



October 1, 2010

Vanguard's International Makeover

Investors should put more of their money overseas! At least, that's the message Vanguard was conveying this past week as they made significant changes to a number of funds. First up, a change in benchmarks and the addition of an ETF share class for Total International Index. And on the heels of that news came a remodeling of a number of fund-of-funds to increase their international exposure.

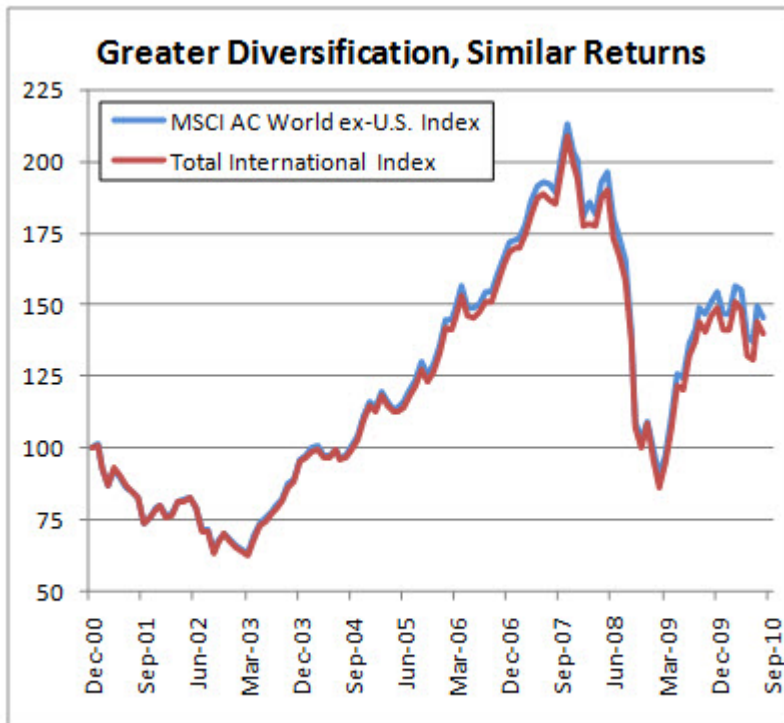
Total International's New Look

On September 24, Vanguard said it would switch Total International Index's benchmark from the MSCI EAFE + Emerging Markets index to the MSCI All Country World ex-U.S. index, while also revealing plans to introduce a Total International ETF early in 2011.

Taking a look under the hood of the new bogey, we found it offers greater diversification than the EAFE + Emerging Markets index (approximately 6,000 holdings versus 1,714 at the end of August), and it adds Canada into the mix at about 8% of assets. In terms of performance, the AC World ex-U.S. index and Total International Index have had similar returns over the last decade or so (see chart below).

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Sources: MSCI and Adviser Investments

For an idea of the comparative riskiness of the new benchmark, we ran a maximum cumulative loss (MCL) analysis for the most recent bear market, which showed that the MSCI index lost 58.5%, while Total International Index lost 57.6%. It should be noted that the returns for the AC World ex-U.S. index (in the chart and MCL analysis) do not include any operating expenses, while those for Total International do. Investors in Total International will likely not notice any differences in the fund's performance due to the switch.

The second part of the story will have a wider-ranging impact. The introduction of Total International ETF will once again put Vanguard head to head with its competitors in the ETF marketplace, in this case, iShares and State Street, both of which have ETFs tracking the same MSCI bogey. iShares' ACWX has an expense ratio of 0.35% and State Street's CWI charges 0.34%, while Vanguard's Total International ETF is expected to cost just 0.20%.

This is just the latest whack at the foundation of the ETF industry; a continuation of Vanguard's efforts to undercut and overtake the competition. ETF investors stand to be the biggest beneficiaries.

Vanguard Restructures Funds of Funds

Following on the changes to its benchmark, Vanguard announced on September 27 it would be changing the composition of its Target Retirement and Managed Payout funds while also boosting

international allocations in the *LifeStrategy* and Target Retirement funds as well as the original STAR.

From inception, the Target Retirement and Managed Payout funds got their international exposure through holdings in a trio of funds, Emerging Markets Index, European Index and Pacific Index. Going forward, however, those three funds will be replaced by Total International Index, which obviously simplifies the funds' structures, but also has the potential to reduce expenses—the current expense ratio on Total International (0.32%) should come down as assets in the fund increase, and should be smaller than the mixed operating expenses for the three foreign index funds formerly included in the funds' portfolios.

The move to increase international exposure in portfolios (whether through the firm's official recommendations to clients or its allocation choices in funds and fund-of-funds) is one that has slowly developed over the years. Founder and former chairman Jack Bogle originally counseled that U.S. investors didn't need any direct international investments at all, since the largest domestic companies provided enough overseas exposure on their own. As time went on, however, the firm began recommending that clients include an international component to their portfolios, started adding an international allocation in funds of funds (or boosting the existing allocation), while raising the percentage of foreign holdings permitted in the prospectuses of funds run by outside managers as well.

In the table below, you can see the current and new target international allocations for the affected funds. In some cases, the percentage increases are quite dramatic--*LifeStrategy* Conservative Growth, for instance, will see its international exposure more than double, while at Target Retirement 2005, the 6.9% to 11.0% change represents a 59% increase.

	Aug. 2010	Target
<i>LifeStrategy</i> Income	0.0%	6.0%
<i>LifeStrategy</i> Conservative Growth	5.0%	12.0%
Target Retirement Income	6.0%	9.0%
Target Retirement 2005	6.9%	11.0%
Target Retirement 2010	9.7%	15.0%
<i>LifeStrategy</i> Moderate Growth	10.0%	18.0%
Target Retirement 2015	11.8%	18.0%
STAR	13.0%	19.5%
Target Retirement 2020	13.2%	20.0%
Target Retirement 2025	14.8%	23.0%
<i>LifeStrategy</i> Growth	15.0%	24.0%
Target Retirement 2030	16.3%	25.0%
Target Retirement 2055	17.8%	27.0%
Target Retirement 2050	17.8%	27.0%
Target Retirement 2040	17.9%	27.0%
Target Retirement 2035	17.9%	27.0%
Target Retirement 2045	18.0%	27.0%

Source: The Vanguard Group

Vanguard plans to maintain the overall balance between stocks and bonds in the Target Retirement and *LifeStrategy* funds, so this is strictly a readjustment to the equity portion of each portfolio, with the increase in foreign exposure coming at the expense of the domestic stock allocation. The changes will increase risk in the funds to a certain extent, but not enough so that investors should be overly concerned. Of course, our long-held opinion, voiced in this space regularly, is that investors can do better than relying on Vanguard's one-size-fits-all lifecycle funds of funds.

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