ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

January 22, 2009

The Myth of Rebalancing
In our last *Adviser Fund Update*, we took a look at what Vanguard and Fidelity recommend when it comes to rebalancing, with both firms feeling that investors should tweak their portfolios every time a position moves 5-10% off of their target allocation or otherwise on a semiannual or annual basis. When we ran our own numbers, we found that over two decades, a portfolio that was never rebalanced actually showed better average returns over all annual and multi-year periods than a portfolio rebalanced twice a year, albeit by a narrow margin. For all of the details, please take a look at our *Adviser Fund Update* archives by directing your browser to http://www.adviserinvestments.com/research/fund-updates and clicking on the update posted on January 8th.

Now that we've looked at how frequent rebalancing contrasted with never rebalancing has a rather small effect on long-term returns, this week we thought we would point out some of the other issues that one needs to consider when developing a rebalancing strategy.

Frequent Trades Can Cost You
There is one very strong argument against becoming a rebalancing fanatic, and that's cost. When conducting our analysis two weeks ago, we assumed that all distributions were reinvested along the way, and did not factor in transaction fees or taxes on realized gains from trades. But these are both very important issues to consider when thinking about a rebalancing strategy.

If you choose to rebalance annually or even more frequently in a taxable portfolio, carefully review how the various transactions you'll need to make will affect your tax return as well as any fees you might incur—do funds in your portfolio have front- or back-end loads or short-term trading fees? Are you buying into a fund paying a distribution? (While Vanguard's Total International Index pays distributions annually, 500 Index pays out quarterly.) Will the sale of a fund create a taxable gain? These are all questions you should be asking yourself when developing a rebalancing strategy. (Even though taxes won't be an issue if you're rebalancing your IRA, 401(k) or any other tax-free account, you still should consider fees and expenses from trades.)

However, there are more ways to rebalance than just buying and selling out of the funds in your portfolio on a fixed schedule. One of

In This Issue

the simplest, and one we've recommended for years, is to re-direct distributions to or make new investments in the under-allocated funds in a portfolio. Or if you're at the point where you're drawing on the portfolio for income, take withdrawals out of your winners to reduce their allocation (this of course will generate its own tax bill, but of course you can't avoid taxes forever if you're drawing down your account). These kinds of moves will be the most effective in keeping taxes and expenses down when compared to making numerous trades over the course of a year.

Remove Emotion from the Equation

There's another issue at stake in rebalancing that often gets overlooked, and that's the human factor. It's easy enough to calmly discuss rebalancing a hypothetical portfolio, but when it comes to reality, many investors may find the idea counterintuitive, as it requires you to reward the losers in your portfolio with more money while reducing your exposure to the proven winners.

If you have a fund in your portfolio that's been burning up the markets month after month, you're probably not going to want to sell it to invest more in a fund that's been losing you money. But the standard theory of rebalancing requires that you do exactly that, and not just once, but over and over and over. As Vanguard Chairman Jack Brennan has said, "If you are going to rebalance, you have to be absolutely clinical, or you are better off not doing it." We share this view.

Of course you could take the more laidback route and rarely rebalance—if at all—so long as you have a tolerance for the increased volatility that is part of an "unbalanced" portfolio. And when you figure the tax bill on frequent trades, you could come out substantially ahead. As illustrated by our analysis, from a returns standpoint, going with the flow isn't that bad an idea.

Several more things to consider: If you do choose to rebalance on a set schedule, is your target allocation still appropriate—do you still have the same investment goals as when you started? Over a 22-year period such as the one we looked at last time, or even the 40-year period Vanguard looked at back in 2006, your allocation might need a change, requiring even more buying and selling. Do you have a lower or higher tolerance for risk? Just because you picked a certain allocation at one point doesn't mean that it suits your purposes now. Are you prepared for the headaches and tax implications of making multiple trades per year? While many firms allow you to make trades online, you still open yourself up to having to review more paperwork, track all of the changes to make sure there weren't any errors (on your part or the fund company's) and fill out extra lines on your tax return for every capital gain realized. This seems like a lot of extra hassle to us for a reduction in risk and in total return.

