The Case for Indexing

Vanguard®

> competitive performance

Index portfolios have provided institutional investors with competitive investment performance over the long term. For example, in the 20 years ended December 31, 2008, 59% of actively managed equity funds underperformed the Dow Jones Wilshire 5000 Composite Index. During the same 20-year period, 94% of actively managed bond funds underperformed the Barclays Capital U.S. Aggregate Bond Index.[1]

Indexing also can deliver competitive performance in many discrete market segments.[2] Consider the chart to the right.

Here we show the average excess returns[3] of active managers versus their style benchmarks. Over the past 15 years, active managers have underperformed their style benchmarks in both the equity and the fixed income markets. Relative performance can be time-period dependent, but due to higher average costs, we would expect active, on average, to underperform over longer time periods. Ultimately, we would expect active management, on average, to trail an index by the margin of its expenses.

Average annualized excess returns for actively managed funds versus style benchmarks

15 years annualized as of December 31, 2008

		Value	Blend	Growth
Large-cap	Equal-weighted average fund returns	5.72%	4.53%	3.93%
	Index total returns	7.65%	6.51%	5.15%
	Actively managed fund out- (under-) performance	(1.92%)	(1.99%)	(1.22%)
Medium	Equal-weighted average fund returns	7.04%	7.46%	4.83%
	Index total returns	9.38%	7.65%	4.92%
	Actively managed fund out- (under-) performance	(2.33%)	(0.19%)	(0.10%)
Small	Equal-weighted average fund returns	7.59%	7.55%	5.22%
	Index total returns	8.82%	7.73%	5.85%
	Actively managed fund out- (under-) performance	(1.23%)	(0.18%)	(0.63%)

		Government	Corporate	GNMA	High Yield
Short	Equal-weighted average fund returns	4.41%	3.85%	5.32%	2.96%
	Index total returns	5.54%	5.42%	6.41%	4.26%
	Actively managed fund out- (under-) performance	(1.13%)	(1.57%)	(1.09%)	(1.30%)
Medium	Equal-weighted average fund returns	5.04%	4.54%		
	Index total returns	5.98%	5.61%		
	Actively managed fund out- (under-) performance	(0.94%)	(1.08%)		

Equal-weighted average fund returns

Index total returns

Actively managed fund out- (under-) performance

Note: We excluded long-term government and long-term corporate funds from the analysis, as Lipper Inc. does not have a reasonable benchmark for average long-term funds. Any discrepancies in underperformance figures are due to rounding.

Sources: Average active fund returns from Lipper, Inc. Equity benchmarks are represented by MSCI style benchmarks. Fixed income benchmarks are represented by Barclays Capital benchmarks.

Please see the disclosures on the back cover for information about MSCI US Index performance.

[1] Derived from data provided by Morningstar, Inc. Only taxable bond funds were included in the fixed income analysis.

[2] Please note that you cannot invest directly in an index. Index funds have operating expenses and transaction costs. Therefore, an index fund, while expected to track its target index closely, typically will be unable to match the performance of the index exactly. Past performance is not a guarantee of future results.

[3] Excess returns are based on NAV returns net of fees versus the respective target benchmark.

Even in market downturns, index portfolios, which strive to remain fully invested at all times, have performed on par with actively managed funds. Active managers have the flexibility to sell securities and raise cash before a market tumble, but they have shown no systematic ability to time the market correctly.

Bear market performance of U.S. funds versus Dow Jones Wilshire 5000 Index

Bear market	Number of funds	Percentage outperforming market benchmark
Jan. 1973–Sept. 1974	110	44%
Dec. 1980–Jul. 1982	167	78%
Sept. 1987–Nov. 1987	291	57%
Jun. 1990–Oct. 1990	405	44%
Jul. 1998–Aug. 1998	1,082	39%
Sept. 2002–Feb. 2003	1,405	60%
Nov. 2007–Dec. 2008	2,200	38%

Sources: Lipper Inc. and Wilshire Associates, Inc.

Past performance is not a guarantee of future results.

The chart to the left illustrates how hard it's been for active managers to outperform the Dow Jones Wilshire 5000 Index over the last three decades. In four of seven bear markets, the average actively managed stock fund underperformed the broad-market index. These results are especially noteworthy, given that most bear markets are usually relatively brief.

