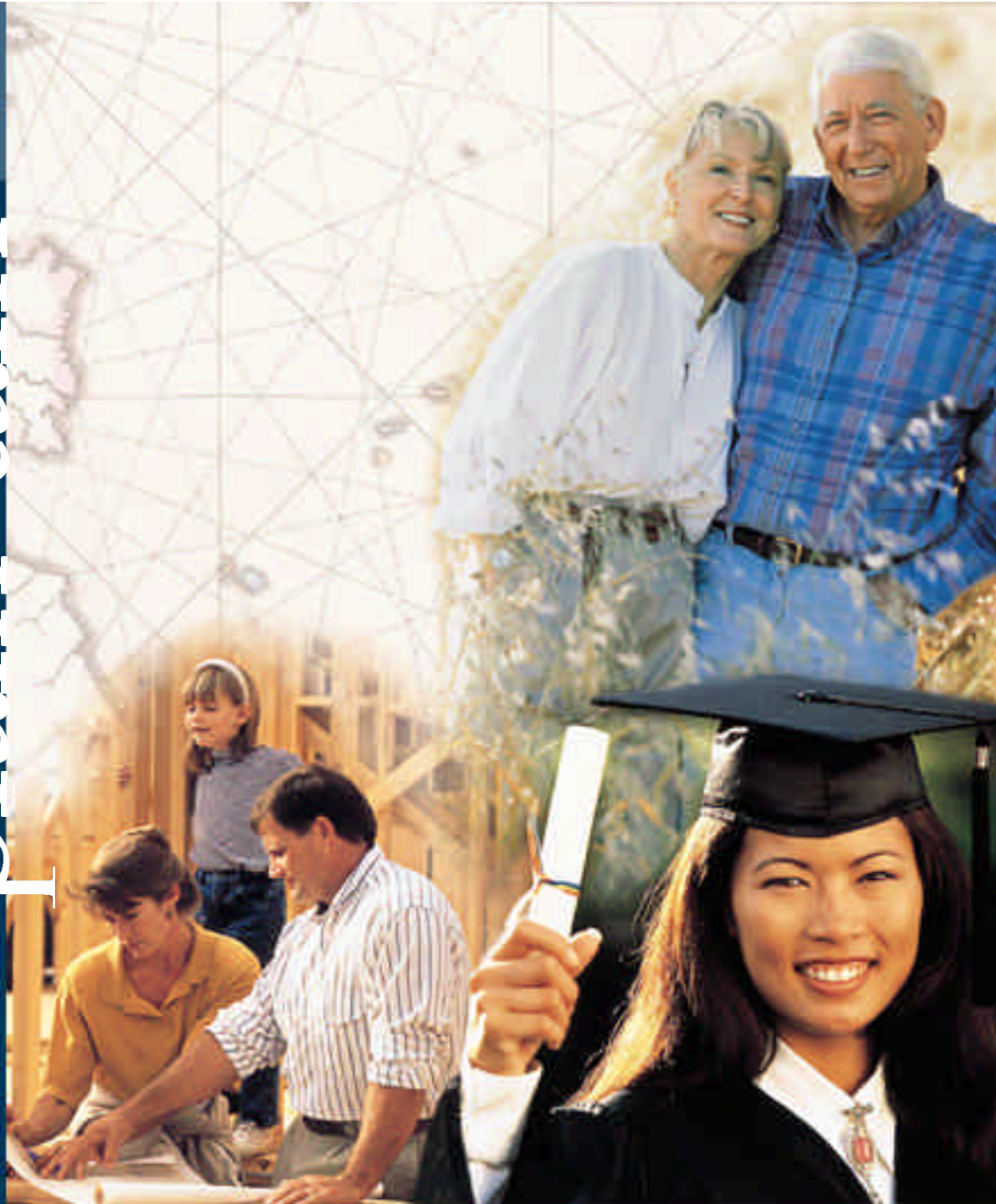


# The Vanguard Investment Planner

*Your guide to building an investment portfolio*

plain talk<sup>®</sup>



## Why Plain Talk?

At The Vanguard Group—a leading proponent of investor education in the mutual fund industry—we believe that knowledge is one of the keys to investment success. To that end, we have developed our Plain Talk Library, a series of candid, concise, and easy-to-understand publications on a wide variety of investment topics.

To request a free copy of any of these brochures, call us at **1-800-662-7447** on business days from 8 a.m. to 10 p.m. and on Saturdays from 9 a.m. to 4 p.m., Eastern time. You can also read or order them online at [www.vanguard.com](http://www.vanguard.com).

We hope you find the information in the Plain Talk Library helpful as you chart your investment course with us.

- *Mutual Fund Basics*
- *The Vanguard Investment Planner*
- *Women and Investing*
- *Financing College*
- *Preparing to Retire*
- *Investing During Retirement*
- *Estate Planning Basics*
- *How to Select a Financial Adviser*
- *Measuring Mutual Fund Performance*
- *Bear Markets*
- *Bond Fund Investing*
- *Index Investing*
- *International Investing*
- *Taxes and Mutual Funds*
- *Dollar-Cost Averaging*
- *Why Vanguard?*

## The Vanguard Investment Planner

**T**he number of mutual funds available to investors has been growing each year. Today, investors can choose from more than 8,000 funds—more than double the number of stocks listed on the New York Stock Exchange.\*

The process of sifting through thousands of funds to find a handful that best fit your investment needs may seem like a daunting task. It needn't be, if choosing funds is part of a broader portfolio-building process that starts with a clear statement of investment goals and an appropriate mix of financial assets—or *asset allocation*—to achieve those goals.

*The Vanguard Investment Planner* describes this investment decision-making process. This Plain Talk brochure should prove helpful whether you have just begun investing, want to ensure that your current investment portfolio matches your needs, or are ready to expand your mutual fund choices. To help you organize your thoughts, the *Investment Planner* provides worksheets at several points and an Investor Questionnaire to help you select an appropriate asset allocation for each of your financial goals.

Please note that this brochure assumes that you are familiar with the basics of mutual funds and investing. If you're not, another Plain Talk brochure, *Mutual Fund Basics*, provides an introduction to those topics.

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\*Sources: Investment Company Institute and New York Stock Exchange.

All other mutual fund industry data provided by Lipper Inc. unless otherwise noted.

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# A LOOK AT WHAT'S AHEAD

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People invest in mutual funds for a range of reasons—for easy access to a stable pool of cash with higher earning potential than a bank account (money market funds\*), for income (bond mutual funds), or for capital growth and dividends (stock mutual funds). These multiple examples, of course, may characterize a single investor, since one investor may have several financial needs.

Despite the variety of goals and investment possibilities investors have, anyone can use this brochure's framework for creating a portfolio of mutual funds. This framework will help you to:

- **Determine the right mix of assets.** The type of assets you select for a portfolio will largely determine the long-term investment returns of that portfolio. As you select an appropriate mix of assets, consider these four factors: your investment objective, the length of your investment period, your ability to tolerate the risks of investing, and your personal financial situation. We provide an Investor Questionnaire that considers those four factors to help determine an appropriate mix of investments for each financial goal.
- **Diversify within an asset class.** Once you've decided on a "strategic" asset allocation, you can begin focusing your attention on the segments within the stock and bond markets—your "sub-asset allocation." For stock investors, we'll discuss some of the factors to consider when deciding how to divide your investments between large- and small-company funds or between "growth" and "value" styles of investing. For bond investors, we'll discuss different bond fund maturities (short-, intermediate-, and long-term), as well as the pros and cons of corporate and government bonds and taxable and tax-exempt bonds.
- **Construct a portfolio.** Once you have decided how much of your portfolio should be in the various segments of the stock and bond markets, you are ready to match specific funds with those segments you want in your portfolio. Of course, some funds may cover several segments of a market or even the entire stock or bond market. These funds can help to ensure that your portfolio is never inadvertently overexposed or underexposed to any one market segment.

