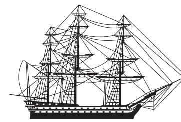
Vanguard's Investment Philosophy



Vanguard®

Successful investment management companies base their business on a core investment philosophy, and Vanguard is no different. Although we offer many strategies with both internally and externally managed funds, a common theme runs through the investment advice we provide to clients. Indeed, these tenets have been a part of the company since our inception and are embedded in Vanguard's culture. We've distilled our philosophy into nine statements, which are presented here. For Vanguard, they represent both the past and the future—enduring principles that guide the investment decisions we help our clients make.

Vanguard believes that . . .

1. Investing is for meeting long-term goals; saving is for meeting short-term goals.
2. Broad diversification, with exposure to all parts of the stock and bond markets, reduces risk.
3. An investor's most important decision is selecting the mix of assets to be held in a portfolio, not selecting the individual investments themselves.
4. Consistently outperforming the financial markets is extremely difficult.
5. Minimizing cost is vital for long-term investment success.
6. Investors should know how each investment fits into their plans and why they own that particular asset.
7. Risk has many dimensions, and investors should weigh "shortfall risk"—the possibility that a portfolio will fail to meet longer-term financial goals—against "market risk," or the chance that returns will fluctuate.
8. Market-timing and performance-chasing are losing strategies.
9. An investor should not expect future long-term returns to be significantly higher or lower than long-term historical returns for various asset classes and subclasses.

Investing is for meeting long-term goals; saving is for meeting short-term goals.

Money that will be needed for a short-term objective—two years or less—should be kept in short-term vehicles such as money market funds, bank accounts, or U.S. Treasury bills to protect principal. The risk of short-term price declines is too significant in the bond and stock markets to hazard money kept for short-term goals. Investing in the bond or stock market is for money that will be needed years from now.

That is why at Vanguard:

- Our advisory services focus on the cash-flow needs of institutional or individual clients so that liquidity for short-term needs is assured.
- We highlight the risks of investment products.

And it's why we advise the following:

- Begin by making an asset allocation decision that gives heavy weight to the time-horizon of the investment objective.

Broad diversification, with exposure to all parts of the stock and bond markets, reduces risk.

Investors whose holdings vary substantially from overall market weightings—in terms of capitalization, style (growth or value), and industry sectors—are assuming additional risk that is unlikely to pay off over the long term.

This is why at Vanguard:

- We obtain diversity of thought and investment methods by selecting external advisory firms to manage certain funds.
- Our equity index funds track market indexes that are capitalization-weighted, and not price-weighted (like the Dow Jones Industrial Average) or equal-weighted (like the Value Line Index).

And it's why we advise the following:

- Build and maintain portfolios that are broadly diversified across all sectors of a securities market.
- Use broadly diversified, low-cost index funds as the core portion (at least 50%) of long-term portfolios.
- Have exposure to bonds with a broad range of maturities and credit quality.
- Hold both growth and value stock funds.
- Consider some exposure to international stocks.

Keep in mind that diversification does not ensure a profit or protect against a loss in a declining market. Also, just as stock investing entails various risks, investments in bond funds are subject to interest rate, credit, and inflation risk. Foreign investing involves additional risks, including currency fluctuations and political uncertainty.

An investor's most important decision is selecting the mix of assets to be held in a portfolio, not selecting the individual investments themselves.

This asset allocation decision—made in light of each investor's financial needs, risk tolerance, and time horizon—is the most important determinant of long-term returns. For example, deciding what percentage of a portfolio to put in stocks will influence long-term returns more than deciding which stock fund or individual stocks to own. In devising an investment policy, or asset mix, an investor should weigh the trade-off between return and risk. Potential return rises along with the risk of volatility in an asset mix.

This is why at Vanguard:

- Our advisory services use a top-down approach to building a portfolio. After analyzing a client's objectives, time horizon, cash-flow needs, and risk tolerance, we focus first on establishing allocations to the major asset classes of stocks, bonds, and cash. Next we turn to sub-allocation—how to weight types of stocks and bonds. Specific investment recommendations come last.

And it's why we advise the following:

- Focus most intently on choosing the mix of stocks, bonds, and cash investments. Once the mix is set, the sub-allocation decision comes next. For bonds, this means deciding degrees of exposure to issues with short-, intermediate-, or long-term maturities; with high, medium, or low credit quality; and with taxable or tax-exempt status. For stocks, attributes to consider are market capitalization (large-, mid-, and small-), style (growth and value),

and domestic or international exposure. In considering these sub-allocations, it's important to be aware that each category can have specific risk factors to be weighed.
- Periodically rebalance portfolios to maintain the target asset allocations. Research shows that portfolios that are never rebalanced have generated greater returns (because stocks over long periods are expected to outperform other asset classes), but with greater risk. Investors who take on more risk may not meet financial obligations or may find it hard to maintain an asset allocation during a market downturn. The timing of rebalancing—annually, semiannually, quarterly, or monthly—does not significantly affect a portfolio's risk/return characteristics. What is important is to get it done.

