fund providers have all been making such a big deal out of relatively small amounts of savings at the individual investor level, just look at the popularity of index funds, which have seen massive inflows of cash in recent years. 2016 was a record year, as investors put nearly $505 billion into passively managed stock and bond funds.

While Fidelity is best known for its celebrated active managers, it also touted nearly $300 billion in passive assets as of June's end, about 13% of its $2.3 trillion under management.

Fidelity Providing Savings on Active Funds, Too

Although the index-fee reduction got the most press, the cost savings for investors in Fidelity's index funds pales in magnitude next to the shareholder-friendly move they've made on five of their actively managed funds. In fact, you could make an argument that the real story of Fidelity's ongoing challenge to Vanguard is the changes it's making in its actively managed fund lineup.

The Boston-based fund giant recently launched identical Z share classes of five of its retail funds for financial advisers and their clients that carry expense ratios that are 0.09% to 0.14% cheaper (or about 14% to 22% less on an absolute basis) than their investor-class shares. (Adviser Investments uses Z shares for our clients where they are available and when it's to the client's benefit.)

Fidelity Fund Name	Annual Net Expense Ratio (Z Shares)	Annual Net Expense Ratio (Retail Shares)	Difference
International Discovery	0.85%	0.99%	-0.14%
International Growth	0.84%	0.98%	-0.14%
Mega Cap Stock	0.53%	0.68%	-0.15%
Stock Selector All Cap	0.54%	0.63%	-0.09%
Total Bond	0.36%	0.45%	-0.09%

Source: Morningstar.

There are also no transaction fees for buying or selling these funds. By shifting into the new shares of these five funds, investors could save more than $54 million combined.

Fidelity's custodial business also dropped trading costs on many of the non-Fidelity, institutional share-class funds it makes available to investors. Institutional shares typically cost 0.25% less than other share classes because they don't charge a 12b-1 fee, but transaction costs had made them prohibitive for smaller investors. Those are starting to go away, and if the industry followed Fidelity's lead, some $2.3 billion in savings would be passed along every year. Hardly chump change.

Fidelity's Z shares are available through eligible employer-sponsored retirement plans and accounts where advisers charge an asset-based fee.

While the debate over passive versus active management rages on, we see an important ongoing trend in investors' steady drift from high-fee to low-fee funds. And as passive investments' expense ratios continue to inch toward 0.00%, we'll be watching closely to see how active funds drop their fees to remain competitive.

Vanguard Adds International Manager

Vanguard has announced that it is adding a third sub-adviser, TimesSquare Capital Management, to its International Explorer fund's ranks by the end of August. Is the fund giant's only actively managed international small-cap fund running up against its capacity limits? And if that's the case, will adding another manager help the fund or kneecap the performance of those already managing assets there?

TimesSquare's Magnus Larsson will come aboard to manage less than 5% of the firm's assets at first, which will be ceded by the fund's current sub-advisers: Schroder Investment Management and Wellington Management. If history is any indication, we would expect to see Larsson take on more responsibility going forward, and at Schroder's expense. After all, when Wellington joined the fund in 2010, manager Simon Thomas only oversaw 1% of the portfolio to begin with. As of April 2017, the most recent data we have, Wellington oversaw 30% of total assets.

It is too soon to say whether this hiring is Vanguard's attempt to handle a capacity issue and keep a popular and profitable fund open by adding a new manager or if there is something else going on. Vanguard does not provide much of a rationale for adding the new-to-the-firm sub-adviser in their press release regarding the move, other than to broadly state "a multimanager structure enables each manager to focus on longer-term opportunities where they have the most conviction," so we can only guess as to the motive. Cash has just recently started to flow back in to the fund after a full year of steady outflows, but TimesSquare is joining the ranks as International Explorer's assets near $3.5 billion—slightly more than its previous high-water level in May 2007.

The addition of another manager to International Explorer continues a multimanager trend at Vanguard we've written about before. Adding a third sub-adviser risks turning International Explorer into an index fund charging active management fees, but, again, it's too early to determine what TimesSquare will bring to the table and how the fund will be affected from a holdings and performance perspective, particularly with the new manager starting out with a tiny, 5% portion of the fund.

The firm has seen the multimanager strategy be successful in a few cases, but we've also seen where it can be to shareholders' detriment. One only needs to look at International Explorer's namesake bigger brother, Explorer, which has underperformed its benchmark and Vanguard's indexed options since fattening its management ranks years ago for an example of multi-management's downside.

About Adviser Investments
Adviser Investments operates as an independent, professional money management firm with particular expertise in Fidelity and Vanguard mutual funds. We advise more than 3,000 clients and have over $4 billion under management. Our investment professionals focus on helping individual investors, trusts, foundations and institutions meet their investment goals. Our minimum account size is $350,000. In 2016, Adviser Investments was named to *Barron's* list of the top 100 independent financial advisers nationwide and its list of the top advisory firms in Massachusetts for the fourth consecutive year. We have also been recognized on the *Financial Times* 300 Top Registered Investment Advisers list in 2014, 2015 and 2016.

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