*myth*  
With my stock and bond funds, I don't need a special "rainy day" fund.

All investors should have easy access to money for emergencies or short-term expenses. Most financial advisers recommend saving enough to cover living expenses for three to six months (and up to a full year if you are self-employed or your job is unstable). Since emergencies are unexpected events, your money must be easily accessible and in a stable investment such as a money market fund. Stock funds and longer-term bond funds are too volatile to use for emergency funds.

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\*An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at \$1 per share, it is possible to lose money by investing in such a fund.

- **Choose a fund.** Before you invest, keep in mind these other investment variables: the cost of mutual fund investing, including operating expenses and any sales charges; the investment approach of a fund—whether it is an actively managed fund or an index fund; and the role of taxes, which can significantly reduce the amount of the investment earnings you actually get to keep. Careful consideration of these variables, which are discussed in more detail in special sections of this brochure, will help you to maximize your total return without taking on unnecessary risks.
- **Monitor your portfolio.** You should review your investment portfolio periodically—perhaps once a year—to ensure that you still have an appropriate asset allocation. Because different asset classes provide very different returns over short periods, you may find that you need to shift investments within your portfolio to maintain the risk level you chose. You may be able to rebalance by making new investments in an asset class that’s underrepresented or by taking distributions from the one that’s overrepresented. Of course, if you sell securities to rebalance your portfolio, you may incur taxable capital gains and fees or commissions.

### The three basic classes of financial assets

Most mutual funds invest in one or more of the three major classes of financial assets: common stocks, bonds, and cash investments.

- **Common stocks** These represent part ownership, or equity, in corporations. Many corporations pay out part of their profits to stockholders in the form of dividends, though most corporations reinvest some or all of their profits in an attempt to increase future sales and profits. The primary goal of most investors in common stocks is to see the value of their shares increase over time.
- **Bonds** These are IOUs, or debt, issued by corporations or governments. In exchange for an investor’s money, the bond issuer promises to repay the money at a specified date in the future and to make periodic interest payments in the interim. Usually, the amount of interest paid—the “coupon”—is fixed at a set percentage of the amount invested, which is why bonds are called “fixed income” investments.
- **Cash investments** Generally found in money market funds, cash investments are short-term (usually a year or less) IOUs issued by governments, corporations, banks, or other financial institutions. U.S. Treasury bills and bank certificates of deposit (CDs)\* are two types of money market instruments.

\*Bank deposit accounts and CDs are guaranteed (within limits) as to principal and interest by an agency of the federal government.

# Step 1

## DETERMINE THE RIGHT MIX OF ASSETS

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The three basic financial asset classes are stocks, bonds, and cash investments. Deciding on the mix of assets in your portfolio—the percentage of your money in stocks compared with bonds, for example—is known as strategic asset allocation.

Financial experts agree that your asset allocation decision is an extremely important factor—possibly the most important factor—in determining both the long-term return and the volatility of your portfolio. Because no one can know for certain what an asset class will earn (or lose) in a future period, allocating some percentage of investments to all three asset classes enables you to “hedge your bets.” You can think of asset allocation as a way of setting a policy for how your portfolio will be invested. Only after you have selected an asset allocation should you begin considering individual mutual funds to build that allocation.

Stocks, for example, may be on the downswing while bonds are on the upswing. At other times, stock prices may be rising while bond prices are falling—or rising less quickly than stocks. By investing in different asset classes, you create a portfolio in which you’re able to potentially offset—to some degree—losses in one asset class with gains in another. The overall effect is to moderate the volatility, or fluctuations, of your investment returns.

But what’s the right mix of assets, given the fact that no one can know what returns each asset class will provide in the future? The answer is unique to each individual and even to each financial goal of that individual. Four interrelated factors should be considered in determining an asset allocation:

- ***Your investment objective***
- ***Your time horizon (the length of your investment period).***
- ***Your risk tolerance (the level of comfort you have with market fluctuations).***
- ***Your personal financial situation.***

In the following pages, we will discuss the various types of investment risk and then each of the four factors listed above.

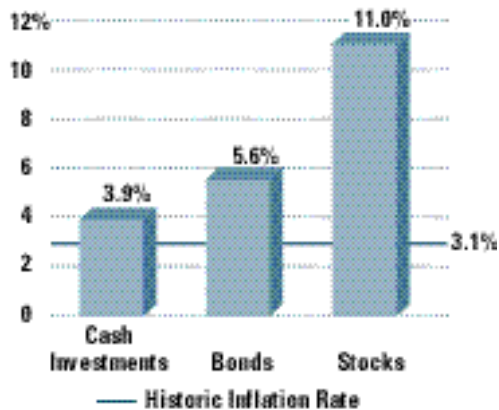
*myth*  
**Inflation is very low. I don't need to worry about it.**

Inflation—or the increase of prices in general—erodes the purchasing power of your earnings and savings, even when it's rising slowly. Consider the average long-term inflation rate of about 3.1% a year: If that rate continued for the next ten years, you'd need \$1.36 to buy what \$1 can buy today. That's why it's important to consider an investment's “real” rate of return, which is the amount by which its return exceeds the rate of inflation. An investment that fails to keep up with inflation leaves you with a steadily decreasing amount of purchasing power.

Figure 1

### The rewards of investing: comparing the three primary asset classes with inflation

Average annual returns: 1926–2000



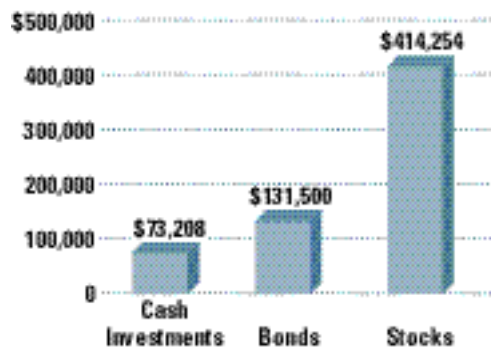
Over the long term, stocks—on average—have produced higher annual returns than bonds, and both have outperformed cash investments. More important, the 11.0% average annual return of stocks has outpaced the average 3.1% rate of inflation by the widest margin. Of course, over shorter time periods, both investment returns and inflation rates can differ—sometimes significantly—from the long-term averages.

Cash investments are represented by U.S. Treasury bills, bonds by long-term U.S. corporate bonds, and stocks by the Standard & Poor's 500 Index (S&P 500 Index). Returns include the reinvestment of all income, dividend, and capital gains distributions.

Source: The Vanguard Group.

Figure 2

### Growth of \$10,000 investment: 1971–2000



A long-term investment of \$10,000 in a diversified stock fund historically would have earned significantly more for investors than an equivalent amount invested in bonds or cash. This example is based on the period from 1971 through 2000, when average annual returns were 13.2% for stocks, 9.0% for bonds, and 6.9% for cash investments.

