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May 28, 2010

### **Vanguard Reverts on Convertibles**

On May 27, Vanguard announced that it was reopening Convertible Securities 11 months after closing the fund in June, 2009. The firm also removed the \$25,000 annual cap on investments in the fund, although opening a new account will require a \$10,000 minimum investment.

When Vanguard closed the fund due to accelerating cash inflows (which were a response to the fund's outperformance) in June last year, we remarked that this was following a pattern we've observed throughout the fund's history, with investors chasing returns at the wrong time. In fact, as investors flooded Convertible Securities with cash in late 2008 and early 2009, nearly doubling the fund's assets and forcing Vanguard to act, the fund had already begun to lag the market, leading us to predict that the fund would begin to see outflows.

This has happened several times in the past decade. Starting in the spring of 1999 and into early 2000, the fund outperformed 500 Index substantially, and investors tried to catch the lightning in a bottle, with the fund showing a net cash inflow starting around October 1999, reversing a steady outflow. Soon after, Convertible Securities began to lag the market, and by the time it was outperforming again later in 2000, investors had begun selling off their shares. Something similar happened a year later, with new money moving into the fund just as its relative performance began to lag the market.

Vanguard shut the doors in May 2004 and it wasn't until months after the June 2005 reopening that money began to flow back into the fund. A fairly steady, but small flow of new money has been moving into Convertible Securities over the past couple of years, but that flow picked up in November 2008 and the continuation of that trend is what forced Vanguard's hand.

Flash forward to the present—over the last year, Convertible Securities has seen about \$180 million walk out the door, more than a tenth of the fund's current \$1.8 billion in assets. The outflows began, as

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predicted, when the fund began to lag the S&P 500, so this reopening comes as no surprise. We expect the fund to remain open (and not see significant inflows) until the next time it heats up and investors once again chase its outperformance.

We've invested in Larry Keele's Convertible Securities fund in the past in some client accounts, finding that its best use is in an income-focused portfolio where higher yields and lower risk are more important than absolute tax efficiency and performance. But it has very specific uses in a portfolio and is not necessarily the best choice for most investors. We suspect that investors who rushed the gates as the fund outperformed, only to see it underperform over the last year, may now wonder whether they did the right thing for their individual investment objectives.

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