Vanguard

September 2024

Portfolio perspectives

Each month, you'll receive the latest insights from our Portfolio Solutions experts to help you address evolving issues that may affect your clients' portfolios.

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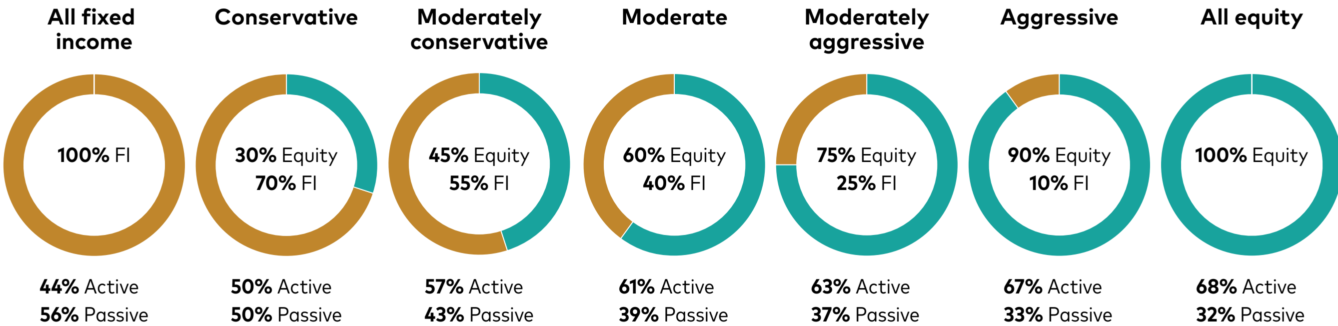
How Vanguard's model methodology can help you decide on your active/passive allocation

The Portfolio Analytics & Consulting team helps advisors refine their existing discretionary models or develop new ones. One of the earliest portfolio construction decisions for advisors is how to use active and index funds. We often see models ranging from all active to all index, but quite often, advisors are looking for guidance on how to combine active and index. One starting point is to reference the methodology of Vanguard's model franchise.

At Vanguard, we believe in both low-cost active and index investing. We design models that show how we think about combining the two. We also consider both the client's desire to try to outperform by taking on active risk and the fact that active management in all asset classes is a zero-sum game.

Of course, with active management, you can either outperform or underperform a benchmark. Historically, 95% of successful active managers who outperformed their benchmark over 10 years underperformed at least three years out of 10 (source: Tidmore, Chris and Andrew Hon. 2019. *Patience with active performance cyclicality: It's harder than you think*, Journal of Investing). This opens a behavioral issue of whether the client will be able to stomach underperforming active funds and hold onto them with the guidance of their financial advisor. Because even successful active managers do fall behind for periods of time, our models have been scaled to include more active management as they become more aggressive (that is, hold more equity allocation) and more indexes for more conservative models, where there's less tolerance for underperformance and greater desire for capital preservation (see Figure 1).

FIGURE 1: Vanguard's active/passive weightings by asset allocation



Source: *Vanguard Active-Passive Model Series* client brochure.

Note: The figure illustrates, from left to right, how Vanguard scales active exposure as the model becomes more aggressive. For example, a 30% equity/70% fixed income model is 50/50 active/index, whereas a 90% equity/10% fixed income model is 67% active and 33% index. The higher equity allocation models include greater active risk because those clients should have a longer time horizon and would be better able to tolerate periods of active underperformance.

In active management, performance is a zero-sum game. For every outperforming dollar, there's an underperforming dollar. Vanguard's research, *Considerations for active fund investing*, shows that a small subset of highly successful active funds with reasonable costs have continued and, we believe, should continue to be on the winning side of the zero-sum game. We review active managers using a robust framework that considers the firm, people, philosophy, and process. This evaluation requires constant oversight, and the conviction to stick with a manager through thick and thin.

Given that the path to investment success isn't a straight and smooth road, we offer portfolios that include

both active and index products to dampen the active risk. We also continue to hear that advisors are reluctant to be active in every single part of the market. That's because some believe that certain asset classes have greater inefficiency (such as emerging market equities or fixed income). It's true that some asset classes may have informational inefficiencies, but those same markets still operate in a zero-sum game with materially higher costs and frictions. In fact, the case for indexing holds as strong in less efficient markets as it does in efficient markets. To that end, Vanguard models still use indexes as a complement to active to lower overall active risk in all asset classes, whether that asset class has greater market inefficiencies or not.

Next steps to consider: Check out Vanguard models

Our model franchise serves as a reference point on how we scale active versus index proportions across stock and bond allocations. To learn more, reach out to your Vanguard representative.

Taking a client-centric approach to duration

Fixed income continues to be a dominant theme in our discussions with advisors, with a specific focus on duration positioning and the interest rate outlook. All of this noise can make fixed income allocation decisions challenging for you and your clients.

Higher relative yields and safety have led money market funds to be a dominant theme over the past couple of years, including bringing in over $400 billion over the last 12 months, yet a closer look at cash flows shows that advisors are beginning to invest further out on the curve on duration. While money markets have brought in more than $60 billion year-to-date, taxable and muni bond funds have taken in more than $290 billion this year. The majority of the flows have gone out on the curve in duration, including core (+$69 billion), core plus (+$30 billion), multi-sector bond (+$25 billion), and intermediate/long Treasury products (+$32 billion) (source for cash-flow data: Morningstar, Inc., as of June 30, 2024).

