MUTUAL FUND Investor Guide

THE Investor Guide TO VANGUARD FUNDS

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Matthew Sauer is the Founder and Chief Investment Officer of the Mutual Fund Investor Guide family of newsletters. Each month he analyzes and provides buy, sell and hold recommendations for hundreds of mutual funds and ETFs in the Investor Guide to Fidelity Funds, Investor Guide to Vanguard Funds, as well as the ETF Investor Guide.

Prior to founding the Mutual Fund Investor Guide, Matt was the President and Chief Investment Officer of the Fidelity Independent Adviser, ETF Report, and Sector Momentum Tracker.

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SPECIAL REPORT:
The Best Vanguard Fund to Buy Before 2015
VANGUARD DIVIDEND APPRECIATION (VDAIX)

One of the best dividend funds is a Vanguard offering: Vanguard Dividend Appreciation (VDAIX). We selected this fund as the Best ETF in 2014, which trades under the symbol VIG, but it is a solid choice for 2015 as well. This fund delivers solid gains, but it really shines at the tail end of bull markets, outperforming its competition during a bear market and making it a superior fund for investors that buy and hold through entire market cycles. Since the bull market has been going on for more than 5 years, we are probably closer to the next bear market. This makes VDAIX a good choice for investors over the years ahead.

FUND CHARACTERISTICS

Vanguard Dividend Appreciation (VDAIX) tracks the Nasdaq US Dividend Achievers Select Index. The index tracks dividend paying companies and uses several criteria to select holdings. The first is that the firm must have paid dividends for 10 consecutive years and that those dividends must have increased each year. The index also uses criteria to screen for higher quality dividend payers.

The index is a modified market capitalization weighted index, meaning no single holding can exceed 4 percent of the fund's total assets at the time of rebalancing. The fund is rebalanced once a year in February, which is implemented in March. REITs and limited partnerships are not included in the index.

VDAIX falls in the Large Cap Core section of the Morningstar Stylebox, right on the edge of the Giant Cap Core section.

HOLDINGS

VDAIX has 163 holding and at the end of October 2014, with 36.0 percent of assets in the top ten positions. The top holding was Johnson & Johnson (JNJ), with 4.4 percent of assets. A who's who of blue chip giants follows, including Coca-Cola (KO), Exxon Mobil (XOM), Qualcomm (QCOM), Pepsi (PEP), Wal-Mart (WMT) and International Business Machines (IBM). The fund isn't completely loaded with giant cap stocks, but these funds do make up a large portion of assets due to their larger weight in the portfolio. The heavy weighting in large caps is why VDAIX tracks very closely with the Vanguard Total Stock Market Index (VTSMX).

Sector exposure is where the fund deviates from VTSMX. The largest sectors in VTSMX are financials, followed by technology. VDAIX has sector exposure that more closely resembles dividend funds, with a twist. Industrials has the largest sector exposure, at 23.5 percent of assets. This is followed by two old staples of most dividend funds: consumer goods at 19.2 percent of assets and consumer services at 15.2 percent of assets. Healthcare is 10.6 percent of assets and technology is 9.7 percent of assets. Telecommunications and utilities, often found in dividend funds, are conspicuously underweight. Utilities and telecommunications comprise 1 and 0.10 percent of assets, respectively.

VDAIX also has relatively low exposure to the financial sector at 7.10 percent of assets, due to the criteria that a stock pay 10 consecutive years of rising dividends. In 2008 and 2009, many financial firms cut or halted their dividends, resulting in many of these firms losing their eligibility.

We like the industrial exposure here. Manufacturing is returning to the U.S. and even Chinese manufacturers are opening factories here. Although energy prices have tumbled in recent months, making shipments of goods from Asia cheaper than before, the drop in energy prices hasn't yet hurt energy production in the United

States, which contributes to industrial demand. Additionally, energy within the U.S. is still cheaper than abroad thanks to booming natural gas production. Natural gas is priced locally and many chemical manufacturers are building facilities in the U.S. to take advantage. This will also create demand for industrial supplies for years to come.

HISTORICAL PERFORMANCE

VDAIX has delivered almost the same return as VTSMX since inception in 2006. VDAIX has actually underperformed over most of this period, but it outperformed to such a large degree in 2008 that the total performance over this period has been nearly equal. In 2008, VTSMX lost 37 percent, but VDAIX fell only 26.6 percent because investors hang on to their quality dividend paying stocks. The only other year in which VDAIX beat VTSMX was 2011, when its 6 percent gain beat VTSMX by 5 percent. Nevertheless, in other years, VDAIX was strongly competitive with VTSMX.

