We picked Vanguard Dividend Appreciation as the best ETF to buy in 2014 and the Best Vanguard Fund to Buy Before 2015, and this fund remains one of our favorites, which is why we’ve selected it as the Best Vanguard ETF for 2015. This fund delivers solid gains in bull markets, but it really shines at the tail end of bull markets, outperforming its competition during a bear market. This makes it a superior fund for investors that buy and hold through entire market cycles. Since the bull market has been going on for more nearly 6 years now, we are probably closer to the next bear market or than we are to the start of the bull market in March 2009. VIG is a good choice for investors over the the years ahead.

FUND CHARACTERISTICS
Vanguard Dividend Appreciation (VIG) 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 - no single holding can exceed 4 percent of the fund’s total assets at the time of rebalancing. The fund is rebalanced one a year in February, taking effect in March. REITs and limited partnerships are not included in the index.

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

HOLDINGS
VIG has 163 holdings. At the end of 2014, 35.7 percent of assets were in those positions. The top holding is Wal-Mart Stores (WMT), with 4.2 percent of assets. A who’s who of blue chip giants follows, including Johnson & Johnson (JNJ), Coca-Cola (KO), Exxon Mobil (XOM), Qualcomm (QCOM), Pepsi (PEP) 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 VIG tracks very closely with the SPDR S&P 500 (SPY).

Sector exposure is where the fund deviates from SPY. The largest sectors in SPY are technology, followed by financials. VIG has sector exposure that more closely resembles dividend funds, with a twist. Industrials has the largest sector exposure, with 23.4 percent of assets. This is followed by an old staple of the dividend fund: consumer goods at 19.0 percent of assets and consumer services at 16.8 percent of assets. Healthcare is 10.5 percent of assets and technology is 9.3 percent of assets. Telecom and utilities, often found in dividend funds, are conspicuously underweight: utilities at 0.90 percent of assets and telecommunications at 0.10 percent of assets.

VIG also has relatively low exposure to the financial sector at 7.0 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 still like the industrial exposure. Even though the dollar has strengthened and oil prices have decline, the U.S. is also benefiting from the fact that wages increased faster overseas and the U.S. economy is growing more quickly. Companies are still locating production closer to the point
of consumption and that’s good news for the growing U.S. economy. Low energy prices are likely to weight on the fund to some degree. Top ten holding Exxon (XOM), for instance, could slide if oil prices do not stop declining. More broadly though, booming natural gas production will continue to attract chemical and fertilizer producers from around the globe. Natural gas is priced locally and many chemical manufacturers are building facilities in the U.S. to take advantage. This will create demand for industrial supplies for years to come.

**HISTORICAL PERFORMANCE**

VIG has delivered almost the same return as SPY since inception in 2006. VIG 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, SPY lost 37 percent, but VIG fell only 26.6 percent. Investors sell their quality dividend paying stocks last and that was good news for investors.

This history shows that VIG isn’t the best choice for bottom fishers during a market panic, but it does make VIG a very solid choice for investors already well into a bull market, as well as for long-term investors who plan on holding through multiple market cycles, particularly those who want to see rising dividends.

From the end of 2006 through December 31, 2014, VIG returned 50.9 percent on price alone. An investment of $10,000 would have grown to $15,086 excluding dividends. An investment in SPY over the same period would have grown 45.1 percent, or $14,513. VIG beat SPY by 5.7 percent.

Including reinvested dividends, VIG’s return grows to 77.6 percent, or $17,763, versus SPY’s 71.4 percent return, or $17,141. VIG beat SPY by 6.2 percent.

The difference in performance comes from the fact that VIG’s dividends grew more quickly than SPY’s and the longer the holding period, the larger VIG’s outperformance will grow as compounding dividends do their work.

**INCOME**

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

In the example above, we looked at how dividends helped VIG increase its performance lead on SPY. However, VIG actually yielded less than SPY at the beginning of the time period. This makes it a perfect example of why investors want to own stocks that pay rising dividends.

Take the SPDR S&P 500 (SPY) as a comparison again. Let’s assume an investor put $10,000 into VIG and $10,000 in SPY on the last day of trading in 2006. In the year 2007, the investment in VIG would have collected $162 in dividends, versus $191 for SPY. For this investor, the yield in the first year was 1.62 percent for VIG and 1.91 percent for SPY.

Assuming no dividends were reinvested, in 2014 the investor would have received $295 in dividends from the VIG investment and $271 dollars from the SPY holding. The holding in SPY saw its yield on the original investment of $10,000 grow from 1.91 percent to 2.71 percent, an increase of 80 basis points. The holding in VIG saw its yield on investment rise from 1.62 percent to 2.94 percent, an increase of 132 basis points.

In terms of the dividend growth rate, VIG paid 82 percent more in dividends in 2014 than it did in 2007. SPY paid 42 percent more in dividends than it did in 2007.

