ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Vanguard Manager Sent Packing

Vanguard has become a leading proponent of a "the more, the merrier" philosophy, stacking multiple managers on its active funds increasingly over the years. The firm began using the multimanager approach in 1987, and now uses it for 18 of its actively managed U.S. funds. The stated belief: Dividing fund management among multiple management groups "can reduce portfolio volatility, provide potential for long-term outperformance and mitigate manager risk."

Imagine our surprise to see that one-third of Vanguard Explorer Value's three-adviser team was shown the door earlier this month with no replacement named (though one may be selected down the road). It's almost as if Vanguard has decided that, maybe, two managers might be better than three.

On June 6, Vanguard released a terse statement that it would be parting ways with Sterling Capital Management, reallocating its 31% of Explorer Value's assets to Frontier Capital Management and Cardinal Capital Management. All three teams had co-managed roughly equal portions of the fund since inception in March 2010. Reading the press release, shareholders were left wondering: Was the decision based on Sterling's investment staff, its process or its performance?

There doesn't seem to be any evidence that the company had been beset by personnel problems or that it changed its process all of the sudden, so that makes us think the issue might've been performance. If the team was the fund's weak management link, dragging on returns produced by Cardinal and Frontier, it would make sense for Vanguard to part ways.

So did Vanguard can Sterling for performance problems? Based on our research, it looks as though this was the case, but Vanguard will never say. The fact that they've decided to go ahead with just two teams instead of swapping Sterling for another sub-adviser puts a big question mark over Vanguard's assertion that more is better when it comes to portfolio management teams. But we also doubt the firm will be making wholesale changes to its approach any time soon.

We believe that adding more managers makes a fund look more and more like the index it's trying to beat, defeating the purpose of active management. Sure, you might reduce the chances of a really bad outing, but you also limit the potential for good ones.

Plus, as proponents of a diversified, actively managed portfolio, it's not that we're against owning different managers, especially ones operating in different segments of the market. But when multiple managers in a single portfolio are fishing the same waters, outperformance against an index becomes much less likely.

Vanguard's track record of identifying and attracting a number of top active managers over the last three-plus decades while maintaining low costs is undeniable—we've been happy Vanguard investors since opening Adviser Investments' doors in 1994. It's the more recent decision to lump together three, five or eight at a time in a fund that we disagree with.

It was just this January that the fund titan reduced the management headcount at Explorer and Morgan Growth by one advisory team each (though in our view, both remain multimanager muddles). The last six months suggest that Vanguard may slowly be reining in the "more is more" philosophy. We'll keep you posted.

Fidelity Files 'Smart Beta' ETFs
Near the end of May, Fidelity filed a preliminary prospectus with the Securities and Exchange Commission (SEC) for six "smart beta" exchange-traded funds (ETFs), offering additional information on its plans to join a rapidly expanding section of the ETF marketplace.

This filing came one month after Fidelity petitioned the SEC for more leeway to create "self-indexing" funds, something we covered at the time, along with a discussion of the state of the "smart beta" ETF market.

Commonly referred to as "smart beta" funds, these factor-based products represent somewhat of a blend of active and passively managed ETFs. Passive, because there is no manager making changes to holdings, but active in that they are based on indexes constructed out of active input into the factors ruled in (and ruled out) of asset selection. We like to think of them as more "dynamic" than passive.

The April filing gave us little sense of how these funds would operate. Now we've got the proposed names and objectives. Each index that the ETFs will seek to track uses Fidelity's rules-based, proprietary index methodology (i.e., dynamic indexing).

Fidelity's Proposed Active ETFs and Their Objectives

ETF	Benchmark	Fund Composition/Objective
Fidelity Core Dividend ETF	Fidelity Core Dividend Index	Large- and mid-cap dividend-paying stocks expected to continue to pay and grow their dividends
Fidelity Dividend ETF for Rising Rates	Fidelity Dividend Index for Rising Rates	Large- and mid-cap dividend-paying stocks expected to continue to pay and grow dividends, and are well-suited to a rising interest-rate environment
Fidelity Low Volatility Factor ETF	Fidelity U.S. Low Volatility Factor Index	Large- and mid-cap U.S. stocks with lower volatility than the broader market
Fidelity Momentum Factor ETF	Fidelity U.S. Momentum Factor Index	Large- and mid-cap U.S. stocks that exhibit positive momentum signals

Fidelity Quality Factor ETF	Fidelity U.S. Quality Factor Index	Large- and mid-cap U.S. stocks with a "higher quality profile" than the broader market
Fidelity Value Factor ETF	Fidelity U.S. Value Factor Index	Large- and mid-cap U.S. stocks that have attractive valuations

Source: SEC filing.

The ETFs will be managed by FMR Co., Inc., an affiliate of Fidelity Management & Research Company. Geode Capital Management will serve as a sub-adviser.

This filing underscores Fidelity's later—but, we think, savvier—entry into the non-commoditized passive market ETF niches. As we've discussed, in recent years, we've seen the firm launch multiple sector ETFs (including a real estate ETF) and actively managed bond ETFs. This new lineup extends their reach and demonstrates further how Fidelity plans to capitalize in the ETF field.

As with sector ETFs and bond ETFs that share the same managers and names with existing mutual fund counterparts, these dynamic, or smart beta, ETFs mark the latest attempt by Fidelity to capitalize on its strong reputation for active management expertise with the soaring popularity of exchange-traded funds.

We'll be watching to see if these offerings find a foothold in the markets, and how Fidelity continues its forward march into the ETF arena.

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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