Consistently outperforming the financial markets is extremely difficult.

Academic research and decades of experience have shown that even most professional investors fail to beat the market indexes over the long haul. There are four key reasons for this. First, operating and transaction costs are higher for strategies that try to beat the markets than for buy-and-hold strategies. Second, the world is simply too uncertain to permit accurate, consistent prediction of market movements or the fortunes of individual companies. Third, the financial markets are generally both very competitive and relatively efficient. When someone spots an opportunity to outsmart the market by buying low and selling high, other investors soon catch on. Information spreads quickly and is soon reflected in the prices of stocks, bonds, and other assets. Fourth, any cash held by active portfolio managers tends to be a drag on returns, given that stocks and bonds have outperformed cash over the long term. *Average annual returns from 1926 through 2005 for stocks (Standard & Poor's 500 Index), 10.3%; bonds (Ibbotson Associates and Lehman Brothers Aggregate Bond Index), 5.6%; and cash investments (Citigroup 3-Month U.S. Treasury Bill Index), 3.8%. Unlike stocks and bonds, Treasury bills are guaranteed as to the timely payment of principal and interest. Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.*

This is why at Vanguard:

- We believe in indexing as a way to keep pace with market returns.
- We warn investors that it is difficult to discern, in advance, which actively managed funds or individual securities will outperform the market.
- We stress low costs in both actively managed and indexed funds. Lower costs mean that our shareholders keep a greater share of fund returns than investors in higher-cost portfolios.

And it's why we advise the following:

- Use broadly diversified, low-cost index funds as the core portion (at least 50%) of long-term portfolios. An indexed core reduces "manager risk"—the chance that investments chosen by portfolio managers (or investors themselves) will lag the overall market.

Minimizing the costs of investing is vital for long-term investment success.

Costs matter a great deal because investment returns are reduced dollar for dollar by the fees, commissions, transaction expenses, and, for taxable assets, any taxes incurred. Investors as a group are the market. Therefore, investors as a group earn the market return before fees, expenses, trading costs, and taxes, and they earn somewhat less than the market return after subtracting all those costs. By minimizing costs, investors (and mutual funds) improve their odds of posting superior relative returns.

This is why at Vanguard:

- We operate our funds "at cost"—charging only the amounts needed to cover operating costs and extracting no profits from the funds.
- We focus on keeping operating costs low for all of our funds.
- We charge no sales commissions or 12b-1 distribution fees.

And it's why we advise the following:

- Know and understand the investment costs being incurred, whether in the form of management fees, sales loads, 12b-1 fees, or operating expense ratios.
- Seek low-cost investment products.
- Adopt a buy-and-hold investment philosophy to minimize transaction costs and taxes.
- Consider the tax efficiency of funds or other investment products.

Investors should know how each investment fits into their plans and why they own that particular asset.

Investors who don't do their homework are more vulnerable to unpleasant surprises or to creating non-diversified, lopsided portfolios that expose them to undue risk. Knowing the characteristics of each investment and the role it plays in a diversified portfolio increases investors' chances of selecting suitable investments that can be held for the long term.

This is why at Vanguard:

- We candidly disclose and discuss the risks of each fund or investment product.
- We provide data and online tools to help investors research funds to understand their risks, investment objectives, and investment methodologies.
- We monitor our funds to be sure their operation consistently reflects their stated investment objectives and methodologies.

And it's why we advise the following:

- Consider how each investment fits with other holdings as part of a balanced, diversified portfolio.
- Consider the risk/return trade-offs of the overall asset allocation, not just of individual investments.
- Select investments that have acceptable risk/return characteristics.

Risk has many dimensions, and investors should weigh "shortfall risk"—the possibility that a portfolio will fail to meet longer-term financial goals—against "market risk," or the chance that returns will fluctuate.

In the long run, what matters most is whether your investments enable you to meet your objectives (a foundation's spending commitments, an individual's retirement, etc.). Earning enough to meet objectives is much more important than whether investments suffer interim declines or trail a market benchmark. But many investors react only to market risk. They may bulk up on stocks during bull markets, taking on more market risk than they realize. Conversely, they're tempted to reduce allocations to stocks in response to market downturns. In truth, to achieve long-range goals, most investors need to accept some level of risk from stocks.

This is why at Vanguard:

- Our approach to long-term planning analyzes both the liability and the asset sides of each investor's finances. This means considering the amount and timing of future spending (for a pension plan's or college endowment's expenses, for example).
- Our advice services use many possible scenarios in "stress-testing" investment portfolios. Returns from the markets are volatile over short periods, and the timing of an investor's returns and expenditures can have a powerful influence on the prospects for reaching his or her goals.