"What should my duration be?" and "Should I try to get back to the benchmark?" are questions we have been hearing from advisors recently given current market expectations for rate cuts. The truth is, predicting interest rates and duration timing is a very challenging proposition. Within goals-based financial planning, there's no magic duration number, and the duration across your clients' fixed income allocations may vary based on their individual circumstances.

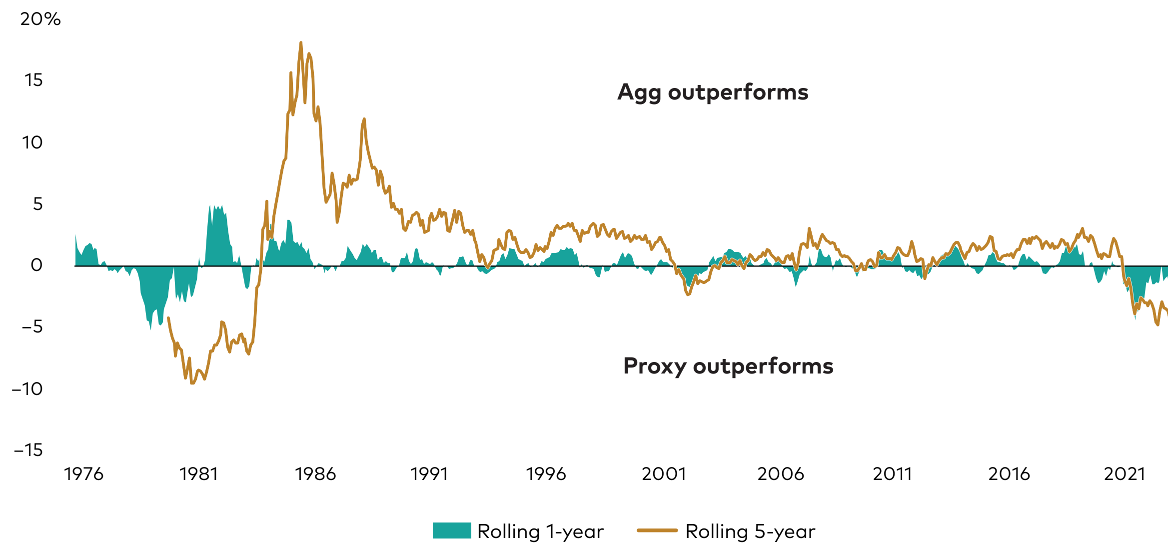
We know that across many client statements, the most commonly used benchmark is the Bloomberg U.S. Aggregate Index ("US Agg"). While that exposure can be a good building block for fixed income portfolios, its duration profile might not make sense for all clients to target, given different investment time horizons. Over the last several years, the duration of the US Agg has fluctuated between 5.5 and 6.5 years, and at the same time, our advisor trend data[1] suggests that advisors have maintained a somewhat stable but shorter duration profile relative to the index. As a result, the active risk, particularly from duration, has varied on a year-by-year basis.

In addition, running a consistent short-duration position against the US Agg is not without risk when it comes to long-term client outcomes, as a short-duration positioning can lead to prolonged and significant periods of underperformance. Figure 2 captures the performance differentials between the US Agg and a proxy portfolio that approximates the duration exposures we see in our advisor trends data. The proxy portfolio, with a duration in the mid four-year range, has underperformed the US Agg more than 60% of the rolling one-year windows and 80% of the rolling five-year windows since the mid-1970s.

1 The duration analysis is based on actual advisors' taxable fixed income portfolios that we have reviewed. It does not include individual bonds and money market funds.

FIGURE 2: Straying from the Agg may lead to periods of underperformance

Rolling cumulative return differential between the Bloomberg U.S. Aggregate Index and proxy portfolio



Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Source: Vanguard, data as of June 30, 2024.

Notes: The proxy portfolio is designed to represent advisor trends duration positioning in taxable bonds. The portfolio is comprised of 50% Bloomberg 1–5 Government/Credit Index and 50% Bloomberg 5–10 Year Government/Credit Index. Rolling returns represent the difference between the annualized performance of the Bloomberg U.S. Aggregate Bond Index and the proxy portfolio.

Next steps to consider: Review your duration options

We believe it's important to understand the sources of active risk within clients' portfolios and advocate for aligning the benchmark used in client statements with the long-term policy portfolio you are implementing. If you have a strategic, structural short-duration strategy, matching the client statement benchmark to the strategy being implemented will avoid unnecessary noise from perceived underperformance. However, if your short-duration position was temporary given the market returns of bonds, and you're interested in moving back to neutral, we have a product line-up that spans active and passive, taxable and tax-free. These options can help you align your clients' portfolios to their long-term investment goals and benchmarks. For more guidance on your particular situation, please consider meeting with the Vanguard Portfolio Solutions team. In the meantime, here are some possible duration options:

- Short duration: VUSB (active), VGSH, BSV, and VCSH.
- Intermediate duration: VCOBX (active), VCRB (active), BND, BNDX, and BIV.
- Long duration: VGLT, BLV, and long-term munis.

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In addition, our on-demand Portfolio Analytics tool allows you to evaluate your clients' portfolios from a variety of angles, confirming your current portfolio construction approach and/or identifying opportunities for improvement.

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