ADVISER INVESTMENTS

# ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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**New Benchmarks, Names for Vanguard Funds**
Vanguard is getting more conservative in its middle age. On August 8, it announced that three bond index funds (and ETF counterparts) will get new names and portfolio renovations in the fourth quarter as the funds transition from tracking government bond indexes to Treasury-only indexes.

The funds—Short-Term Government Index, Intermediate-Term Government Index and Long-Term Government Index—currently aim to mimic government bond indices that include Treasurys as well as bonds issued by government agencies like Fannie Mae and Freddie Mac. At some point in the fourth quarter—Vanguard isn't saying exactly when to prevent front-running by other traders—the funds will shift to Treasury-only indexes.

| Current Fund Name | Current Benchmark* | New Benchmark* | New Fund Name |
|---|---|---|---|
| Short-Term Govt. Bond Index | Bloomberg Barclays U.S. 1–3 Year Govt. | Bloomberg Barclays U.S. Treasury Bond 1–3 Year | Short-Term Treasury Index |
| Interm.-Term Govt. Bond Index | Bloomberg Barclays U.S. 3–10 Year Govt. | Bloomberg Barclays U.S. Treasury Bond 3–10 Year | Interm.-Term Treasury Index |
| Long-Term Govt. Bond Index | Bloomberg Barclays U.S. Long Govt. | Bloomberg Barclays U.S. Long Treasury | Long-Term Treasury Index |

*All indexes are float-adjusted. Source: Vanguard.

But this isn't actually that significant of a change. As of June 30, Treasury bonds accounted for more than 90% of all three government index funds' portfolios. Specifically, 91.5% for Short-Term Government Index, 97.2% for Intermediate-Term Government Index and 95.8% for Long-Term Government Index. These portfolios are already heavily invested in Treasury bonds.

With this move, Vanguard is setting up another testing ground for the grand active vs. passive debate. Its bond team actively manages funds focused on Treasurys, targeting the same short-, intermediate- and long-maturity parts of the market. Following the portfolio revamp, man will square off against machine (indexes) in what is supposed to be one of the most liquid and efficient parts of the capital markets.

The battle begins with the passive funds at an advantage when it comes to costs. The three index funds and their ETF shares charge expense ratios of 0.07%, versus 0.20% for the lowest-minimum investor shares of the actively managed Treasury funds (for investors with more than $50,000, the Admiral share class of the actively managed funds has a 0.10% expense ratio, significantly closing the gap on the index funds' cost edge). We'll be watching to see if Vanguard's active managers can overcome the expense headwind and remain competitive with the index funds.

One area where active management may be a value-add: Risk control. While Treasurys are regarded as the safest asset class of the bond market when it comes to the risk of default (conventional wisdom is that it is extremely unlikely the U.S. government will default on its debt), they do carry the greatest interest-rate risk, typically seeing larger price swings in reaction to rate moves than investment-grade corporate bond funds with comparable maturity. This interest-rate risk is one that many investors overlook and that experienced managers may be able to mitigate better than funds designed to replicate an index as closely as possible.

**Vanguard Plans Corporate Bond ETF-of-ETFs**
Earlier this week, Vanguard filed paperwork with the SEC for the planned launch of a new corporate bond exchange-traded fund (ETF) in 2017's fourth quarter, more than 30 years after it debuted the first U.S. bond index fund. The proposed offering seeks to be the lowest-cost such product available to investors, with an estimated expense ratio of 0.07%, according to its preliminary prospectus.

The future product, Vanguard Total Corporate Bond ETF, intends to replicate the Bloomberg Barclays U.S. Corporate Bond Index upon its scheduled launch in November 2017.

Total Corporate Bond ETF will be available in a single ETF share class and invest in Vanguard's existing three corporate bond ETFs: Short-Term Corporate Bond ETF, Intermediate-Term Corporate Bond ETF and Long-Term Corporate Bond ETF. Essentially, it's a fund-of-funds, enabling the new ETF to trade at tighter spreads for less cost than investing directly in the separate components.

The lower cost is the crux of the matter here. The three funds that will make up Total Corporate Bond ETF collectively hold $39 billion in assets, providing the new offering immediately upon its launch the scale to mimic its benchmark more closely than a new fund starting from scratch. The component funds each carry a 0.07% expense ratio, meaning

Total Corporate Bond ETF will cost less than half of its closest competitor, iShares iBoxx Investment Grade Corporate Bond ETF, which charges a 0.15% expense ratio.

As we've discussed in our decade-long coverage of mutual fund giants' fee wars to bring costs closer to zero, the actual amount of money fund providers help investors save is less significant than the ability to claim the cheapest product on the market (from the fund companies' perspective, at least). Vanguard Total Corporate Bond ETF will cost investors $7 for every $10,000 invested, compared to the $15 cost on the same amount in the iShares product. While this is a small absolute difference for investors, all else being equal, it makes the cheaper fund far more attractive.