Why indexing works

The indexing advantage is simple mathematics: As a group, equity investors earn the market's return. For every investor who leads the market, another must lag. On average, investors can earn no more than the market's return—before costs.

After costs, the average equity investor must lag the market. The higher the costs, the greater the shortfall. Costs do matter.

Indexing achieves its objectives by seeking to match the market's return, while keeping costs far below those of the average investor. The strategy is a simple, yet powerful, formula for pursuing above-average performance.

Consistent relative performance

With an index portfolio, you know what you're getting: consistent performance relative to a benchmark.[4] Talented managers may be able to beat the benchmark, of course, but these managers are extremely difficult to identify in advance. Expectations based on past performance may not be met.

Consider the chart below. At the beginning of 1999, it was clear which equity fund managers had earned the highest ranking over the past ten years. But it was not clear which managers would do best in the next ten years. On average, the top ten performers in the decade ended December 31, 1998, ranked 1,785 in the subsequent decade—out of a total of 2,322 actively managed funds.

Managers' rankings in consecutive decades

1989–1998		1999–2008
1	▶	1,485
2	▶	1,977
3	▶	1,991
4	▶	620
5	▶	1,699
6	▶	2,066
7	▶	1,460
8	▶	2,154
9	▶	2,274
10	▶	2,123

Note: Excludes sector funds and balanced funds.

Source: Lipper Inc.

Indexing offers more fiduciary comfort

Index portfolios offer unique benefits to the fiduciaries charged with helping investors meet their investment goals:

- Index portfolios, in most cases, are easily understood, simplifying investment analysis and due diligence.
- Index portfolio performance tends to be consistent relative to a benchmark, reducing uncertainty about the role a fund will play in your clients' investment programs.
- Index portfolios feature style purity, so you can feel assured that your clients' money is invested as you expected.
- Index portfolios' low costs mean that more of your clients' investments will work for their benefit.
- Index portfolios tend to be tax-efficient due to less turnover.

