Vanguard's Investment Philosophy

We Believe #6

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

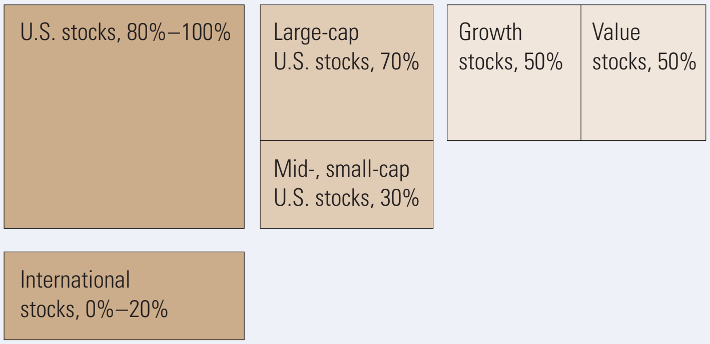
Successful investment management companies base their business on a core investment philosophy, and Vanguard is no different. Although we offer many strategies with both internally and externally managed funds, common themes run through the investment advice we provide our clients. Indeed, these tenets 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, the sixth of which is presented here. For Vanguard, these nine statements represent both the past and the future—enduring principles that guide the investment decisions we help our clients make.

Vanguard believes that . . .

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

A strategic asset allocation establishes the broad parameters both for a portfolio's expected risk and for its long-term return. Although different funds and strategies can be used to implement this asset allocation, the most direct (some might say the simplest) approach is to create a portfolio of broad stock and bond index funds. When an investor establishes a strategic asset allocation with investments other than broad index portfolios, to minimize unintended risk exposure it's important to understand how the various investments interact with each other.

Figure 1. Model equity portfolio sub-asset class allocation



Risk control, alpha, and a combination

Investments in a strategic portfolio should be selected for one of two reasons: to add excess return (alpha) or to provide risk control (lower volatility) relative to a benchmark, often the broad market. The specific goal dictates the fund selection. For example, index funds can closely match the expected risk and return of an asset class, providing tight risk control relative to the market and producing competitive long-term returns. If, however, the goal is to outperform the market, other investment vehicles need to play a larger role.

Many investors seek a balance between risk control and the pursuit of alpha by using a mix of index and actively managed strategies. Successful execution of this approach depends on finding multiple funds that can be combined to produce a risk-controlled portfolio with the potential for outperformance. Key challenges in the pursuit of this dual goal include the potential for portfolio overlap, unintended overweights, and style drift.

Overlap

Consider a portfolio that includes half of its assets in a broad index fund and half in actively managed funds. If an investor selects similar actively managed funds—several growth funds, for example—there might be significant overlap in the funds' holdings. Overlap can produce high concentrations in a particular stock, creating a high degree of company-specific risk. A large overweight in one part of the portfolio implies significant underweights elsewhere in the portfolio.

Unless selections are made within the context of a strategic asset allocation, the effort to diversify by combining two actively managed funds can paradoxically increase portfolio risk.

Overweights

Another issue investors should consider is the weighting of a portfolio relative to the sub-asset classes, or investment styles, that make up the market. Figure 1 shows that the U.S. stock market is composed of roughly 70% large-capitalization stocks and 30% mid- and small-cap stocks. By definition, growth and value stocks each account for half the market's value. A model portfolio might also include an allocation of as much as 20% of assets to international stocks.

Some investors choose to overweight a particular sub-asset class or sector, either because they perceive the opportunity for excess returns in a particular segment or to address a unique financial circumstance. Intentional overweights represent a deliberate strategy with acknowledged risk and return implications, but portfolios can also develop unrecognized overweights, which lead to unexpected risks. For example, appreciation in a particular market or segment can alter a portfolio's asset allocation and thus change its risk profile. This risk can be controlled through regular portfolio rebalancing, using the structure of the market-weighted portfolio as a guide to appropriate portfolio weights.

Drift

Another challenge in maintaining a risk-controlled portfolio is style drift. Style drift refers to a fund manager's or a benchmark's deviation from its expected investment style. Style drift can produce surprises by inadvertently increasing exposure to specific market-segment risk. Drift often occurs gradually. For instance, a successful small-cap manager might begin to hold larger companies as stock selections grow in value, potentially causing the portfolio to drift toward mid-cap stocks.

Figure 2 illustrates this gradual transformation, comparing two "value" funds, *Fund A* and *Fund B*. If the investment style is consistent, the fund should remain in the same part of the style quadrant over time. In Figure 2, *Fund B* consistently occupies the large-value quadrant of the grid. *Fund A*, by contrast, slowly and steadily drifts from a value tilt to a growth tilt, potentially introducing an unintended growth overweight to an investor's overall portfolio.

Conclusion

Understanding why and how each investment fits into a portfolio, as well as overall asset allocation, is critical to achieving an investor's goals. Using a decision framework that explores risk-control and alpha-producing properties of individual funds, as well as a combination of multiple funds, can help you find the right fund to play the right role within your portfolio.

Figure 2. Comparing two managers' approaches: Style pure versus opportunistic

Source: Zephyr Analytics.

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