Vanguard Index Funds and ETFs

Exceptional value indexing
from the people who pioneered it

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Vanguard Asset Management, Limited
The funds profiled in this brochure are distributed by Vanguard Asset Management, Limited, in the UK. The Vanguard Group, Inc. is the investment adviser to the funds and the parent company of Vanguard Asset Management, Limited.

The Vanguard Group, Inc.
The Vanguard Group, Inc. launched the world’s first retail mutual index fund in the US in 1976 and now manages over $2.9 trillion (as at 30 June 2014) globally. The Group’s experienced and expert index investing teams aim to provide straightforward, transparent portfolios, tight benchmark tracking and impeccable execution in all market cycles.
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Indexing driven by values, scale and experience

Our values mean we put you first, always
The Vanguard Group’s ownership structure means that its value system and business model put investors’ interests first and foremost.

Our scale delivers lower costs and transparency
With us, you get no surprises and we expect our funds’ AMCs to equal our TERs.
You can access our fund range with AMCs/TERs between 0.05% and 0.50%.

Our experience helps us get it right
As a group, Vanguard has 35+ years’ continuous experience managing index portfolios. This experience translates into some of the tightest benchmark tracking in the field of index fund management.

Scale, experience and client focus result in a highly disciplined and robust risk management process.
A rigorous approach to index selection

Since launching the first index mutual fund for individual investors in 1976, Vanguard has developed a rigorous process to screen, evaluate, and select benchmarks for its index funds. We select indices that we think provide a good representation of the various target market segments.

What Vanguard seeks in an index

We look for indices with:

- Market segmentation that provides defined portfolio building blocks.
- Major, recognisable and transparent core indices that can be tracked effectively and efficiently.
- Construction based on objective rules, not selective opinions.
- An accurate reflection of markets and available liquidity. For example, we prefer full-float adjustment to reflect only those shares that are available and freely traded on the open market.
- Overlapping buffer zones around the breakpoints between market-capitalisation segments. (on relevant asset classes)
- Orderly rebalancing to reflect market changes.

The benefits of better indices for index funds

- Low portfolio turnover, which leads to lower transaction costs and potentially greater tax-efficiency.
- A better reflection of the targeted markets, which makes index funds better asset allocation tools, especially for those investors who divide their portfolios by market segments or sectors.
- Improves ease and efficiency of tracking, leading to the potential for tighter tracking.
We aim to give you index funds that tightly track their indices at the lowest cost.

We implement portfolios based on full replication techniques where possible as this is the ‘purest’ form of indexing and results in lower tracking error. Where necessary, due to fund size, illiquidity in the market or a low number of issues, we may seek to use replication, optimisation or a hybrid of the two, please see table below for further information.

**Index methods at a glance**

<table>
<thead>
<tr>
<th>Full replication</th>
<th>Optimisation</th>
<th>Hybrid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy all securities in the benchmark index</td>
<td>Buy a representative sample of securities that will replicate the risk and return characteristics of the target benchmark</td>
<td>Buy as many of the securities of the index as possible</td>
</tr>
<tr>
<td>Ideal index tracking technique</td>
<td>Better suited to benchmarks that hold an unmanageable number of issues or contain illiquid securities</td>
<td>Use optimisation to track illiquid securities</td>
</tr>
<tr>
<td>Typically results in lower tracking error</td>
<td>Manager’s skill in matching risk characteristics of benchmark is important</td>
<td></td>
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</table>
A fair and transparent approach to costs

Our Annual Management Charge (AMC) delivers exceptional value and is among the lowest in the industry, ranging from 0.05% to 0.50% on our range of index funds and ETFs.

We also expect our funds’ AMCs to equal their Total Expense Ratios (TER), because we pay running costs out of the AMC rather than charging them back to the fund (the investors), which would cause a performance drag.

The Vanguard approach

\[ \text{AMC} = \text{TER} \]

- TER
- Transaction costs

- Low cost
- Transparent
- Fair

Low cost + Transparency

Transaction costs in focus

We also take a different approach to transaction costs. We ask all investors to pay for their own significant transactions costs, such as Stamp Duty Reserve Tax (SDRT) and the trading expenses caused by investors entering or exiting the fund (dilution), rather than charging those to existing investors in the fund.

