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### Comment on VIPERs Expense Ratio Cut

Ed Hynes, CFA

We applaud the growing price war between Vanguard and Fidelity. Not only will investors save money, which directly adds to returns, but publicity over the rate decreases will raise investor awareness of costs in general and the benefits of indexing.

The expense ratio drop of Vanguard's Total Stock Market VIPER to 0.07% is especially intriguing since we like total market indexes. The two main reasons are:

1. Owning the "whole" market removes the need for investors to determine, implement or track investments based on capitalization. To us, managing allocations between large, medium and small cap stocks is active management, and most investors are not very good at this.
2. By owning one fund investors avoid some of the transaction costs when companies move between categories i.e. from small cap to medium cap.

When looking at the various ETFs that offer total market indexes, there are four principal players:

<u>Exchange-Traded Fund</u>	<u>Expense Ratio</u>
iShares Dow Jones US Total Market	20
iShares Russell 3000	20
iShares S&P 1500	20
Vanguard Total Stock Market VIPERs	7

Vanguard is a great company with low costs, but we do not recommend their VIPERs, which are not true ETFs. Most ETFs use an in-kind creation and redemption process to move assets in and out of the fund. Traditional funds accept and pay cash. The in-kind process has a number of benefits for fund holders including the assurances of:

- No capital gains resulting from investors moving in and out of the fund
- No transaction costs borne by the fund due to investor trading

VIPERs are very different. Rather than having a pure ETF fund, Vanguard's VIPERs are just an additional class of shares attached to a traditional mutual fund. Unfortunately, this has muddied the water and diluted the term Exchange-Traded Fund.

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For instance, when an investor buys a VIPER it is created by the in-kind process. But other investors in the same fund invest cash and therefore the fund opens itself up to capital gains and transaction costs from trading which impacts all share classes. At the end of January, the Total Market Fund VIPER share class was only 7.5% of the Total Market Fund. This is just a traditional 1940 Act fund with a trading sidecar.

Vanguard's response to this criticism is that they are very good at controlling capital gains and transaction costs and this should not be a worry. They are good, but when Farm Creek recommends investments investors hold an ETF for the next 20-30 years, it would be irresponsible to take a chance on VIPERs when "in-kind" ETFs are available (unless their cost advantage became overwhelming).

We also have a beef with the American Stock Exchange in this regard since we think the term Exchange-Traded Fund should have a distinct meaning including in-kind creation and redemption. Otherwise investors will be confused and we suspect they already are. Do VIPER investors know they are not getting a "real" ETF product? Both the Amex and Vanguard should be ashamed of themselves for misleading investors.

Finally back to the other funds. At the end of the day, we like the S&P 1500. The Russell is a problem due to massive rebalancing every June. The Dow is good, but we lean toward the S&P based on its selection process. Over years of watching the index management, we think it is good to have a judgment component (S&P) rather than being strictly rules based (Dow).

### Disclaimers

Before investing in any fund investors should carefully consider the investment objectives, risks, and charges and expenses of any fund. This information is contained in the prospectus which should be read carefully before investing. Prospectuses are available. For iShares products contact (800) 474-2737 or [www.iShares.com](http://www.iShares.com), for Vanguard go to [www.vanguard.com](http://www.vanguard.com). Also, remember past performance is no indication of future performance and that there are risks to investing including the loss of principal.