ADVISER INVESTMENT MANAGEMENT

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investment Management

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Are the Vanguard Bond ETFs Right for Your Portfolio?

While bond funds hardly qualify as exciting, the news that Vanguard is opening four bond index exchange-traded funds has caused some buzz, as there are so few fixed income ETFs currently on the market. Their projected rock-bottom 0.11% expense ratios make them all the more appealing and, dare we say it, exciting. With these new ETFs scheduled to open this week, we thought we'd take a look at the four underlying funds and how they could fit into a portfolio.

The Funds

As we mentioned in January when Vanguard first announced its intentions, the four bond ETFs will actually be separate share classes of four of the firm's existing bond funds: Short-Term Bond Index, Intermediate-Term Bond Index, Long-Term Bond Index and Total Bond Market Index.

Fund	ETF Ticker	Investor Expenses	ETF Expenses
Short-Term Bond	BSV	0.18%	0.11%
Intermediate-Term Bond	BIV	0.18%	0.11%
Long-Term Bond	BLV	0.18%	0.11%
Total Bond Market	BND	0.20%	0.11%

Short-Term Bond Index tracks the Lehman 1-5 Year Government/Credit Index of about 1,700 investment-grade Treasury, government agency and corporate bonds with maturities of one to five years. As such, it invests about half of its assets in government bonds and spreads the remainder among corporate bonds, with a few high quality foreign issues thrown in. This results in high credit quality throughout the portfolio, with more that 80% of assets in issues rated Aa or better. The Treasury holdings could be a potential liability if interest rates rise quickly, but in the current market environment that seems unlikely.

This fund is very safe—its maximum cumulative loss (MCL) is just 1.8% incurred over two months in 2004, and it recovered that loss in just three months. Of the new ETFs, this is the least risky of the bunch, and most investors could be very comfortable using it as the fixed income portion of their portfolio. Year-to-date through March, Short-Term Bond Index is up 1.5%.

Intermediate-Term Bond Index tracks the Lehman 5-10 Year Government/Credit Index, which is made up of about 1,400 investment-grade Treasury, government agency and corporate bonds with maturities of five to 10 years. The fund owns about 850 of them, as it's required to put at least 80% of assets in issues held by its bogey, and as a result, credit quality is very high. This fund should perform similarly to Total Bond Market Index over a full market cycle, although the volatility here may be higher as there are no GNMA securities in this fund's portfolio as there are in Total Bond Market's. The fund's MCL of 5.3% was suffered over two months in 2003, and it took just six months to recover the loss. This fund offers a higher risk/return ratio than its short-term sibling and more conservative investors may not be comfortable with this fund's swings. Through March, the fund is up 1.5% for the year.

Total Bond Market Index is Vanguard's one-stop bond index, tracking the entirety of the bond market via the Lehman Aggregate Bond Index of some 6,500 bonds. This fund differentiates itself from the other three in that it invests in GNMAs, and as such it has a more varied mix of securities, with about 24% in corporate bonds, 36% in mortgage-backed securities, 36% in Treasurys and a tiny remainder in foreign and asset-back bonds. While it occupies the same maturity range as Intermediate-Term Bond Index, Total Bond Market suffers less volatility while delivering similar returns. The fund's MCL of 5.8% was suffered over seven months in 1987 and it recovered that loss in four months. We'd give this fund the nod over Intermediate-Term Bond Index for investors considering the two. Total Bond Market Index is up 1.4% for the year through March.

Long-Term Bond Index tracks the Lehman Long Government/Credit Index of about 1,300 investment-grade Treasury, government agency and corporate bonds with maturities greater than 10 years. As with the funds above, credit quality is high, and with the fund on the long end of the yield curve, the yield is more generous. That said, this is one of Vanguard's riskiest fixed income options (as can be seen in its 10% MCL over two months in 2003, from which it took eight months to recover) and to date its long-term returns haven't done much to distinguish it from the safer intermediate-term funds like Intermediate-Term Bond Index and Total Bond Market Index. Through March, Long-Term Bond Index is up 0.6% for the year. This is not a fund we would currently recommend.

We would not advise switching out of investor or Admiral shares of these funds just to get into the new ETFs, but if you are looking to add to the fixed income portion of your portfolio, one of these offerings may fit the bill, as the low expenses are extremely investor-friendly.

About Adviser Investment Management, Inc.

Adviser Investment Management, Inc. is an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 1,400 clients and $1 billion dollars under management, Adviser is one of the nation's largest mutual fund research and money management firms. Our staff of 27 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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