All sums collected as transaction costs, including preset dilution levy on purchase or redemption, or SDRT, are returned to the fund for the benefit of the fund’s investors, or, in the case of SDRT, paid directly to HMRC (rather than paying the tax out of the fund). We think this is more transparent and will result in closer benchmark tracking.
A conservative approach to risk management and securities lending

Like many mutual funds, our index funds have the ability to engage in securities lending in the marketplace for a profit; in our case for the profit of the fund’s investors in the form of tighter tracking. We take a very conservative approach to securities lending and a robust, thorough and disciplined approach to risk management. We never take any unnecessary risks with investors’ money.

In addition, we ensure that all gains made from securities lending return to the fund for the benefit of the fund’s investors. Vanguard doesn’t profit from our securities lending, but rather net proceeds go back to the relevant fund to help track the index more closely.

The team’s disciplined risk-management approach is embedded in every aspect of its culture, and has enabled us to provide clients with a clear, transparent service. In over twenty years we’ve not experienced a default in our securities lending programme.
Socially Responsible Investing (SRI) funds, built using Vanguard’s indexing expertise

Many investors are becoming more socially aware and want investments that reflect their concerns. As an adviser, you want to ensure that you give your clients the best chance of achieving their long-term investment and life goals. Vanguard SRI funds can help, offering Socially Responsible Investing, while maintaining broad market exposure.

Vanguard SRI funds offer risk and return characteristics that make them suitable for portfolio construction, while excluding securities that violate UN Global Compact principles or that produce land mines, cluster bombs or nuclear weapons. The end result helps meet your clients’ SRI needs without sacrificing diversification.

The optimised investment process aims to track a standard benchmark index, while excluding securities that do not satisfy SRI criteria. This means that you can integrate ethical, social and environmental considerations into your client portfolios without compromising asset allocation. Both in terms of overall performance objectives and SRI goals, this helps to address your clients’ ethical concerns while giving them the best chance of investment success.

Third-party SRI screening agencies employed by FTSE conduct a rigorous analysis of all companies in each benchmark, assign SRI ratings to the companies and make regular re-assessments. Companies that fail are excluded from the universe of securities that are otherwise included in the index. The screening process is expected to remove 5% to 15% of the market capitalisation of each fund’s target benchmark.

**Risk characteristics in line with benchmark**

We use an optimisation technique to invest in the securities that pass the SRI screens. Using sophisticated computer programmes, we assemble a portfolio that resembles the target index in terms of both fundamental and statistical risk characteristics. Because the funds hold fewer securities than the target benchmark, they may experience wider tracking error between their total return and their benchmark than a standard Vanguard index fund.

**Constructing Vanguard SRI funds**

<table>
<thead>
<tr>
<th>FTSE</th>
<th>Builds benchmark and develops exclusion policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Third-party SRI screening agency</td>
<td>Identifies securities for exclusion</td>
</tr>
<tr>
<td>- Human rights</td>
<td>- Nuclear weapons</td>
</tr>
<tr>
<td>- Labour standards</td>
<td>- Land mines</td>
</tr>
<tr>
<td>- Environment</td>
<td>- Cluster bombs</td>
</tr>
<tr>
<td>- Ethics and corruption</td>
<td></td>
</tr>
<tr>
<td>Vanguard</td>
<td>Optimises fund to track broad market</td>
</tr>
<tr>
<td>You</td>
<td>Achieve SRI compliance and broad market exposure</td>
</tr>
</tbody>
</table>
Offering a choice of fund structures

We aim to offer you a range of choices when accessing our index fund expertise. That is why we offer both traditional index mutual funds and Exchange Traded Funds (ETFs).

Vanguard does not take a view on which is ‘best’ since both fund structures simply offer a different way to access exposure to an underlying index. Assuming a traditional index fund and an ETF track the same index, with an identical portfolio of securities, the characteristics of ETFs – the risk and return attributes, holdings, and portfolio turnover – will broadly be the same as a traditional index mutual fund.

Whether you chose a Vanguard index mutual fund or a Vanguard ETF, you will get access to the same indexing expertise, experience and risk control process.
The choice between traditional mutual funds and ETFs

Although both structures offer UCITS-compliant, open-ended collective investment funds that seek to track the performance of a benchmark index, there are differences in how they trade and how their costs are structured.

