

1. Background:

In the universe of mutual funds, hybrid is the technical term used to describe those funds with portfolios that are comprised of a mix of stocks and bonds. In general, fund company literature employs such terms as balanced, asset-allocation, and all-weather to identify these funds in their offerings. All these terms mean the same thing. They are funds that tend to perform reasonably well during both favorable and unfavorable economic and market conditions. Hereafter, to simplify the terminology issue in this discussion, I'll use the balanced label, which is the most widely used moniker by fund companies.

The actual stock and bond components in a balanced fund can vary within a range of percentages in order to give the fund managers some investment flexibility and/or define their interpretation of "balanced." In most cases, the two favored positions fall into two categories – moderate asset allocation and conservative asset allocation. Roughly speaking, as a percentage of a fund's total portfolio, the former maintain positions of approximately two-thirds stocks and one-third bonds; the latter reverse the percentage mix with one-third stocks and two-thirds bonds.

I'll pause here to remind readers that stock investments, historically, have had an average annual return of approximately 10%, while bond returns fall between 4% to 6%. Conservative allocation funds are for investors who are satisfied with a relatively lower return in exchange for more safety. On the other hand, the moderate allocation funds incur some risk but reward investors with a higher return.

Using a football metaphor, conservative allocation funds are emphasizing defense over offense, while moderate allocation funds like more offense than defense. Don't forget, however, that both allocations have stock and bond exposure in their portfolios; they simply differ on their apportionment. Depending on their risk tolerance and investment objectives, investors can use these funds to "balance" their risk-return positions in accordance with their individual circumstances.

Balanced funds are not expected to produce spectacular returns; nor are they going to suffer dramatic losses. The stock-bond mix in these funds is a structural feature that cushions your investment in down markets and yet still provides reasonable growth in up markets. Used wisely, balanced funds represent good choices as core investments, no matter which allocation strategy you choose.

2. Getting the Best of Both Worlds

Let's take another look at my sports metaphor. Obviously, in the game of football, a coach is relying on his defensive squad to stop the opposition from scoring and his offensive squad to put points on the board. Both efforts are important to winning the game. However, there are going to be times when either the defense or the offense is going to play the more critical role in winning a game.

In this regard, I think that investors can learn something from a football coach's playbook. I'm going to suggest that you create a virtual balanced fund by combining two such funds, one with a moderate allocation and one with a conservative allocation. You would match the dollars invested in each fund as closely as possible with the intention of maintaining a stock-bond equilibrium, or reasonably close to that position.

However, when market conditions experience substantive change, you can redirect your reinvestment of fund distributions (dividends, interest, and capital gains) to a more advantageous risk-return position.

For example, Fund M has a typical moderate allocation of 65% stock and 35% bond. Fund C has a typical conservative allocation of 35% stock and 65% bond. In a sustained down market, you would reinvest both funds' distributions in Fund M to take advantage of buying more stocks at lower prices. In an overheated market, you would do the opposite by reinvesting both funds' distributions in Fund C, buying more bonds and avoiding overpriced stocks.

I would recommend the same strategy for regular monthly investors such as those in 401(k) plans. Using moderate and conservative balanced funds from the same fund company makes these adjustments easy and convenient (see below).

My proposed "balanced-combo" fund, with an effective combined 50-50 stock-bond portfolio allocation, may seem a little tame for stock investors who perceive stronger growth prospects in equities. However, in the uncertain years ahead, modest returns accompanied by the relative safety of principal might look like a winning proposition.

In a recent article, "In Defense of the Humble Balanced Portfolio," Morningstar's John Coumarios comes to the same conclusion that "... a roughly even split between stocks and bonds has held up reasonably well over the long and short terms ...". I would also remind readers that the legendary Ben Graham, in his investing classic, *The Intelligent Investor*, strongly suggested that a 50-50 stock-bond mix was a prudent asset allocation for the vast majority of individual investors.

For skeptical readers, it would be in your best interest to reserve judgment on this proposition until you review the information presented later on for the Vanguard "Balanced Combo" fund.

3. Selecting Funds for a Balanced-Combo Fund

My search for moderate and conservative balanced funds that could be utilized to construct a balanced-combo fund started with choosing balanced funds from Morningstar's 500 fund selections. I assumed that it would be easier to operate a balanced-combo fund strategy if both the moderate and conservative balanced funds were sponsored by the same fund company. With these criteria in mind, I found the following combination prospects. The stock/bond percentage allocations (cash not included) are current approximations:

Fidelity Balanced (FBALX)	moderate	59/31
Fidelity Strategic Real Return (FSRRX)	conservative	13/56
Manning & Napier Pro Blend (EXBAX)	moderate	44/47
Manning & Napier Pro Blend Cnsv (EXDAX)	conservative	24/67
T. Rowe Price Balanced (RPBAX)	moderate	65/32
T. Rowe Price Personal Strategy (PRSIX)	conservative	45/40
Vanguard Wellington (VWELX)	moderate	65/33
Vanguard Wellesley Income (VWINX)	conservative	38/59

My standard mutual fund selection screen dictates that a fund have: (1) a high overall Morningstar Stewardship grade (A or B), (2) a Morningstar “Analyst Pick” designation, and (3) a no-load fund status.