Cash investments are represented by U.S. Treasury bills, bonds by long-term U.S. corporate bonds, and stocks by the returns of the S&P 500 Index. Returns include the reinvestment of all income, dividend, and capital gains distributions.

Source: The Vanguard Group.

## Understanding risk

It's crucial to understand the inescapable trade-off between investment performance and risk: Higher returns are associated with higher risks of price fluctuations. Stocks historically have provided the highest long-term returns of the three asset classes (as shown in Figures 1 and 2), but they have also shown the biggest losses over short-term periods. At the other extreme, cash investments are among the safest investments when it comes to price stability, but they have provided the lowest long-term returns.

The overall risk of a portfolio can be moderated by holding diversified investments in each of the three asset classes. You can also align investments with each financial goal—taking on an appropriate level of risk depending on when the money will be needed. Money that will be needed in the near future should be kept in money market funds, while money that will not be needed until later may be invested more aggressively, possibly in stock funds or longer-term bond funds.

Unfortunately, no matter how well diversified your portfolio, there is no way to eliminate risk altogether. Some important investment risks to consider—and how to reduce these risks—follow:

- **Market risk** The general prices of stocks and bonds can move up and down dramatically. This risk may be reduced by holding an investment for a long period—at least ten years—or by investing in more than one asset class.
- **Specific risk** Investing in a single security creates the risk of losing money if the issuer should run into trouble or even fail. This risk may be significantly reduced by investing in a broadly diversified mutual fund that holds many securities.
- **Inflation risk** Rising prices due to inflation can erode the real value, or purchasing power, of investments. Over long periods, stock investments have beaten inflation by a larger margin than have bond or cash investments, as shown in Figure 1.
- **Manager risk** Investment managers can make good decisions that help your investment “beat the market,” or they can make poor decisions that reduce the value of your investment. This risk may be reduced by investing in index funds that seek to match the performance of all or part of the stock or bond markets.

## Investment objectives and time horizons

To create effective portfolios, you should set distinct investment goals (such as funding your retirement or a child's college education) and design a portfolio for each of those goals. These separate portfolios will enable you to match the time horizon of each goal—the length of your investment period—with investments that have an appropriate balance of risk and potential reward. (Setting goals serves another very important purpose: As the markets rise and fall, you may be tempted to alter your investment strategy. A clear set of goals helps to keep you on course.)

For example, don't include stock funds in a portfolio designed to pay for a spending goal that's one or two years away. Stocks are highly volatile in the short run, and a market decline could cause losses just before you need your money. Yet stocks may be totally appropriate for a goal that is many years away. While stock prices do fluctuate considerably in the short run, history shows that—over long periods—the range of returns has been muted, as shown in **Figure 3**.

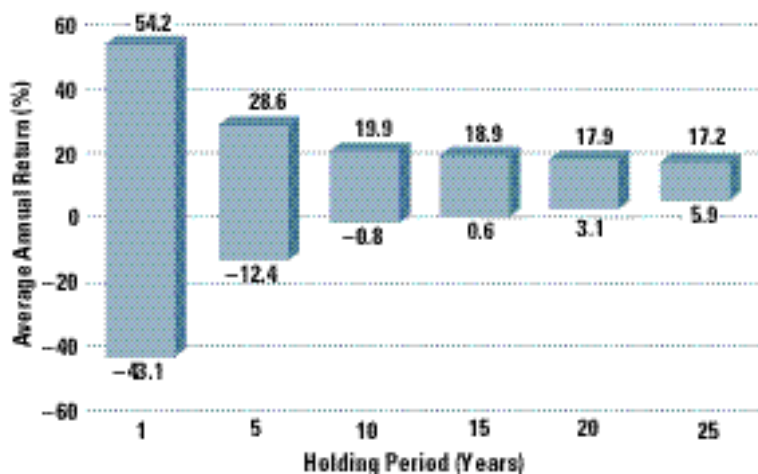
As this point suggests, your time horizon is crucial to the decision about the kinds of assets to include in your portfolio. In some cases your time horizon might start with an initial investment and end when funds are withdrawn all at once (for example, to make a home down payment). In other cases, it includes a period of withdrawal (such as for college tuition payments or for retirement income) during which you would continue to be invested.

Consider a newly retired couple, both age 65. The average life expectancy of a man that age is 16.0 years, whereas for a woman it is 19.2 years.\* Some of their retirement savings may be needed in the next few years, so a portion of their investments should be in stable investments such as money market funds. Some of their investments should be in bond funds in order to produce a durable stream of income. But some of the savings will be needed in a decade or more, so these assets should be invested in stock funds, which are likely to provide higher long-term returns and some protection against inflation.

Many people, of course, have more than one investment objective. So you might view your total portfolio as two or three smaller portfolios, each with a different time horizon and corresponding mix of assets.

Figure 3

### Range of returns on common stocks: 1926–2000



Total returns produced by stocks have varied greatly over the short run, as shown above. Historically, however, total returns have been more consistent over longer periods—a key advantage of long-term investing. But there's still risk: Long-term returns in future years could be higher or lower than the ranges shown.

Stock investments are represented by returns of the Standard & Poor's 500 Index (S&P 500 Index).

Source: The Vanguard Group.

\*Source: National Vital Statistics Reports, United States Life Tables, 1998; *National Center for Health Statistics*, 2001.

## Risk tolerance and your personal financial situation

Your personal financial situation—job status, major upcoming cash outlays, the extent of your emergency savings, and your investment experience—and your ability to tolerate investment risk are additional elements to consider. They're the most personal elements shaping your asset mix. Two investors with identical goals and time horizons could choose significantly different asset mixes if they have different views of risk. For example, one of the investors might feel comfortable with a portfolio that has as much as 80% in stocks. Yet the other investor might consider a portfolio that is 50% stocks to be overly aggressive.

There's no simple answer to how your risk tolerance or financial situation will affect your asset allocation. It takes time—and some experience with investing—to understand your ability to accept risk and your willingness to ride out short-term losses in pursuit of potential long-term gains. The volatility of a fund's total return could be a key factor in your decision to invest (or not invest) in a particular fund. Reviewing a fund's year-by-year results can be a useful way to gauge how much a fund's returns have fluctuated in the past—and whether you'd be comfortable as an investor in that fund.

If it seems difficult to consider all four factors needed to determine an appropriate asset allocation (investment objective, time horizon, risk tolerance, and personal financial situation), the Investor Questionnaire on pages 7 and 8 can help. The Questionnaire and the sample portfolios on the following pages take those four factors into consideration and can offer some guidance in designing an investment portfolio that is appropriate for a *specific* goal.

## Investor Questionnaire

This questionnaire is designed to help you choose an appropriate asset allocation strategy for each of your investment goals. Answer these questions with a specific goal in mind—retirement, for example. Because you will likely have a number of investment goals, you should fill out the questionnaire more than once, with a different goal in mind each time. Our Investor Questionnaire is not designed for goals that would require you to spend all of your money for the goal in two years or less. Savings for short-term objectives should be invested in stable investments—primarily cash investments like money market funds.

For each of your investment goals, answer the questions below, then add up your points and record the number at the bottom of page 8. Now match the total points with one of the asset allocations suggested on page 9. Once you have decided on an asset allocation for each goal, you can begin to consider specific mutual funds.