This history shows that VDAIX isn't the best choice for bottom fishers during a market panic, but it does make VDAIX a very solid choice when we are well into a bull market or for long-term investors who plan on holding through multiple market cycles.

INCOME

For a long-term investor, it is important to think about income in future years. The dividend stream from an investment in VDAIX is poised to grow faster than the dividends paid by VTSMX.

From inception in 2006 through November 25, 2014, VDAIX returned 62.6 percent on price alone. An investment of $10,000 would have grown to $16,259 excluding dividends. An investment in VTSMX over the same period would have grown 63.2 percent, or $16,318.

Including reinvested dividends, VDAIX's return grows to 91.5 percent, or $19,154, versus VTSMX's 91.3 percent return, or $19,133. VDAIX went from slight under performance to slight outperformance.

The difference in performance comes from the fact that VDAIX's dividends grew more quickly than VTSMX's and the longer the holding period, the larger VDAIX's outperformance will grow as compounding dividends do their work. VDAIX yielded less than VTSMX back in 2006, but through faster growth became the higher yielding fund.

Assume an investor put $10,000 into VDAIX and $10,000 in VTSMX at the end of 2006. In calendar year 2007, the investment in VDAIX would have collected $157 in dividends, versus $177 for VTSMX, ignoring dividend reinvestment. As of November 2014, had no dividends been reinvested the entire time, the VDAIX investor would have collected $269 in dividends in the past year, versus $240 for the investor in VTSMX.

In terms of the dividend growth rate, VDAIX paid 83 percent more in dividends over the past year than it did in its first year of existence. Over the same period, VTSMX only grew its dividends by 48.0 percent.

Vanguard reported a 30-day SEC yield of 1.91 percent for VDAIX on November 25. VTSMX had a yield of 1.70 percent. For an investor in search of dividend payments, there's no need to forego any income in order to obtain faster dividend growth as was required in 2006 when choosing VDAIX over VTSMX.

INCOME SUSTAINABILITY

While it is positive that VDAIX rapidly grew its dividends over the past 7 years, is it likely to continue growing its dividends at a solid pace? Evidence suggests yes. Earlier this year, *Barron's* published work by Credit Suisse comparing various dividend ETFs (VIG being the ETF version of VDAIX) by their ability to pay dividends, based on the average financial metrics of the underlying companies.

The first metric is familiar to dividend investors: the payout ratio. By taking the dividends paid and dividing it by net income, you are able to determine the payout ratio, a very rough estimate of how much room a firm has to raise its dividend. Sometimes this is referred to as dividend safety: a firm with a very low payout ratio can continue paying dividends even if income drops substantially, while a firm with a very high payout ratio may be forced to cut its dividend if income drops. Among dividend funds surveyed by Credit Suisse, VDAIX had the lowest payout ratio, which is excellent news for investors.

The second data point used by Credit Suisse research is the fixed charge coverage ratio. This ratio looks at the dividend from the other side: could rising costs make it harder to pay the dividend? The costs include interest and capital expenditure, and these are then compared to cash flow. Cash flow is used because net income is an accounting profit, but in order to pay dividends, a firm needs cash. For example, a firm that spends a lot of money investing in new plant and equipment may report very high profits, but also have little cash leftover to pay a dividend. On the fixed charge coverage ratio, VDAIX also scores among the best.

In sum, this research shows that the stocks in VDAIX have a very strong ability to raise dividends. They have room to increase the dividend and other costs are manageable. These are exactly the types of companies we want to own when we're looking for dividend growth and VDAIX delivers them in a single fund.

PURCHASING & FEES

VDAIX is a very inexpensive fund, charging only 0.20 percent in fees. The ETF shares, trading under the symbol VIG, are even cheaper. They only charge 0.10 percent in fees.

Vanguard clients can trade VDAIX and VIG commission free and while customers of TD Ameritrade can trade VIG commission free.

RISK

VDAIX is slightly less volatile than the S&P 500 Index and VTSMX.

VDAIX has a 3-year beta of 0.90 versus the S&P 500 Index. This compares to VTSMX's beta of 1.03.