Vanguard’s website reported a 30-day SEC yield of 2.00 percent for VIG on January 29, while SPDR’s website reported a 1.90 percent 30-day SEC yield for SPY. Based on the December 31 price of VIG and SPY, the trailing 12-month dividend (the dividends paid in 2014 divided by the end price) was 1.95 percent for VIG and 1.87 percent for SPY. By either measure, VIG yields more than SPY. Unlike in 2006, an investor buying today won’t even have to forego some income when choosing VIG over SPY.

**INCOME SUSTAINABILITY**

It is one thing for VIG to have rapidly grown its dividends in the past 7 years. Is VIG likely to continue growing its dividends at a solid pace? Evidence suggests yes. Barron’s recently published work by Credit Suisse comparing various dividend ETFs 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. Take the dividends paid and divide it by net income and you have 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, VIG had the lowest (best) payout ratio.

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, VIG also scores among the best.

In sum, this research shows that the stocks in VIG 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 VIG delivers them in a single ETF.

One caveat on income. VIG pays a lower dividend than high yield funds and it would take many years for it to catch up...
to the income produced by a high yield fund. Investors who need high income today cannot get it from VIG, but it may still make sense for an income investor to substitute VIG for a fund with a similar yield, such as SPY, in order to boost the portfolio’s total income over time.

**PURCHASING & FEES**
VIG is a very inexpensive fund; it only charges 0.10 percent in fees. It is heavily traded and can be purchased from any broker.

Vanguard clients can trade VIG commission free, as can customers of TD Ameritrade.

**RISK**
VIG has a beta of 0.92 versus the S&P 500 Index. It also has a lower standard deviation than the S&P 500 Index, which provides less volatility.

The main risks faced by VIG, aside from general stock market risk, are rising interest rates and investor preferences.

Rising interest rates weighed on dividend funds in 2013 and rising rates could send income investors out of stocks and into bonds, while the short-term traders sell to avoid losses. VIG 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, VIG has trailed the S&P 500 in the years following the 2008 market crash. Investors should not worry about year to year performance and instead measure the fund over a full market cycle, from bull to bear and back again.

**RECOMMENDATION**
VIG 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.

Investors can reduce their exposure to a broad market ETF such as the SPDR S&P 500 (SPY) and add VIG in its stead. VIG can serve as core holding as well, completely replacing a fund such as SPY. This will reduce volatility, boost long-term income and should increase performance. Since VIG falls in the large cap category, some investors may also look at substituting VIG 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 ETFs and replace them with VIG. This will reduce current income, which may be an unsuitable choice for retired investors, but is certainly suitable for investors with a longer time horizon and those who reinvest dividends. Currently, Vanguard High Dividend Yield (VYM), iShares Select Dividend (DVY) and iShares Core High Dividend (HDV) all yield around 3 percent, or roughly 50 percent more than VIG.

### Runner-Up

**VANGUARD HIGH DIVIDEND YIELD (VYM)**

VYM is a similarly cheap ETF charging only 0.10 percent in management fees, and it comes with a substantially higher yield of 2.93 percent. It could take nearly a decade, and perhaps more, for VIG’s dividends to reach parity with VYM. For income investors who want higher income today and in the near future, VYM may be a better choice.

VYM has a balanced portfolio, with 13.6 percent in consumer staples, 12.7 percent in financials, 11.9 percent in industrials and 11.2 percent in healthcare. Technology is surprisingly the largest sector, at 18.10 percent. Microsoft (MSFT) and Apple (AAPL) are top ten holdings. Also, utilities are much higher in VYM at 8.1 percent of assets.

VYM’s performance compared to VIG is similar to that of SPY. Where VIG lags slightly during the bull market and then shines in the bear market, VYM has led slightly during the...
ETF INVESTOR GUIDE

Each month we provide buy, hold and sell recommendations for hundreds of ETFs from companies including Fidelity, iShares, SPDR and PowerShares. Additionally, you will have access to our model portfolios, specifically created for conservative, moderate and aggressive investors.

To learn more, call (888) 252-5372.

MEMBERSHIP OPTIONS:

1-Year Via 1st Class Mail & Online Access: $99.95................... LIMITED TIME $49.95
2-Years Via 1st Class Mail & Online Access: $149.95................... LIMITED TIME $74.95

INVESTOR GUIDE TO FIDELITY FUNDS

Each month we provide buy, hold and sell recommendations for hundreds of mutual funds from Fidelity and dozens of other companies. Additionally, you will also have access to our model portfolios, specifically created for conservative, moderate and aggressive investors.

To Become a Member simply call me at (888) 252-5372.

DISCLOSURE: Mutual Fund Investor Guide, LLC (MFIG) is an independent company unaffiliated with any of the fund companies discussed in this newsletter, including Fidelity Investments. These results include the reinvestment of all dividends and capital gains. Model trading does not involve financial risk; model trading cannot completely duplicate the financial risk associated with actual trading. MFIG is not an investment advisor and does not provide specific investment advice. This newsletter has been prepared solely for informational purposes. PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS. All investments involve risk including total loss of principal.