Only the Vanguard Wellington and Wellesley funds, as a combination, passed this screen. It should be noted here that the Manning & Napier funds have not yet been rated by Morningstar’s Stewardship grading process, however, their two balanced funds cited above have very strong fundamentals and would otherwise be worthy of consideration.

The next step is to look at the investment qualities of the Vanguard Wellington and Wellesley Income funds as the building blocks for a balanced-combo fund.

4. Investment Profile – Vanguard Wellington Fund (VWELX)

- **FUND TYPE:**

Moderate Allocation Balanced Fund – Roughly two-thirds blue-chip, large-cap value stocks and one-third medium credit-quality investment grade U.S. bonds. The Fund seeks to provide long-term capital appreciation and reasonable current income.

- **FUND COMPANY:**

The Vanguard Group – Founded in 1975 by John Bogle, this fund company manages over \$1 trillion in assets. It is well-known and recognized as one of the most respected mutual fund companies in the investment management business.

- **GENERAL INFORMATION:**

The Fund was created in 1929 and was designed to offer an “all weather” mutual fund, and has performed as such for over 80 years. It has been managed by sub-advisor, Wellington Management Company, since its inception. WMC is among the nation’s oldest and most highly regarded institutional investment managers.

The Fund’s fiscal year runs from December to November. PricewaterhouseCoopers, LLC audits the Fund’s financial statements. The most current audit was for the fiscal year ending November 30, 2009, for which it received a “clean opinion” (no exceptions or qualified remarks).

The fund’s total net assets for its share class, as of December 31, 2009, were \$28.5 billion.

The Fund currently has a higher than average initial minimum investment amount of \$10,000; additional investments can be made at the \$100 level.

The Fund makes quarterly distributions (dividends, interest, and capital gains) on a calendar-year basis – March, June, September, and December.

- **FUND MANAGERS:**

John Keogh and Ed Bousa are responsible for the Fund’s day to day management. Keogh has been with WMC since 1993 and manages the fixed-income component of the Fund’s portfolio, a position he assumed in 2006. Bousa is a veteran of some 30 years of investment management and has advised and managed the Fund’s equity portfolio since 2000. Morningstar describes the fund’s managerial style as following “disciplined strategies.”

Most importantly, the Fund's Statement of Additional Information (SAI) affirms that, as of November 30, 2009, each manager owned shares of the Fund in an amount exceeding \$1 million – a positive indication that the Fund's managers' interests are aligned with those of the shareholders.

● **PORTFOLIO CHARACTERISTICS:**

As of year-end 2009, the Fund's stock component consisted of 104 large-cap value stocks. There is no indication of any concentration in any individual stock or market sector. The bond component consisted of 432 bonds with top-quality credit ratings – 39% as AAA to AA (high credit-quality investment grade) and 60% as A to BBB (medium credit-quality investment grade). The bond portfolio has an average duration of 5.2 years, which translates into a relatively low interest-rate-risk sensitivity. The portfolio's asset allocation at year-end was 65% stocks, 32% bonds, and 3% cash. The portfolio's low turnover rate for 2009 was 30%, which is consistent with the fund's historical average.

● **COSTS AND EXPENSES:**

VWELX is a no-load, no-12b-1, and no-redemption fee mutual fund. The Fund's expense ratio has declined over the years from a high of 0.36% in 2002-2003 to 0.29% in recent years. However, in 2009 the expense ratio jumped up significantly to 0.35%, which, while still very low when compared to the average moderate allocation fund figure of 1.04%, is something to watch in the years to come. Vanguard is well-known for its low-cost mutual funds, so that last year's expense ratio increase is most likely to be reversed over time.

