ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

January 22, 2010

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 equal or 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 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.

Trading Comes with Costs
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

In This Issue

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 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 former 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 the two-plus decade period such as the one we looked at last time, 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 two-year stretch as topsy-turvy as 2008-2009—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 Adds to Windsor II

On January 13th, Vanguard announced that it was adding a sixth management team to Windsor II. The new team hails from Sanders Capital, and will initially manage about 8.5% of the fund's assets. Vanguard's claim is that Sanders (and the multi-management approach, in general) can add value to a fund, although, in most cases, we disagree.

Sanders Capital is a brand new firm, having only begun managing client accounts in the second half of 2009. It will employ a bottom-up, fundamental research-driven approach to value investing on its 35-45 stock portfolio. The firm's genesis came from the ousting of CEO Lewis A. Sanders from AllianceBernstein in 2008 (a 32-year veteran of the firm, and one of its predecessors, Sanford C. Bernstein)—he started up his own shop and has been recruiting his former employees, such as his co-manager on Windsor II, John Mahedy, over the last year. Mahedy may be a name familiar to Vanguard investors—he was formerly AllianceBernstein's manager on Windsor, before leaving last year to join Sanders Capital.

As the multi-management trend has gathered steam over the last decade, we've made the point repeatedly that the more managers and stocks added to a managed fund's portfolio, the more index-like the returns will become. We feel that investors would get more value from a new fund run by a promising manager than from a multi-managed fund collecting talent that won't be able to shine.

While Windsor II's returns have been improving against its benchmark of late, the addition of Sanders Capital may make that improvement temporary. As the fund now stands, we prefer Vanguard's Dividend Growth fund in the large-cap arena and Selected Value in the mid-cap range.

About Adviser Investments

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