### 1a. I plan to begin taking withdrawals from this portfolio in . . .

- a. Less than 1 year (0 points)
- b. 1 to 2 years (1 point)
- c. 3 to 5 years (4 points)
- d. 6 to 10 years (7 points)
- e. 11 to 15 years (12 points)
- f. More than 15 years (17 points)

Points:

### 1b. I plan to spend the money in this portfolio over a period of . . .

- a. 2 years or less (0 points)
- b. 3 to 5 years (1 point)
- c. 6 to 10 years (3 points)
- d. 11 to 15 years (5 points)
- e. More than 15 years (8 points)

Points:

### 2. When making a long-term investment, I plan to hold the investment for . . .

- a. 1 to 2 years (0 points)
- b. 3 to 4 years (1 point)
- c. 5 to 6 years (3 points)
- d. 7 to 8 years (5 points)
- e. 9 or more years (7 points)

Points:

### 3. In October 1987, stocks fell more than 20% in one day. If I owned an investment that fell by 20% over a short period, I would . . . [if you owned stocks in October 1987, select the answer that corresponds to your actual behavior]

- a. Sell all of the remaining investment (1 point)
- b. Sell a portion of the remaining investment (3 points)
- c. Hold on to the investment and sell nothing (5 points)
- d. Buy more of the investment (6 points)

Points:

### 4. Generally, I prefer investments with little or no fluctuation in value, and I am willing to accept the lower returns associated with these investments.

- a. I strongly agree (0 points)
- b. I agree (1 point)
- c. I somewhat agree (3 points)
- d. I disagree (5 points)
- e. I strongly disagree (6 points)

Points:

### 5. When the market goes down, I tend to sell some of my riskier assets and put the money in safer assets.

- a. I strongly agree (1 point)
- b. I agree (2 points)
- c. I somewhat agree (3 points)
- d. I disagree (4 points)
- e. I strongly disagree (5 points)

Points:

### 6. I would invest in a mutual fund based solely on a brief conversation with a friend, coworker, or relative.

- a. I strongly agree (1 point)
- b. I agree (2 points)
- c. I somewhat agree (3 points)
- d. I disagree (4 points)
- e. I strongly disagree (5 points)

Points:

### 7. During the first half of 1994, some bond investments fell more than 10%. If I owned an investment that fell by 10% over a short period, I would . . . [if you owned bonds during the first half of 1994, select the answer that corresponds to your actual behavior]

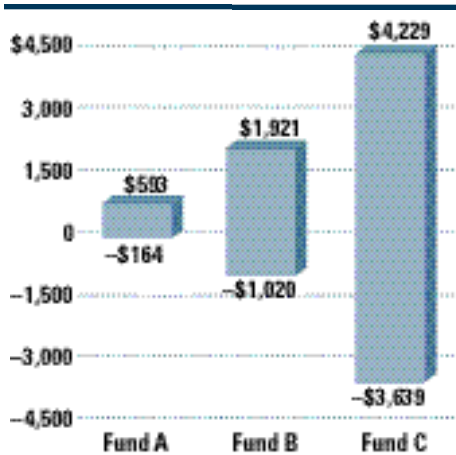
- a. Sell all of the remaining investment (1 point)
- b. Sell a portion of the remaining investment (3 points)
- c. Hold on to the investment and sell nothing (5 points)
- d. Buy more of the investment (6 points)

Points:

8. The chart below shows the greatest one-year loss and the highest one-year gain on three different hypothetical investments of \$10,000.\* Given the potential gain or loss in any one year, where would you invest your money?

- a. Fund A (1 point)
- b. Fund B (3 points)
- c. Fund C (5 points)

Points:



\*The maximum gain or loss on an investment is impossible to predict. The ranges shown in this chart are hypothetical and are designed solely to gauge an investor's risk tolerance.

9. My current and future income sources (such as salary, Social Security, pension plans) are . . .

- a. Very unstable (1 point)
- b. Unstable (2 points)
- c. Somewhat stable (3 points)
- d. Stable (4 points)
- e. Very stable (5 points)

Points:

10. When it comes to investing in stock or bond mutual funds (or individual stocks or bonds), I would describe myself as a/an . . .

- a. Very inexperienced investor (1 point)
- b. Somewhat inexperienced investor (2 points)
- c. Somewhat experienced investor (3 points)
- d. Experienced investor (4 points)
- e. Very experienced investor (5 points)

Points:

Add up your points and record the total point score for each goal below.

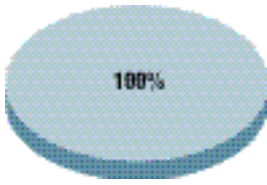
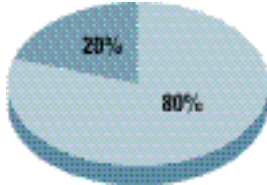
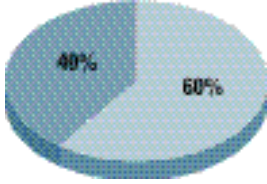
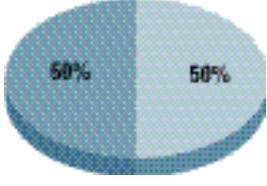
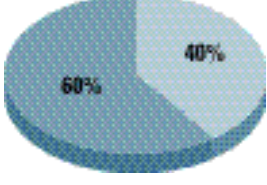
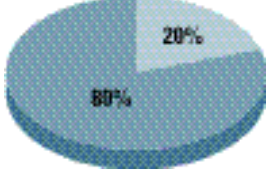
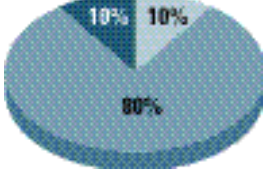
### Asset allocation strategy for your goals

Based on your total point score for each goal, select a suggested mix of asset classes from the table on page 9. The asset mix indicated by each total point score is only a suggestion, and you still might reasonably select a different mix, one with slightly higher or lower risk. Record your choices in the spaces below since you'll need to refer to them when you select specific funds.

Goal	Total Point Score	Asset Allocation
1. _____	_____	<input type="text"/> % stocks <input type="text"/> % bonds <input type="text"/> % cash investments
2. _____	_____	<input type="text"/> % stocks <input type="text"/> % bonds <input type="text"/> % cash investments
3. _____	_____	<input type="text"/> % stocks <input type="text"/> % bonds <input type="text"/> % cash investments

Figure 4

**Choose an asset allocation strategy according to your score\***

Your Total Point Score	Suggested Allocation**	Average Annual Return (1926–2000)	Worst Annual Loss (1926–2000)	Number of Years With a Loss (1926–2000)	Types of Funds to Include in Your Portfolio
69–75		11.0%	–43.1%	21 of 75	<p><b>Stock funds</b> Actively managed growth or value funds, or index funds that track the total stock market or a segment of it.</p>
59–68		10.3%	–34.9%	20 of 75	<p><b>Bond funds</b> Actively managed short-, intermediate-, or long-term corporate, government, or tax-exempt funds, or index funds that track the total bond market or segments of it.</p>
51–58		9.3%	–26.6%	18 of 75	<p><b>Money market funds</b> Actively managed taxable or tax-exempt funds that invest in cash investments issued by governments, corporations, banks, or other financial institutions.</p>
40–50		8.8%	–22.5%	16 of 75	<p><b>Balanced funds</b> Actively managed or index funds that hold a mix of stocks, bonds, and (sometimes) cash investments. This type of “all in one” fund can automatically maintain your target asset allocation through a single investment.</p>
32–39		8.2%	–18.4%	16 of 75	<p>*These are sample portfolio allocations only. Depending on your tolerance for risk or your individual circumstances, you may wish to choose an allocation that is more conservative or more aggressive than the model suggested by your score. Keep in mind that these allocations are for longer-term financial goals. You may very well hold cash investments for shorter-term goals and emergencies.</p> <p>**Cash investments are represented by U.S. Treasury bills, bonds by long-term U.S. corporate bonds, and stocks by the returns of the S&amp;P 500 Index.</p>
23–31		7.0%	–10.1%	13 of 75	
7–22		6.2%	–6.7%	10 of 75	

