ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Vanguard Takes a New Tack at Six Funds

Sometimes you have to admit when something is not working as well as it should and move on. That appears to be the impetus for Vanguard's decision to revamp management and strategy for six of its funds, including Asset Allocation, Growth & Income and the four LifeStrategy funds-of-funds at the end of September.

Growth & Income's Manager Change

While Vanguard avoided pointing fingers, poor performance was at least partially behind its decision to fire Mellon Capital Management as the sub-adviser for Growth & Income. Three new sub-advisers will each now manage one third of the fund's $4 billion in assets in Mellon's place. The new roster includes Los Angeles Capital Management's Thomas D. Stevens and Hal W. Reynolds, D.E. Shaw Investment Management's Anthony Foley and Vanguard's own James Troyer, a member of the firm's Quantitative Equity Group.

The new managers will continue to employ a quantitative approach, using computer models to select stocks. The former manager's computers have struggled in recent years, particularly in 2008, when the fund tanked 37.7%, slightly more than its S&P 500 index benchmark. The fund's annualized performance also trails the S&P 500 over the three-year (-0.6% vs. 1.2%) and five-year periods (-2.6% vs. -1.2%) ended September 30. Over the last year, the fund did slightly outperform its benchmark, but it was a case of too little, too late for Mellon. If the new management setup doesn't perform to Vanguard's satisfaction, we wouldn't be surprised if Growth & Income were merged into one of the firm's broad-based index funds down the line. For now, we'd advise staying away.

Asset Allocation Closed, Merging with Balanced Index

Asset Allocation suffered an even harsher fate than Growth & Income, as Vanguard has fired former manager Mellon, closed the $8.6 billion fund and announced plans to merge its assets with Balanced Index.

While Asset Allocation had the freedom to shift its assets between stocks, bonds or cash depending on market conditions and former manager Mellon's quantitative modeling (over the last few years, Mellon had allocated 70% to 100% of assets to stocks, with the remainder in bonds), Balanced Index keeps a static 60%/40%

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stock/bond mix. Under the supervision of two Vanguard managers--Gregory Davis of the Fixed Income Group and Michael Perre of the Quantitative Equity Group--Asset Allocation will gradually change its makeup to match that of Balanced Index, at which point the funds will be merged.

Here again, it's likely Mellon has been ousted over performance issues. Through the five-year period ended September 30, the fund delivered an average annual loss of 1.8%, while its benchmark (a 65%/35% mix of the S&P 500 index and the Barclays Capital U.S. Long Treasury Bond index) achieved an average 4.2% annual gain. Last quarter, Mellon's managers made some ill-timed shifts between stocks and bonds. The fund sold down stocks in mid-August, only to buy them back at higher prices a couple of weeks later, which resulted in a 5.8% loss for the month. Through the end of September, Asset Allocation was down 7.4% for the year, the second-worst performance of all of Vanguard’s balanced funds in 2011.

If you're currently an Asset Allocation investor and you're okay with having your investment shifted into a more conservative allocation similar to Balanced Index, you don't have to lift a finger. If you want to remain in an actively-managed, balanced Vanguard fund, we'd suggest Wellington, which boasts long-term performance better than both Asset Allocation and Balanced Index.

LifeStrategy Funds Go All-Index

Vanguard's four LifeStrategy Funds, with a combined $25 billion in assets, are abandoning active management. These funds-of-funds, launched in 1994, originally adopted an approach that blended active and passive management by investing in a handful of Vanguard's offerings.

The four funds will eliminate their exposure to Asset Allocation (which, as noted above, has become a balanced index fund and will soon cease to exist) and Short-Term Investment-Grade. Going forward, all of the assets in these funds will be invested in three broad market index funds (see table below): Total Stock Market Index, Total International Index and Total Bond Market II Index (a clone of Total Bond Market Index used solely in Vanguard's funds-of-funds).

	LifeStrategy Income	LifeStrategy Conservative Growth	LifeStrategy Moderate Growth	LifeStrategy Growth
Total Bond Market II Index	80%	60%	40%	20%
Total Stock Market Index	14%	28%	42%	56%
Total International Index	6%	12%	18%	24%

Source: The Vanguard Group

Unlike Vanguard's Target Retirement funds, which become more conservative over time, the asset allocations in these funds remain static. Vanguard says the all-index approach will provide more clarity around each fund's risk exposure and will result in lower expense ratios. Eliminating Asset Allocation, where the mix of stocks, bonds and cash could vary significantly from month to month, and which once accounted for as much as 25% of assets in all four LifeStrategy funds, should certainly give investors a clearer picture of their portfolio's allocation between stocks and bonds. That said, we've never been fans of the LifeStrategy lineup, and don't recommend any of the four options.

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