So is rebalancing necessary? Even though the media or your fund company may have you think so, when you look at the evidence—even after a year as wild as 2008—there is little benefit when it comes to the portfolio's returns, and only some benefit when you think about risk. (And this assumes no tax consequences.) Our recommendation would be to make a few trades over the course of several years, as we do for our clients, as opposed to being overly active each year with potentially costly trades that are not going to improve your returns. Of course, if rebalancing frequently gives you peace of mind *and* you're willing to be clinical about it, your portfolio will not suffer too much for it either.

Vanguard Growth Equity Reborn?
On January 16th, Vanguard announced that it was replacing Turner Investment Partners as a manager of Growth Equity, splitting assets 50-50 between co-manager Baillie Gifford (added in 2008) and newly added Jennison Associates. Baillie Gifford has managed a portion of International Growth since 2003 and was added as a fourth manager to Global Equity in 2008, while Jennison Associates has been managing a slice of Morgan Growth since 2007.

Growth Equity, formerly known as Turner Growth Equity, was adopted by Vanguard in 2000, which shortened the name and retained Turner Investments as manager (the firm had been running the fund since its 1992 inception under its own label). Since that time, the fund has mostly been a great disappointment for investors, who've experienced a couple of years of outperformance offset—and exceeded by—long periods of underperformance. The fund dropped into a massive hole in September 2002, having racked up a cumulative loss of 68.7% over the prior two-plus years, and was far from recovery when it suffered an additional 47.9% drop in 2008.

Vanguard finally showed some concern for Growth Equity's shareholders in April of 2008, a team from Baillie Gifford was added as a minority co-manager, but the addition was little comfort with Turner Investments remaining in control of a majority of assets.

The replacement of Turner with Jennison has remade Growth Equity into a new fund. Turner's earnings momentum-based quantitative investment style, supposedly sector neutral to its Russell 1000 Growth Index benchmark, but in fact relying on heavy bets on technology stocks, is gone, leaving two qualitative managers to run the show. While this re-making does not yet give us a compelling argument to invest here, we certainly see it as a positive step for the fund, which now has the chance to prove itself as a worthy competitor to Vanguard's other large-cap growth funds.

Fidelity Manager Change
On January 12th, James F. Catudal replaced Tim Cohen as manager of Growth & Income. Cohen has been reassigned to the equity research group as a research analyst following the energy sector. Catudal will continue to manage Growth & Income's Advisor and VIP clones, as well as the Stock Selector fund. He joined Fidelity in 1997 as an equity research analyst following North American non-ferrous metals companies. From 1998 through 2001, Catudal managed Select Energy Services, Select Financial Services (Advisor & VIP versions too) and served as Fidelity's financial services sector leader. He began managing Stock Selector in 2001 and Advisor Growth & Income and VIP Growth & Income in 2005. Previously, Catudal worked for State Street Research & Management as an equity analyst with the aggressive growth team, where he followed banks, thrifts, and Real Estate Investment Trusts (REITs). He also worked for Textron, McCord Winn Division, from 1987 to 1993, beginning as a quality engineer and finishing as the divisional quality manager, responsible for overseeing three manufacturing plants. He began his career as a process control engineer for Union Carbide Corporation, Bennington, Vermont, in 1983.

This change should not be a cause of concern for investors—in fact, based on Jim Lowell's year-end proprietary manager ranking analysis (which calculates a rating for each fund manager based on their career performance and risk records on the various funds they've managed), Growth & Income's prospects just got brighter. Jim has James Catudal ranked 12th out of the 39 managers in the Fidelity's Growth/Growth & Income group, while Tim Cohen placed 38th.

About Adviser Investments

Adviser Investments is an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 1,500 clients and $1.2 billion dollars under management, Adviser is one of the nation's largest mutual fund research and money management firms. Our staff of 40 investment professionals focuses on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is $350,000.

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