\*These are sample portfolio allocations only. Depending on your tolerance for risk or your individual circumstances, you may wish to choose an allocation that is more conservative or more aggressive than the model suggested by your score. Keep in mind that these allocations are for longer-term financial goals. You may very well hold cash investments for shorter-term goals and emergencies.

\*\*Cash investments are represented by U.S. Treasury bills, bonds by long-term U.S. corporate bonds, and stocks by the returns of the S&P 500 Index.

**Note:** The returns shown include the reinvestment of income dividend and capital gains distributions; they do not reflect the effects of investment expenses and taxes.

Source: The Vanguard Group.

 Stocks
  Bonds
  Cash Investments

## myth

**When I retire, I should sell all my stocks and buy bonds.**

Stocks actually are appropriate for many retirees. Many people live 20 years or longer after they retire, a time period that's appropriate for long-term stock investing. Therefore, retirement savings should rarely be invested entirely in bonds—unless you need to maximize current income. Stocks should be part of the mix because they provide higher long-term returns than bonds, and they can provide some protection against inflation.

## Make sure you're comfortable with your choice

After you complete the Questionnaire and determine your asset allocation strategy, review the historical returns and losses shown in **Figure 4** on page 9. For example, if your score was between 40 and 50, the asset allocation is 50% stocks and 50% bonds. The average annual return for this asset allocation was 8.8% from 1926 through 2000. During this period, the worst annual return was a loss of 22.5%, and annual losses occurred in 16 of the 75 years.

Before investing in any of the suggested asset allocations, make sure you're comfortable with the number and severity of the short-term losses that allocation has suffered in the past. But keep in mind that past investment performance is no guarantee of future results—your experience could be better or worse than what happened in years past. If the asset allocation suggested by your score on the Questionnaire would cause you to worry or lose sleep, you should choose a less aggressive allocation. You may prefer to put some assets in cash investments for greater stability. Alternatively, your personal situation or risk tolerance may suggest a more aggressive allocation.

The following examples illustrate these points:

- **An investor in his 30s** is saving for retirement, and the Questionnaire suggests an all-stock portfolio. Yet he's leery of the stock market and inexperienced with investments—and sees that this portfolio suffered a decline of more than 43% in one year. He drops down one row in the table and chooses instead to build a portfolio of 80% stocks and 20% bonds.
- **A dual-income married couple in their 40s** wants to accumulate additional savings for retirement in about 20 years. The Questionnaire suggests a portfolio of 80% stocks and 20% bonds. But the husband's job (which provides almost half their income) has become unstable, and they're anxious about their economic future. They choose the allocation one row down, which consists of 60% stocks and 40% bonds.
- **A newly retired couple in their 60s** at first considered a portfolio of 40% stocks and 60% bonds. However, they believe that their Social Security benefits (which are indexed to go up with inflation) and pension benefits are ample for their needs. The couple wants to build a larger estate to benefit their grandchildren. They are comfortable with a more aggressive portfolio, one row higher, consisting of 50% stocks and 50% bonds.

## Changing your asset allocation as your time horizon shortens

The Questionnaire and sample portfolios suggest an initial asset allocation. As the years go by and the time horizon shortens, you should reassess your asset mix and (probably) move to a more conservative allocation. You may want to complete the Questionnaire each year to make sure your asset allocation is still appropriate.

Once you've decided on an asset allocation, you need to understand the types of funds that can be found within an asset class. You can build a portfolio by using a single fund that maintains your desired asset allocation or by investing in multiple funds.

# Before you invest . . .

## Consider costs

All mutual funds have expenses, but some funds are much more costly to own than others. *And there is no evidence that higher costs lead to better performance.* Pay careful attention to the fees and expenses charged by a fund because they directly reduce your investment return. Fund costs fall into two categories: sales charges (or “loads”) and operating expenses.

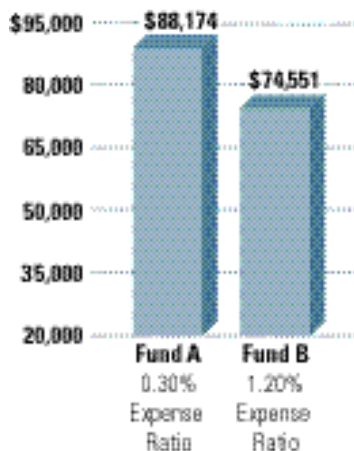
Beware of loads charged up front as a percentage of the sum invested. These “front-end loads” range up to 9%.\* Another sales charge is the “back-end load,” which is applied when an investor sells fund shares. This load may be as high as 6% for a redemption that takes place within a year of the original investment, but it typically declines over time and disappears by the seventh year after the original purchase.

Not all mutual funds impose loads, but all funds have ongoing operating expenses that are deducted from the fund’s income before that income passes through to shareholders. The total of the fund’s annual operating expenses—such as investment advisory fees, legal and accounting services, postage, and telephone service—expressed as a percentage of the fund’s average net assets during the year is known as the expense ratio. Some funds—even some funds that don’t charge a load—add to their operating expenses a “12b-1 fee,” which pays marketing and distribution costs.

Vanguard strives to keep its expenses low and charges neither loads nor 12b-1 fees. The average expense ratio for Vanguard funds in 2000 was 0.27%, compared with 1.30% for the average mutual fund. **Figure 5** shows how costs can affect long-term returns.

Figure 5

### How costs affect returns



Investment expenses can have a major impact on investment returns. For example, over 20 years an investment of \$20,000 in Fund A, with an annual expense ratio of 0.30%, grew to \$88,174. Meanwhile, a \$20,000 investment in Fund B, with an annual expense ratio of 1.20%, grew to only \$74,551. The difference between the two amounts is nearly two-thirds of the value of the original \$20,000 investment.

The example assumes an average annual return of 8% before expenses in a tax-deferred account. All dividends and distributions were reinvested. This is a hypothetical illustration only and should not be considered indicative of the return on any investment.

\*Source: Morningstar, Inc.

# Step 2

## DIVERSIFY WITHIN AN ASSET CLASS

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### *myth*

**I can reduce my risk by holding only large-cap stocks.**

Although large companies generally have greater financial resources than smaller companies, even large-cap stocks have their rough periods. In some years, the best returns have come from stocks of small or midsize companies. For the greatest diversification, don't concentrate all your stock investments in one size sector.