Trading

Unlike conventional index tracking funds, which are bought and sold through a fund manager, usually just once per day, ETFs are traded (through a broker or platform offering brokerage services) on stock exchanges whenever the market is open. Trading ETFs is as easy as placing an order through a platform or a stockbroker. The trade settles just like any other stockmarket listed share.

Because they’re traded in the same way as equities, ETF share prices change constantly. As a result, buyers and sellers always know that the price they see at any moment is the price they’ll trade at, unlike conventional index funds which are usually priced only once a day.

Costs

Total Expense Ratios are usually a bit lower with ETFs because they cost less for a fund manager to run, since stockbrokers and other market participants deal with much of the administration. However, trading ETFs involves third-party costs that investors and their advisers need to consider when making a choice. These costs include stockbroker commissions (or execution-only trading fees) and bid-offer spreads.

Conventional funds vs. ETFs

<table>
<thead>
<tr>
<th>Conventional index funds</th>
<th>Exchange Traded Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchased and redeemed directly from fund management company (or via a platform)</td>
<td>Purchased and sold on stock exchanges through stockbrokers</td>
</tr>
<tr>
<td>Priced once a day at net asset value</td>
<td>Priced by market throughout the day; market price can differ moderately from net asset value (NAV)</td>
</tr>
<tr>
<td>Typically no stockbroker fees</td>
<td>Brokerage fees and bid-offer spreads</td>
</tr>
<tr>
<td>Trading restrictions to curtail frequent trading may apply</td>
<td>No restrictions on frequent trading</td>
</tr>
<tr>
<td>No short selling, no margin trading; no stop, limit or open orders</td>
<td>Short selling permitted, margin trading possible; stop, limit, or open orders possible</td>
</tr>
</tbody>
</table>

You can find further educational resources and CPD on ETFs by visiting vanguardlearning.co.uk
Using ETFs in client portfolios

At their most basic, ETFs provide a diversified investment, tracking all or a representative sample of the companies, countries or elements of the index it tracks, just like a traditional index mutual fund. As such, they can be sensible components of broadly diversified long-term investment portfolios.

However, ETFs do have some attributes that some investors find useful for some very specific purposes in addition to using them as portfolio building blocks.

**Long-term cost savings for buy-and-hold investors**

With typically lower annual costs, ETFs can help to reduce overall costs compared to some traditional mutual funds, as long as you take into account the full ‘all-in’ cost of investing in an ETF, which would include stockbroker commissions (or fixed transaction fees in the case of execution-only platforms) and bid-offer spreads. These additional trading costs mean that it’s often cost prohibitive to use ETFs for regular savers.

**Maintaining exposure during a restructure**

Being out of the market during a portfolio restructure can mean that investors miss out on market gains. ETFs’ low management costs and liquidity make them useful as a tool to maintain exposure to equity and/or bond markets while working out a longer-term asset allocation.

**Portfolio rebalancing**

Over time portfolios can drift away from their strategic asset allocations as markets move. Without rebalancing, portfolios can move too far from the strategic asset allocation and jeopardise the chances of meeting the client’s objectives. Taking advantage of their liquidity, some advisers and institutional investors use ETFs to quickly and easily rebalance client portfolios.
About our ETFs

Our ETFs enjoy the same recognised expertise in index investing which has made The Vanguard Group one of the world’s largest investment management groups. We take the same exceptional value, client focused approach to ETFs as we do with all our investment products.

Simplicity

Our ETFs are straightforward indexing products, just like our other index mutual funds. They’re based on holding all, or a representative sample, of the securities in the benchmark index, so investors know exactly what they’re getting.

Exceptional value

Vanguard aims to offer exceptional value, low-cost investments to investors no matter which fund structure they choose. Our ETF index funds have expense ratios ranging from 0.07% to 0.29%.

Transparency

We provide regular information to the market including the daily fund Net Asset Value (NAV), making ETFs a highly transparent investment.
Our range of equity and bond index funds

Vanguard Asset Management offers a range of equity and bond index tracking funds in the UK. All are domiciled in either the UK or Ireland. Our funds offer investors the ability to spread risk through broadly diversified exposure to markets at a very low cost.

For up-to-date details of individual funds, see the fund information included in the back pocket of this brochure, or visit our website: vanguard.co.uk.
For more information on any of Vanguard Asset Management investment funds, please contact our Adviser Support line on 0800 917 5508, or email us at enquiries@vanguard.co.uk