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Vanguard's Bond Blitz

As the bond market bumps along near its all-time highs, and investors have become newly enamored of bond ETFs, Vanguard announced last month that it will make an ambitious new foray into bond indexing with what appears to be the goal of grabbing control of the exchange-traded bond fund market from Barclays' iShares group and going head-to-head with planned offerings from PIMCO as well as new entries that might come from the iShares acquirer BlackRock Inc.

The seven new bond index funds that Vanguard plans to introduce on Monday, November 2 are officially known as the *Scottsdale Sector Bond Index* funds. The funds track seven Barclays Capital bond indexes and will be available in institutional fund shares, Signal shares and ETF shares. The corporate bond funds will all have front-end loads, ranging from 0.25% to 1.00%, making them pretty unattractive. It is likely the bulk of assets investors send to these funds will be going into the ETFs.

As a whole, the seven bond sector funds will cover approximately 92% of the entire Barclays Aggregate Bond Index now tracked by Vanguard's Total Bond Market Index. Only asset-backed bonds, foreign government bonds, taxable state and municipal bonds and commercial mortgage-backed bonds are missing from this line-up's holdings.

	Minimum	Operating Expenses
Institutional shares	\$5 million	0.09%
Signal shares	\$1 million	0.15%
ETF shares	no minimum	0.15%

The government bond index funds will invest in Treasury bonds (excluding inflation-protected bonds) as well as bonds issued by government agencies and foreign, dollar-denominated debt guaranteed by the U.S. government. The corporate bond index funds will invest in investment-grade taxable bonds. The mortgage-backed securities fund will invest in Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC) issued mortgage pass-through securities. All of the funds' portfolios will be sampled, meaning they will use a selection of securities from their benchmark

indexes, rather than investing in all of the securities that make up the relevant indexes.

	Avg.-Weighted Maturity (years)	Sales fee/load	Securities in index
Short-Term Government Index	1.9	none	447
Int.-Term Government. Index	5.9	none	413
Long-Term Government. Index	19	none	130
Short-Term Corporate Index	3.1	0.25% front-end	1,215
Int.-Term Corporate Index	7.9	0.50% front-end	1,154
Long-Term Corporate Index	24.7	1.00% front-end	886
Mortgage-Backed Index	5.8	none	1,609

It's worth mentioning that some of these funds, particularly those with longer maturities, may languish for lack of interest if interest rates begin rising and bond prices begin falling. When Vanguard introduced its original three sector bond index funds in March 1994, the Fed had just begun to raise interest rates, doubling the Fed Funds Rate from 3.00% in February 1994 to 6.00% in February 1995. Falling bond prices were a headwind to market acceptance and Long-Term Bond Index struggled to build assets while Short-Term Bond Index and Intermediate-Term Bond Index grew fairly quickly. The intermediate-term fund topped \$1 billion in assets by 1998 and the short-term fund by 1999. It wasn't until 2004 when the long-term fund saw assets break the billion-dollar mark.

It remains to be seen how popular these new index funds will be, especially since some of them will face stiff competition from Vanguard's managed funds covering similar territory.

Fidelity Pushing Bonds Too

While Fidelity hasn't revealed any plans to introduce new bond funds, the firm has reacted to an increase in investor interest and will be more aggressively marketing its bond funds.

Near the end of August, Fidelity announced that it was launching a new website dedicated to educating investors about bonds, and specifically, their offerings: www.fidelity.com/fixedincomechoices (the site does provide a good amount of information on the different bond types and risks associated with them, but we would not recommend it as your sole source for making an investment decision). The firm also has increased its pool of fixed income phone specialists and will be conducting educational seminars on bond fund investing at their Investor Center locations around the country.

Why this new focus on bonds? Well, as we mentioned in the piece above, the bond market is near its all-time highs, and strong performance attracts attention. At Fidelity, the form of that attention was huge cash inflows into their bond funds, which as a group saw assets increase by 17% in the first half of 2009. Particular favorites were corporate bond funds, which grew assets by 24% over that period.

Our philosophy at Adviser Investments is that bond funds have a place in most portfolios—they provide excellent diversification from stock holdings and can be a great source of income. But choosing the right bond fund or funds for your portfolio

and figuring out the best allocation may not be quite so simple as looking at a website or talking to whichever corporate sales rep is assigned your call. If you are looking to add a bond component to your portfolio, our best advice is to speak to a trusted investment professional, one who can accurately assess your goals and risk tolerance and guide you to the right fund and allocation.

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