VDAIX has a standard deviation of 8.78. This compares to the 9.08 standard deviation of the S&P 500 Index and VTSMX's standard deviation of 9.46.

The main risks faced by VDAIX are rising interest rates and investor preferences.

Rising interest rates weighed on dividend funds in 2013 and rising rates could weigh again in the future. While VDAIX has a lower yield than other dividend funds and the companies held by VDAIX face less risk from rising interest rates, investors may lump VDAIX together with other dividend ETFs.

Somewhat related to rising interest rates is the recent investor preference for dividend paying funds. To the extend dividend paying funds have attracted more short-term oriented investor money looking for price appreciation in a low rate environment. Here again, VDAIX is less prone to this than other dividend ETFs that target higher yielding shares, but it could be weighed down by association.

Finally, as mentioned in the performance section, VDAIX has trailed VTSMX in the years following the 2008 market crash. Long-term investors should not worry about this year to year performance and instead measure the fund over a full market cycle, from bull to bear.

RECOMMENDATION

VDAIX offers investors a way to profit from the bull market, while leaving them positioned less aggressively than the broader market and collecting a stream of growing dividends. There are several ways to use it in a portfolio.

VDAIX can serve as core holding, completely replacing a fund such as VTSMX. This will reduce volatility, boost long-term income and should increase performance over time. Since VDAIX falls in the large cap category, some investors may also look at substituting VDAIX in place of another large cap holding.

Investors concerned about the length of the bull market or rising interest rates can reduce exposure to higher yielding dividend funds and replace them with VDAIX. This will reduce current income, which may be an unsuitable choice for retired investors, but is certainly a good choice for investors with a longer time horizon and reinvest dividends.

Runner Up

Vanguard Dividend Growth (VDIGX) takes a similar approach to income growth, hunting for companies with rising dividends and strong financials. VDIGX's portfolio is quite different in terms of sector exposure and some investors might want to consider it if they lack exposure to sectors such as healthcare. The main reason to prefer VDAIX over VDIGX at this time is due to the companies in VDAIX having stronger balance sheets. If the Federal Reserve begins raising interest rates in 2015, companies in VDAIX will face less of an impact. Companies with large debts will face higher debt servicing costs, but VDAIX's methodology screens out firms with high debt levels. Also, VDIGX outperforms during bull markets and VDAIX outperforms during flat or falling markets. The difference in performance isn't great, but it has been consistently this way since the inception of VDAIX. Even though the bull market in stocks is still intact and that will work in VDIGX's favor heading into 2015, next year will also mark the seventh year of the bull market. Both funds are solid choices, but unless 2015 is a barn burner for stocks, it won't cost investors much in the way of performance to hold the more conservative fund.

VDAIX is also a low cost passive index, whereas VDIGX is actively managed and has higher fees. At 0.31 percent, VDIGX is extremely low cost for an actively managed fund, but it is more expensive than VDAIX's 0.20 percent. If investors buy the Admiral shares (VDADX) or the ETF class (VIG) shares of Dividend Appreciation, the gap is even wider.

If you have any questions or comments about these funds, we would be delighted to speak with you. Please call us at (888) 252-5372, Monday through Friday 8:30am to 5:30pm, eastern time. You can also email me at Matt@mutualfundinvestorguide.com.

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VANGUARD DIVIDENT APPRECIATION INDEX FUND INVESTOR SHARES (VDAIX)

Top 10 Holdiings	% of Assets
Johnson & Johnson	4.3
Coca-Cola Co	4.3
Wal-Mart Stores Inc.	4.3
PepsiCo Inc.	4.3
QUALCOMM Inc.	3.5
Exxon Mobil Corp.	3.4
International Business Machines Corp.	3.2
CVS Health Corp.	3
3M Co.	3
United Technologies Corp	2.8

FUND CHARACTERISTICS	
YTD Return	9.77%
1 Year Average Annual Return	11.07%
3 Year Average Annual Return	15.87%
5 Year Average Annual Return	13.23%
10 Year Average Annual Return	N/A
Since Inception Average Annual Return	7.30%
Morningstar Category	Large Blend
SEC Yield	1.86%
Turnover	3.00%
NAV	$31.65
NET Assets	$25.4 Billion
Morningstar Overall Rating	3 Star
Morningstar Risk Rating	Low
Investment Minimum	$3,000
Front / Deffered Load	None
Short - Term Redemption Period / Fee	None
Expense Ratio	0.20%
Holdings	163

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