Once you've decided on an appropriate asset allocation, you have one more step before you select specific mutual funds: considering how to allocate your investments within each asset class. A careful sub-asset allocation among the various segments of the stock and bond markets can help you achieve an appropriate balance of risk and potential reward and avoid unnecessary taxes.

Of course, accurately predicting which segment of an asset class will perform best in any given period is difficult—if not impossible. As a result, Vanguard suggests that shareholders consider investing in all the segments of an asset class—to avoid having an unintended “bet” on one segment or another. That strategy ensures that you never have 100% of assets invested in the poorest-performing segment, and you always have some assets invested in the best-performing segment.

The following section outlines the issues you should consider in building a *well-diversified* portfolio.

### **Determine a sub-asset allocation for stocks**

The domestic stock market can be segmented in two key ways: by size of companies and by style of investing. Both are important considerations in choosing an appropriate mix of stock investments.

### **Consider market capitalization**

The size of a company is typically measured by market “cap”—its stock price multiplied by the number of shares outstanding. (If a company has 1 million shares outstanding selling for \$10 a share, then it has a market cap of \$10 million.) Over short periods, total returns can vary significantly from one segment to another: In 1999, for example, the return for large-cap stocks was 21%; for mid-cap stocks, 18.2%; and for small-cap stocks, 21.3%. In contrast, the total returns during 2000 were -9.1% for large-cap stocks, 8.3% for mid-cap stocks, and -3.0% for small-cap stocks.\*

In general, the stock prices of small- and mid-cap companies have tended to provide higher long-term returns, but with significantly more price volatility than large-cap companies. Investors who want dividend income, however, may want to focus on large-cap companies because they historically have been somewhat more likely to pay dividends. While there are no exact definitions, Vanguard currently considers large companies to be those having a market cap over \$13 billion, mid-cap companies as those having a cap of \$1.5 billion to \$13 billion, and small-cap companies as having a cap of less than \$1.5 billion.

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\*Large-cap stocks as measured by the S&P 500 Index, whose weighting is dominated by large-cap stocks; small- and mid-cap stocks as measured by the Russell 2000 and Russell Midcap Indexes, respectively.

How should you divide stock investments among large-, mid-, and small-cap stocks? Vanguard suggests following their market weightings, which would help to keep investment returns in line with the performance of the *entire* U.S. stock market. Large companies make up 69% of the total stock market capitalization, mid-cap stocks represent 23%, and small-cap stocks are the remaining 8%.\*

### Consider investment style

The next consideration is investment style: growth stocks versus value stocks. Growth-oriented stock funds look for companies that, due to their strong earnings and revenue potential, offer above-average prospects for capital growth. In contrast, value-oriented stock funds seek companies that, given their assets and earnings history, are attractively priced—perhaps because they are “out of favor” or because investors have low expectations for them. While investors in growth stocks and value stocks are both seeking capital gains, there are significant differences between these two styles:

#### Growth stocks

Lower or no dividends  
High price/earnings ratio  
More total return volatility

#### Value stocks

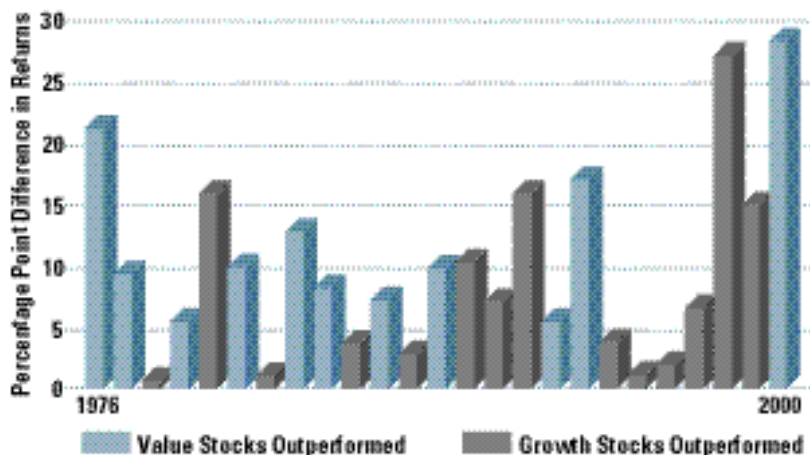
Higher dividends  
Low price/earnings ratio  
Less total return volatility

While growth and value stocks have, in the past, provided similar long-term returns, there have been long periods when one has outperformed the other, as shown in **Figure 6**. In general, value investing appeals more to those who want some dividend income with the potential for capital growth with *relatively* less stock-price volatility. Growth investing appeals to those who can tolerate larger stock-price fluctuations in hope of a greater capital return. To ensure that long-term total returns do not vary greatly from those provided by the total stock market, some investors divide stock investments equally between growth and value stock funds.

Because value stock funds usually provide more dividend income, you may want to emphasize those funds in tax-deferred accounts such as individual retirement accounts (IRAs). You might emphasize growth stock funds in taxable accounts because more of those funds’ returns is likely to come from capital appreciation, which may be taxed at lower rates than dividend income.

Figure 6

### Growth versus value stocks: 1976–2000



At times, value stocks may produce higher returns than growth stocks, and at other times growth stocks may outperform value stocks. This chart compares the difference in returns between the two types of stocks. In 2000, for example, value-stock returns were on average about 28 percentage points higher than growth-stock returns. But in 1998, growth stocks outperformed value stocks by an average of 27 percentage points. Including both types of stocks in a portfolio aids diversification.

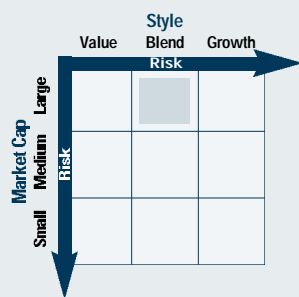
Stock investments are represented by the returns of the S&P 500/BARRA Growth Index and the S&P 500/BARRA Value Index.

Source: Standard & Poor’s/BARRA.

\*Source: Wilshire Associates Incorporated, December 31, 2000.

## A useful tool to show a stock fund's focus

"Style boxes" such as the one below are often used to illustrate the investment focus of a stock mutual fund. A growth fund that invests primarily in small companies would be placed in the box at the lower right-hand corner, where the "Growth" column intersects the "Small" row. A broadly diversified index fund that invests in both growth and value large-cap stocks would be placed in the middle box in the top row, where "Blend" (a mix of value and growth investing) intersects "Large." When reading such tables, keep in mind that they reflect only the dominant characteristics of funds. An index fund that tracks the entire U.S. stock market (small, medium, and large companies) would end up in the same box (as shown below) as a blended large-cap stock fund, because about 65% of the total stock market fund's holdings would be large-cap stocks. You can use style boxes to evaluate a portfolio and to see where you may have overlapping funds that invest in the same market segment using the same investment style.



## International investing

Once you have a well-defined portfolio of domestic stocks, you may wish to consider international stock funds. The primary reason for doing so is to add yet another dimension of diversification to your portfolio and, thereby, reduce its longer-term volatility. Foreign investments, however, carry risks not found with domestic stock funds.

### The benefits of foreign investments

The opportunity to decrease the overall risk of an all-U.S. stock portfolio by investing abroad arises from the fact that U.S. and foreign stock markets have often moved in different directions at different times, or in the same direction but by different magnitudes. Economies around the world are far from synchronized—economic policies, growth rates, inflation, interest rates, currency values, and investor perceptions still differ considerably from one country to another.