● **PERFORMANCE DATA:**

Key Fund Data Points (as of December 31st):

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
NAV \$	28.21	27.26	24.56	28.81	30.19	30.35	32.44	32.62	24.43	28.85
Total Return %	10.40	4.19	-6.90	20.75	11.17	6.82	14.97	8.34	-22.30	22.20
Net Assets \$BB *	22.8	21.7	19.5	24.3	28.3	26.3	29.7	31.0	23.2	28.3
Expense Ratio %	0.31	0.36	0.36	0.36	0.31	0.29	0.30	0.27	0.29	0.35
Turnover Rate %	33	33	25	28	24	24	25	23	30	30

* Share class total net assets

Comparative Average Annual Returns – As of December 31, 2009:

	<u>1-Year</u>	<u>3-Year</u>	<u>5-Year</u>	<u>10-Year</u>
Wellington Fund	22.2%	0.9%	4.8%	6.2%
Wellington Composite Index	21.3%	-1.6%	2.1%	1.9%
S&P 500 Index	26.5%	-5.6%	0.4%	-1.0%

● **COMMENTS:**

In the so-called “lost decade” (2000 – 2009), investors in the Wellington Fund survived reasonably well. The one-third bond weighting in its portfolio provided some protection from the negative onslaught of the stock market decline in 2002 and the financial markets meltdown in 2008. While the ten-year average annual return is modest, it looks a lot better than the –1.0% registered by the all-stock S&P 500 Index for the same timeframe. And, the Fund easily outperformed its benchmark, the Wellington Composite Index (65% S&P 500 and 35% Lehman and Barclays Capital bond indexes). The Fund's year-to-year performances also reflect an ability to recover from down markets and a healthy consistency in two important operational indicators – the expense and portfolio turnover ratios. A \$10,000 investment in the Fund in 2000 would have grown, with dividend reinvestment, to \$18,164 by the end of 2009. My summary take on the Fund's performance numbers is this – the Fund's “defense” played well and it's “offense” was able to put a few points on the scoreboard.

Not a bad record considering the unfavorable economic and market conditions for the period reviewed. Based on the portfolio characteristics noted above, the consistency of the fund's managerial approach, and the total return data presented herein, I view VWELX's investment risk, as a conservative allocation balanced fund, as average and its investment return in a range from above-average to high.

5. Investment Profile – Vanguard Wellesley Income (VWINX)

- **FUND TYPE:**

Moderate Allocation Balanced Fund – Roughly two-thirds medium credit-quality investment grade U.S. bonds and one-third blue-chip, large-cap value, stocks. The Fund seeks to provide long-term growth of income and a high sustainable level of current income, along with moderate long-term capital appreciation.

- **FUND COMPANY:**

The Vanguard Group – Founded in 1975 by John Bogle, this fund company manages over \$1 trillion in assets. It is well-known and recognized as one of the most respected mutual fund companies in the investment management business.

- **GENERAL INFORMATION:**

The Fund was created in 1970 and was designed to offer investors current income from bond interest and stock dividends along with moderate share price appreciation. It has been managed by sub-advisor, Wellington Management Company, since its inception. WMC is among the nation's oldest and most highly regarded institutional investment managers.

The Fund's fiscal year runs from October to September. PricewaterhouseCoopers, LLC audits the Fund's financial statements. The most current audit was for the fiscal year ending September 30, 2009, for which it received a "clean opinion" (no exceptions or qualified remarks).

The fund's total net assets for its share class, as of December 31, 2009, were \$8.5 billion.

The Fund currently has an initial minimum investment amount of \$3,000; additional investments can be made at the \$100 level.

The Fund makes quarterly distributions (dividends, interest, and capital gains) on a calendar-year basis – March, June, September, and December.

- **FUND MANAGERS:**

Michael Reckmeyer (stock portfolio) and John Keogh (bond portfolio) are the Fund's co-managers and responsible for day to day management. Keogh also runs the bond portfolio component of the Vanguard Wellington Fund. Both Reckmeyer and Keogh are new to Wellesley, having taken over the Fund's management in mid-2008. Considering the economic and market problems they faced almost immediately, their managerial performance has been exemplary.

Keogh has been with the Wellington Management Company since 1983 is a veteran of some 30 years of investment management. Reckmeyer joined WMC in 1994 and has over 25 years of portfolio management experience.

The Fund's Statement of Additional Information (SAI) affirms that, as of September 30, 2009, each manager owned shares of the Fund in an amount within the \$100,001 - \$500,000 range. Given their relatively short tenures at the fund, this relatively modest level of managerial fund investment is understandable. Going forward, these commitments should grow with time.

● PORTFOLIO CHARACTERISTICS:

As of year-end 2009, the Fund's bond component consisted of 341 bonds with top-quality credit ratings – 40% as AAA to AA (high credit-quality investment grade) and 60% as A to BBB (medium credit-quality investment grade). The bond portfolio has an average duration of 5.2 years, which translates into a relatively low interest-rate-risk sensitivity. The Fund's stock component consisted of 54 blue-chip, large-cap value stocks. There is no indication of any concentration in any individual stock or market sector. The portfolio's asset allocation at year-end was 57% bonds, 39% stocks, and 4% cash. The portfolio turnover rate for 2009 was 27%, which is consistent with the fund's historical low average rate.

