



## Fund In Focus: Vanguard Inflation-Protected Securities Fund

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This month's *Fund in Focus* takes a look at the Vanguard Inflation-Protected Securities fund. While Vanguard is known for its low cost index funds, this strategy is one of their actively managed fixed income funds. With more than \$26 billion in total assets as of February 2017, this fund is by far the largest actively managed strategy in Morningstar's inflation-protected bond category.

This relatively new asset class provides investors with a cost-effective solution to protect against the eroding impact of inflation. Treasury Inflation-Protected Securities (TIPS) are considered an effective hedge against inflation, as the bond's principal value (and coupon) will increase with inflation, or conversely, decrease with deflation.

This unique asset class, along with the powerful diversification benefits it provides relative to equities, plays an important role in the asset allocation decisions for participants saving for retirement. Most defined contribution (DC) plans offer this asset class as a stand-alone option within an investment array and also through a target date fund (TDF) that increases its allocation to TIPS as participants move closer to retirement.

### PROCESS

Vanguard's Inflation-Protected Securities fund follows a straightforward approach, predominately investing in TIPS. The manager seeks to generate returns above the index by making small shifts along the maturity spectrum, and exploiting price inefficiencies and changes in inflation expectations when opportunities arise.

While the fund's prospectus grants the manager the flexibility to invest up to 20% in nominal Treasuries and investment-grade corporate bonds, this option is rarely used. The manager

prefers a more style-pure, risk-controlled approach that aims to provide returns consistent with the fund's benchmark, the Bloomberg Barclays US Treasury TIPS index.

Unlike some of its inflation-focused peers, the manager does not invest in the more credit-sensitive sectors of the bond market, such as mortgages, high-yield corporate, emerging markets or unhedged non-U.S. securities, to add incremental value relative to its benchmark. This difference has sometimes restrained the fund's performance in credit-fueled rallies, but over time, has not been a significant disadvantage.

The fund's low expense ratio is a key competitive advantage. With an expense ratio of only 6 to 17 basis points (depending on the share class offering), other inflation-focused active managers have found it challenging to remain as competitive, given this strategy's cost advantage. According to Morningstar, the average expense ratio in the Inflation-Protected Bond category is 72 basis points. This higher expense ratio creates a significantly higher hurdle for the other active managers to overcome just to keep pace relative to their benchmarks or Vanguard's inflation-protected strategy.

### PERFORMANCE HIGHLIGHTS

The combination of low fees and the manager's plain vanilla investment approach has been key to the fund's successful long-term track record. Vanguard's low fee structure means that the manager does not have to take additional risks in the portfolio in order to generate returns that are greater than their investment management fee. This key differentiator has worked to Vanguard's advantage over time.

The fund's straightforward investment approach has delivered consistency relative to the fund's benchmark. The manager's conservative bias can sometimes cause the fund to lag its more aggressive peers when the credit-sensitive sectors of the market outperform. However, these instances tend to be short-lived and often mitigated by the fund's cost advantage relative to its peers.

One caveat investors should be aware of when investing in traditional TIPS funds is their interest rate risk. Like all other bonds, TIPS are not immune to the pressures of rising rates. A traditional TIPS fund has a duration of nearly 8 years, significantly longer than the average intermediate bond fund, which has a duration of roughly 5 ½ years. This means that if rates rise by one percentage point, the typical TIPS fund could lose as much as 8% of its value. Although, if inflation was rising at the same time as interest rates, the inflation adjustment to the principal (and coupon) would partially offset the losses generated from the bond's price return.

For investors concerned about interest rate risk, Vanguard offers an inflation-focused index strategy managed to a shorter-duration benchmark. The Vanguard Short-Term Inflation-Protected Index fund minimizes the volatility that comes from yields going up or down, while still providing the same degree of protection against inflation.

### FUND MANAGER

The Vanguard Inflation-Protected Securities fund is managed by Gemma Wright-Casparius. Ms. Wright-Casparius was hired to replace the fund's long-time manager, Ken Volpert, in 2011. She became the sole manager on the strategy in 2012, when co-manager John Hollyer stepped away from his portfolio management duties to pursue other opportunities within Vanguard.

Ms. Wright-Casparius brings over 30 years of experience to Vanguard's fixed income team and significant expertise in the inflation-linked bond market. While this is her first time managing a fund with a public track record, we have not been overly concerned, given her extensive

background and previous roles as Senior Leader of U.S. Rate Strategy, Fixed Income Portfolio Manager and Deputy Head of Global Macro Research and Strategy for Singapore Sovereign Wealth Fund and Barclays Capital.

We have also been pleased to see that Ms. Wright-Casparius has continued to manage Vanguard's Inflation-Protected Securities fund, keeping with the fund's straightforward mandate. The fund has delivered consistent returns relative to its benchmark under her leadership and continues to be a formidable competitor in Morningstar's Inflation Protected bond category.

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For more information on our services, please contact **Mike Volo**, Senior Partner, at **781.997.1426** or **[mvolo@cammackretirement.com](mailto:mvolo@cammackretirement.com)**.

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