Whether investing abroad also offers the possibility of higher returns compared with domestic stocks depends on the same variety of factors. For the decade ended in 2000, for example, U.S. stocks strongly outperformed international stocks: Domestic stocks that make up the Wilshire 5000 Total Market Index earned an average annual return of 17.0% versus only 8.6% for the foreign stocks in the Morgan Stanley Capital International Europe, Australasia, Far East (EAFE) Index. Yet for the ten years through year-end 1992, the MSCI EAFE Index's average annual return of 17.1% surpassed the Wilshire 5000 Total Market Index's 15.4% return.\*

How much of a portfolio should be invested abroad? As of year-end 2000, international stocks represented 52% of the world stock market, and U.S. stocks 48%.\*\* But because of the extra risks of investing abroad, Vanguard suggests that international investments account for no more than 20% of an aggressive stock portfolio—and less in more conservative portfolios. A greater proportion in international funds can unnecessarily increase the risk of the overall stock portfolio.

\*The performance of an index is not representative of any particular investment, because you cannot invest in an index. The benchmark comparative indexes represent unmanaged or average returns on various financial assets, which can be compared with the funds' total returns for the purpose of measuring relative performance.

\*\*Source: Morgan Stanley Capital International All-Country Index.

## The risks of international investments

Investing abroad entails additional risks. Foreign companies and stock exchanges do not follow the same rules and regulations as U.S. companies and exchanges, and they are generally subject to less government supervision. Be aware that a foreign investment is also subject to the following risks:

- **Country risk** Political events (a war or an election), financial problems (inflation or government default), or natural disaster (an earthquake or a flood) could weaken a country's economy and cause investments in that country to lose money. Of course, an unexpected positive event could also improve a country's economy and bolster investment returns.
- **Currency risk** An increase in the value of the U.S. dollar against other currencies would reduce returns for Americans who have invested abroad. All else being equal, when the dollar rises in value against a foreign currency, an investment in that country loses value for U.S. investors because the foreign currency is worth fewer dollars. Conversely, a decline in the value of the dollar generally leads to higher dollar returns for Americans holding foreign investments.

## Two types of foreign stock markets

Some foreign countries have advanced economies and well-established stock markets—just like the United States. Other countries are still developing from an agricultural or socialist economy toward an industrial free market and have a stock market that, perhaps, was only recently created. These markets are known as emerging markets.

Although short-term returns can vary significantly in many periods, there's no inherent reason for investments in developed markets overseas to provide higher returns than U.S. stocks over long periods. Keep in mind that, during periods of market distress such as in October of 1997, international stock markets tend to be more synchronized, so much of the benefit of diversification is lost.

The potentially faster economic growth in developing countries may offer the possibility for greater long-term returns than advanced economies. Emerging markets, however, carry significantly higher risks. In 2000, the average emerging markets stock fund lost 30.5%.\* Because of the additional risk, Vanguard suggests that individuals with an aggressive portfolio invest no more than 15% of their *international* holdings in emerging markets—with a 5% cap in any given emerging market. Those with more conservative portfolios should invest less or none at all in emerging markets.

\*Based on data provided by Lipper Inc.

*myth*  
I've had great luck  
with the mutual funds  
I own. There's no  
need to change.

Sticking with the same funds (or the same kinds of funds) you have owned for years is an easy way to invest. But you may reduce your exposure to risk—and possibly increase your overall returns—if you have a more diversified portfolio. You should also consider whether the funds are still appropriate as the time to spend the investment draws near. While a fund may have performed well, it may no longer be right for your investment goal.

*How*  
**Vanguard**  
*can help*

### There are several ways to invest internationally.

Broad-based funds, such as Vanguard® Total International Stock Index Fund (which invests in developed countries in Europe and the Pacific as well as in emerging markets), provide investors with exposure to many countries. Other funds invest in specific countries or geographic regions. Call **1-800-662-7447** to order a prospectus.

## Determine a sub-asset allocation for bonds

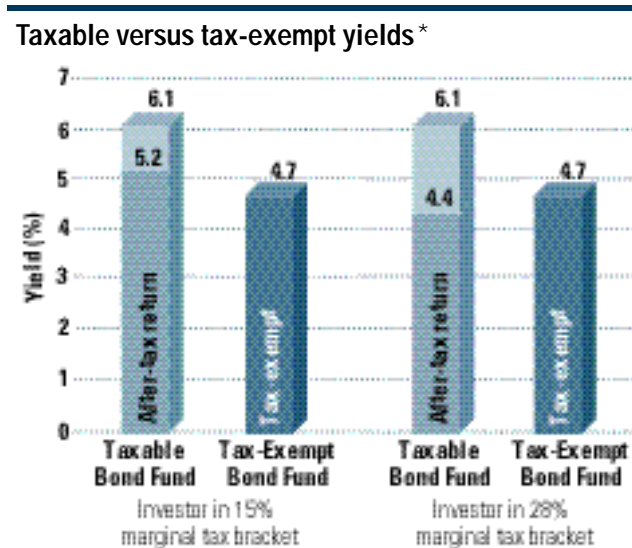
The bond market can be divided into taxable and tax-exempt bonds, and both of those segments can be subdivided into bonds of longer or shorter maturities or bonds of higher or lower credit quality. Each of these factors should be considered in building a sound bond portfolio.

### Taxable versus tax-exempt (municipal) bond funds

Some investors in a high tax bracket (28% or higher) may obtain a higher *after-tax* yield by investing in tax-exempt bond funds—even though the yield on those funds is lower than the pre-tax yield on comparable taxable funds. (Only the interest income from these funds is exempt from federal income tax; the interest income may be subject to state and local taxes. Any capital gain that results from an investment in a tax-exempt fund is still subject to tax. Note also that investments in certain tax-exempt bonds whose proceeds are used to fund private, for-profit organizations may subject the taxpayer to the federal alternative minimum tax.)

Bond fund investors should check their marginal tax rates to determine whether a tax-exempt fund or a taxable fund continues to be appropriate. At times, the

Figure 7



Whether a tax-exempt bond fund or a taxable bond fund provides the highest yield to investors depends on their tax bracket. Note how the taxable fund's yield of 6.1% becomes an after-tax yield of 5.2% for investors in the 15% bracket. This makes the tax-exempt yield of 4.7% unattractive. For investors in the 28% tax bracket, however, the same taxable investment provides an after-tax yield of 4.4%. In this case, the tax-exempt fund is the higher-yielding alternative. Yields are ten-year average yields, as of 2000, for municipal bond funds and diversified taxable bond funds of intermediate maturity.

\*The information shown is hypothetical and does not represent the returns from any particular investment.

yields on municipal bonds compared with taxable bonds may be attractive even for investors at lower marginal tax rates. To decide whether you should invest in a taxable or tax-exempt bond fund, use this formula to determine the “taxable-equivalent yield” of the tax-exempt fund:

$$\text{Taxable-equivalent yield} = \frac{\text{Tax-exempt yield}}{100\% - \text{your tax bracket}}$$

If the taxable-equivalent yield of a tax-exempt bond fund is higher than the yield on a taxable fund with a similar maturity, then you may wish to invest in the tax-exempt fund. If the yield of the taxable fund is higher, then the taxable fund would provide the higher yield even after paying taxes. For an example, see **Figure 7**.