And it's why we advise the following:

- Engage in careful planning for major goals.
- Consider allocating at least some assets to stocks.

Market-timing and performance-chasing are losing strategies.

Both experience and academic studies suggest that a buy-and-hold strategy is better than market-timing (trying to discern when to "get in" or "get out" of stocks or bonds) or chasing performance (investing in the asset class or fund that has performed best lately).

To succeed, market-timers must guess both the right time to get into the market and the right time to get out. And they must be correct often enough to overcome the significant transaction costs of the shifts. The dubious value of market-timing is reflected in the poor results from most mutual funds that use these strategies.

Similarly, experience shows that few investors do well by adopting a momentum strategy—buying an investment simply because its price has been going up or shunning an investment merely because its price has lagged.

Financial-market returns tend to revert toward long-term averages—periods of above-average returns are likely to be followed by periods of sub-par returns, and vice versa. A fund's past performance truly is in the past—you can't buy its past returns by investing in it today.

This is why at Vanguard:

- We make sure that each of our funds follows a disciplined approach consistent with its stated investment objective and strategies. Investors who select a fund to get exposure to, say, large-cap growth stocks should be confident that the fund will continue investing in those stocks even if another market sector is more popular for a time.
- Our bond funds and nearly all of our stock funds remain fully invested in their target markets. Their managers do not try to time the markets.
- We do not advertise our funds' past returns or their peer rankings, which are based on past performance and can mislead investors. The warning mandated by regulators for fund companies that do advertise returns or boast about rankings—"Past performance cannot guarantee future results"—is correct.

And it's why we advise the following:

- Form an asset allocation plan and then stay the course, keeping in mind that some part of a balanced portfolio will always be underperforming other parts. "Buy right and sit tight" is the idea.
- Rebalance periodically to maintain target asset allocations.
- Avoid purchasing an investment simply because of strong recent performance or selling an investment simply because its recent performance is sub-par.

An investor should not expect future long-term returns to be significantly higher or lower than long-term historical returns for various asset classes and subclasses.

No method for predicting market returns is perfect, but when estimating future returns for asset classes (stocks, bonds, cash investments) or subclasses, long-term historical returns are a good place to start. Vanguard expects that returns from various subclasses of the stock market (growth and value stocks, for example, or small-, mid-, and large-cap stocks) will be similar to each other over long periods. Also, Vanguard expects that the long-term return for stocks will be higher than that for bonds, and that bond returns will, in turn, exceed returns on cash investments over long periods.

This is why at Vanguard:

- Our recommended asset allocations for long-term goals include significant commitments to stocks.
- We recommend having exposure to large-, mid-, and small-cap stocks in roughly the same proportions that exist in the overall market (currently 75%–80% large-cap and 20%–25% mid-cap and small-cap, according to the Dow Jones Wilshire 5000 Composite Index).

And it's why we advise the following:

- Have realistic expectations about future returns. Investors who depend on earning returns above the long-term averages for the various asset classes are apt to fall far short of their goals.
- Think and plan with a perspective of decades, not months or a few years.
- Avoid making drastic moves in asset allocations, even in periods of market turbulence. Any changes should be made gradually, not all at once.
- Look at longer time periods (three, five, ten years, or more) when evaluating fund performance.

Vanguard Investment
Counseling & Research

P.O. Box 2600
Valley Forge, PA 19482-2600

Connect with Vanguard™ > www.vanguard.com > 800-523-1036

Vanguard Investment Counseling & Research

Catherine D. Gordon/Principal/Department Head

Joseph H. Davis, Ph.D./Principal
Francis M. Kinniry Jr., CFA/Principal
Daniel W. Wallick/Principal
Nelson W. Wicas, Ph.D./Principal

Frank J. Ambrosio, CFA
John Ameriks, Ph.D.
Donald G. Bennyhoff
Maria Bruno, CFP®
Scott J. Donaldson, CFA, CFP
Michael Hess
Julian Jackson
Colleen M. Jaconetti, CFP, CPA
Kushal Kshirsagar, Ph.D.
Christopher B. Philips
Glenn Sheay, CFA
Kimberly A. Stockton
Yesim Tokat, Ph.D.
David J. Walker, CFA

For more information about Vanguard funds, visit www.vanguard.com, or call 800-662-7447, to obtain a prospectus. Investment objectives, risks, charges, expenses, and other important information about a fund are contained in the prospectus; read and consider it carefully before investing.

Connect with Vanguard, *Vanguard*, and the ship logo are trademarks of The Vanguard Group, Inc. All other marks are the exclusive property of their respective owners.

© 2006 The Vanguard Group, Inc.
All rights reserved.
Vanguard Marketing Corporation, Distributor.

ICRIP 042006