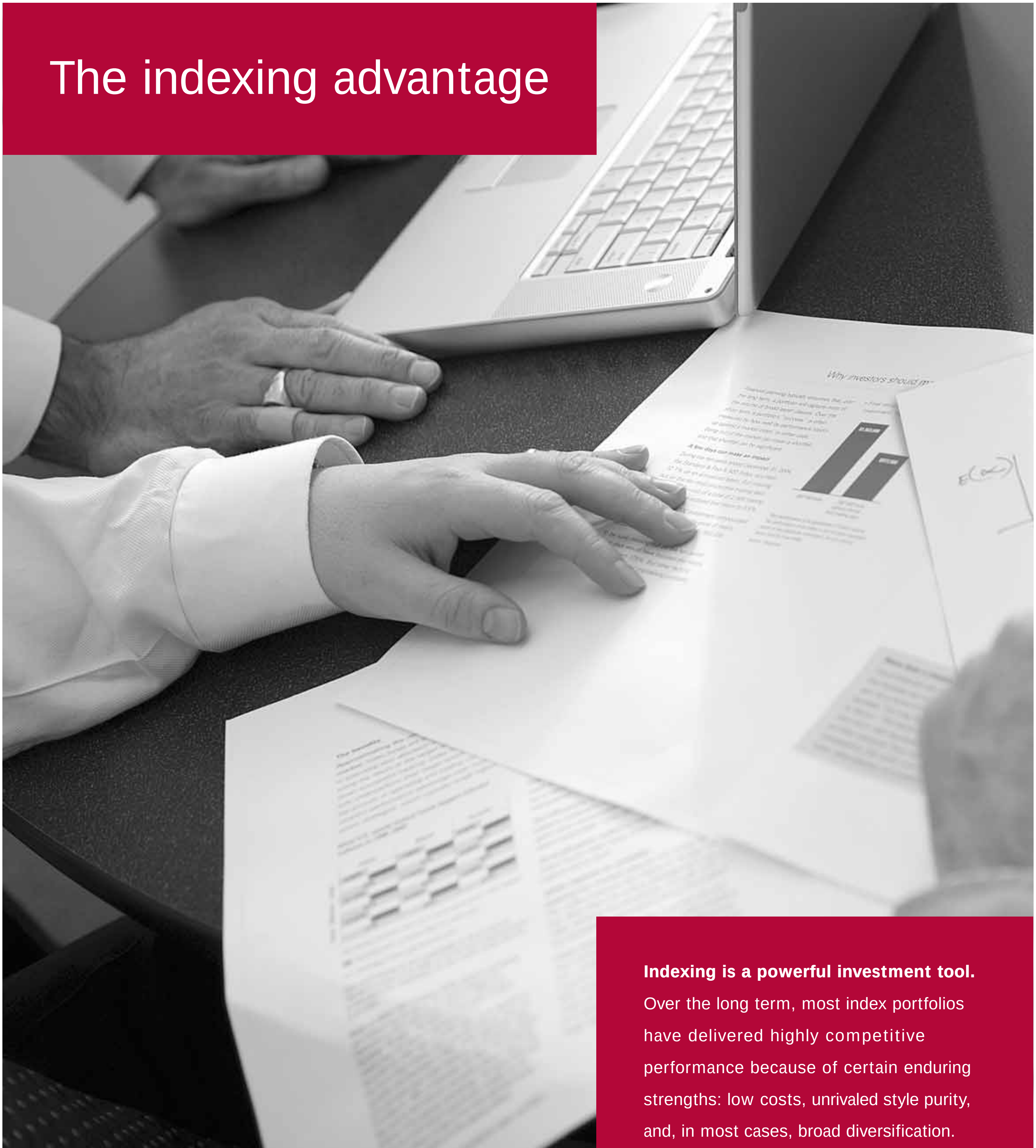
Index with a leader

Vanguard is an indexing leader. We created the first index mutual fund for individual investors in 1976. Today we offer one of the largest and most comprehensive index fund programs in the investment management industry. Our index funds track all major asset classes and discrete segments of the U.S. and international stock markets and the U.S. bond market.

We also have more than 30 years of experience helping investors meet their investment goals. If you would like to learn more about indexing and how Vanguard can help you enhance your clients' portfolios, contact your Vanguard Financial Advisor Services sales executive, or call **800-997-2798**. You can also visit us at **advisors.vanguard.com**.

[4] In certain sector index funds, with the benchmark comprising relatively few securities, performance may not track as closely to the benchmark as in a broadly diversified index fund.

The indexing advantage



Indexing is a powerful investment tool. Over the long term, most index portfolios have delivered highly competitive performance because of certain enduring strengths: low costs, unrivaled style purity, and, in most cases, broad diversification.

Whether you want to offer your clients exposure to an entire market or to a discrete market segment, indexing is a time-tested strategy that can help them meet their investment goals.

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Our commitment to you and your clients.

Indexing expertise
Discipline, experience, and commitment to consistent long-term performance.

Low cost
Lower investment costs mean greater value for you and your clients.

Trusted name
Help grow your business with a firm clients know and trust.

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All funds are subject to market risk. Prices of mid- and small-cap stocks often fluctuate more than those of large-company stocks.

Vanguard ETFs™ are not redeemable with an Applicant Fund other than in Creation Unit aggregations. Instead, investors must buy or sell ETF Shares in the secondary market with the assistance of a stockbroker. In doing so, the investor will incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.

Note on MSCI US Index Performance: MSCI started calculating and maintaining US equity indexes on December 2, 2002 with a base level of 1000 as of November 29, 2002. The initial construction of these indexes used the market capitalization of November 25, 2002 and no buffer rules were applied on the Size or Style indexes. Although the indexes were not available until December 2, 2002, MSCI calculated daily price and total return index levels for all US equity indexes from May 31, 1992 to November 29, 2002. The methodology used for the historical calculation shares most of the features of the ongoing methodology. The main difference is the use of full market capitalization weights for the historical indexes instead of free float-adjusted market capitalization weights for the ongoing indexes because free-float adjusted data for every stock in each index was not available.

The funds or securities referred to herein are not sponsored, endorsed, or promoted by MSCI, and MSCI bears no liability with respect to any such funds or securities. For any such funds or securities, the prospectus or the Statement of Additional Information contains a more detailed description of the limited relationship MSCI has with The Vanguard Group and any related funds.

Vanguard ETFs Investors cannot invest directly in an index.

Investment Products: Not FDIC Insured • No Bank Guarantee • May Lose Value

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