● COSTS AND EXPENSES:

VWINX is a no-load, no-12b-1, and no-redemption fee mutual fund. The Fund's expense ratio has varied over the years within a narrow range of 0.24% to 0.33%. When compared to the average conservative allocation fund expense ratio figure of 0.87%, the Fund is a low-cost option. Vanguard is well-known for its low-cost mutual funds, so that last year's expense ratio increase is most likely to be reversed over time.

● PERFORMANCE DATA:

Key Fund Data Points (as of December 31st):

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
NAV \$	20.34	19.91	19.90	20.91	21.58	21.07	21.81	21.82	18.40	20.37
Total Return %	16.17	7.39	4.64	9.66	7.57	3.48	11.28	5.61	-9.84	16.02
Net Assets \$BB *	6.6	6.5	7.5	8.4	9.3	7.6	7.7	7.9	6.9	8.5
Expense Ratio %	0.31	0.33	0.30	0.31	0.26	0.24	0.25	0.25	0.25	0.33
Turnover Rate %	28	24	43	28	23	18	19	21	27	27

*Share class total net assets

Comparative Average Annual Returns – As of December 31, 2009:

	<u>1-Year</u>	<u>3-Year</u>	<u>5-Year</u>	<u>10-Year</u>
Wellesley Income Fund	16.02%	3.37%	4.93%	6.95%
Wellesley Composite Index	14.05%	1.60%	3.79%	5.11%
S&P 500 Index	26.50%	-5.60%	0.40%	-1.00%

COMMENTS:

The Wellington Fund has done quite well over the periods reviewed. It has consistently outperformed its benchmark index and, over the long-term, has even bested the all-stock S&P 500 Index. A \$10,000 investment in the Fund in 2000 would have grown, with dividend reinvestment, to \$19,580 by the end of 2009. Going back to my football metaphor, Wellesley Income has amply demonstrated that it can play both offense and defense. The Fund's operating ratios, expense and turnover, have been consistently on the low side and its total returns on a year-to-year basis have been more than satisfactory. Based on the portfolio characteristics noted above, the consistency of the fund's managerial approach, and the total return data presented herein, I view VWINX's investment risk, as a conservative allocation balanced fund, as average and its investment return in a range from above-average to high.

6. Creating a Balanced-Combo Fund with Wellington and Wellesley

Obviously, my balanced-combo fund does not exist as a real Vanguard mutual fund offering. However, by using the Wellington and Wellesley Income balanced funds, we can construct a virtual fund of this nature.

In my search for safety of capital, steady performance, and reasonable returns, either one of these funds, individually, would fit the bill. However, by managing them in combination and equal-weighting the dollars invested in each, they can be used to make risk-return adjustments in their portfolios that would provide for the preservation capital and, possibly, add a point or two to their combined total return.

Balanced-Combo Fund Exhibit
2000 – 2009

Year Ended	Vanguard Wellington Total Return	Vanguard Wellesley Income Total Return	BCF Composite Total Return
2000	10.40%	16.17%	13.29%
2001	4.19%	7.39%	5.79%
2002	-6.90%	4.64%	-1.13%
2003	20.75%	9.66%	15.21%
2004	11.17%	7.57%	9.37%
2005	6.82%	3.48%	5.15%
2006	14.97%	11.28%	13.13%
2007	8.34%	5.61%	6.98%
2008	-22.30%	-9.84%	-16.07%
2009	22.20%	16.02%	19.11%

Average Annual Ten-Year (2000 - 2009) Total Returns:

Balanced-Combo Fund	7.08%
S&P 500 Index	-1.00%
Lehman/Barclays Capital Aggregate Bond Index	6.30%

Let's take a look at the numbers in the Exhibit. For example, what happened with the total returns in 2002? Wellington's loss was mostly offset by Wellesley Income's gain, resulting in an insignificant negative return in the balanced-combo fund. In the 2008 stock market crash of some 37%, the balanced-combo fund had a loss as well, but significantly less than Wellington, even with its moderate allocation. The balanced-combo's annual total returns are reasonable. Its average annual ten-year total return is excellent when considering its relatively low-risk and trumps the broad market stock and bond benchmarks' results.

While recognizing that past performance does not guarantee future results, Vanguard's stewardship and management of the Wellington and Wellesley Income funds over an extended period of time is reassuring. It is not unreasonable to expect VWELX and VWINX to continue to deliver the goods at a high single digit total return level, at a relatively low-risk, in the years ahead.

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