**Note:** Tax-exempt bond funds should never be used in a tax-deferred account such as an IRA, because tax-deferred accounts already shield earnings from taxes. Putting a bond with a usually higher taxable interest yield into a tax-deferred account is a better idea.

## Short-, intermediate-, or long-term maturities

Investors should also consider the average maturity of a bond fund, because longer-term bond funds usually provide higher and more stable interest income—but they also fluctuate more in value. Bond funds can be classified as short-term (average maturity less than 5 years), intermediate-term (average maturity 5 to 10 years), and long-term (average maturity more than 10 years).

In recent years, intermediate-term bond funds have provided most of the yield of long-term bond funds, with less of the price volatility. For that reason, many bond fund investors choose to maintain a bond portfolio with an average maturity of between 5 and 10 years. This does not require investing solely in intermediate-term bond funds—you can use a mix of short-, intermediate-, and long-term bond funds.

Some investors choose to use *short-term, high-quality* bond funds as an alternative to money market funds. While this strategy can provide higher returns, it does entail a modest risk that the investor could lose some principal because of fluctuating bond prices.

## The importance of credit quality

Credit quality refers to a bond issuer's ability to repay the interest and principal of its bonds. The highest-quality bonds are U.S. Treasury securities, followed by other U.S. government bonds, and then by high-quality corporate bonds.

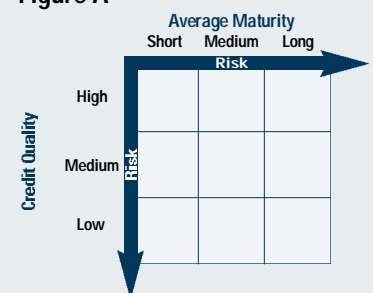
In general, lower-quality bonds must pay a higher interest rate to offset the increased risk that principal and interest won't be paid in full and on time. Because of that, bond funds that hold high-quality corporate bonds generally provide higher current income than U.S. government bond funds with similar maturities. By investing more assets in well-diversified, high-quality corporate bond funds than in government bond funds, investors may obtain a higher yield with a relatively small amount of additional risk. (However, investors who live in states with high income-tax rates may want to consider a U.S. Treasury bond fund, because the interest income on those bonds is generally not subject to state income taxes.)

## Useful tools to show the focus of bond funds

Just as style boxes can be used to illustrate the investment focus of a stock mutual fund, so too can they be used for bond funds. Bond style boxes typically classify mutual funds according to the credit quality of the bonds held in the fund and the average maturity of the bonds (the average amount of time until principal and interest are due to be fully paid on the bonds).

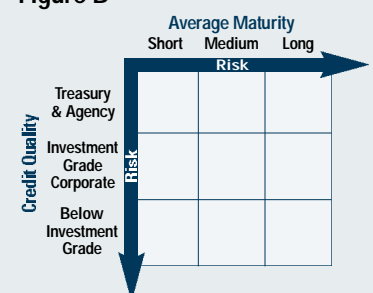
Credit quality is typically listed as High, Medium, and Low as shown in **Figure A** below. Vanguard publications use this type of style box to show the investment focus of tax-exempt bond funds.

**Figure A**



We use a slightly different style box for taxable bond funds—the one in **Figure B**. Credit quality is divided into Treasury & Agency (U.S. government bonds—the highest quality), Investment-Grade Corporate (the next-highest quality), and Below Investment-Grade Corporate (low quality).

**Figure B**



## myth

### If I own many funds, I have all the diversification I need.

Maybe not. If you buy funds with the same investment objective and similar holdings, you've simply duplicated, not diversified, your investments. You could diversify easily in other ways by holding a few funds that have different investment styles or that cover different market segments. It's even simpler, and possibly less expensive, to hold a broad-based index fund. Holding too many funds can be an administrative headache as you try to keep tabs of each fund's performance and handle all the statements and other documents.

Two other risks involved in bond fund investing are:

- **Interest rate risk** Bond prices rise and fall because of changes in interest rates. When interest rates rise, bond prices fall. Conversely, when interest rates fall, bond prices rise. This risk may be lowered by holding shorter-term as opposed to longer-term bond funds.
- **Income risk** As interest rates change, the income provided by money market and bond funds will also change. This risk is lower for longer-term bond funds than it is for shorter-term bond funds or money market funds.

### Other fixed income funds

Two alternative types of funds are available to investors who are willing to take on additional risk. Those funds invest in:

- **Mortgage-backed securities such as "Ginnie Maes."** While these funds may provide higher yields, they also have prepayment risk, which is the possibility that the securities may be paid off early if interest rates decline. Of course, if the securities are paid off early, investors are forced to reinvest at a lower yield. Ginnie Maes are backed by the full faith and credit of the U.S. government and so have no credit risk.
- **High-yield (lower-quality) corporate bonds** These funds (also known as "junk bond" funds) provide higher yields than other corporate bond funds, but they have significant credit risk, which is the danger that the bond issuers will not pay interest or principal, and—in some cases—call risk, which is the possibility that the issuer will redeem the bond before maturity. High-yield corporate bonds are significantly more risky than other corporate bond funds. Because of the greater risk, Vanguard suggests that no more than 10% of *total* assets in an aggressive portfolio be invested in high-yield corporate bond funds—and more conservative portfolios should have less or none at all.

### Asset allocation in a single fund

Not all mutual funds invest solely in stocks or solely in bonds. Some, called "balanced funds," invest in a mix of stocks, bonds, and (sometimes) cash investments. Balanced funds can provide a convenient way to achieve a desired asset allocation with a single investment. Keep in mind, however, that not all balanced funds are alike.

Some traditional balanced funds invest in a stable mix of assets, while others maintain asset allocations that fall within a predetermined range. (For instance, Vanguard® Wellington™ Fund invests 60% to 70% of assets in common stocks and 30% to 40% in corporate bonds.) In either case, the fund manager periodically rebalances the portfolio to achieve the desired asset mix. Because this rebalancing may sometimes be accomplished with asset purchases using money from new shareholders, a balanced fund may be able to avoid the sale of assets that would cause a taxable capital gain. In contrast, an investor who holds both a stock fund and a bond fund may periodically have to sell shares in one fund (the one with the higher recent return) to purchase shares in the other fund. Without this rebalancing, the investor would lose the desired asset allocation.

Other balanced funds, known as “asset allocation funds,” do not maintain a stable allocation of stocks, bonds, and cash investments. Instead, such a fund periodically changes its mix of assets in an effort to get the best mix of risk and return.

You can also diversify your asset mix through a balanced “fund of funds,” which is a mutual fund that invests in other mutual funds.

### **Beyond your initial asset allocation**

Once you have chosen asset allocations that are consistent with your various investment objectives, time horizons, risk tolerance, and personal financial situation, you may want to decide how to invest additional assets. The simplest choice is to continue with your existing fund choices and asset allocations. Because those allocations were carefully selected to meet your needs, that is probably the best choice.

Some investors, however, take another route—and invest the additional assets in market segments they believe will outperform the market as a whole. For instance, if you believe that small-cap stocks are likely to outperform large-cap stocks in the near future, then some of the additional assets might be invested in a small-cap fund. Or, if you believe that a particular industry may do well, then you might invest in a specialized fund that focuses on a single industry, such as health care or energy. Since no one can accurately predict the future, no more than a small portion of your total assets (less than 10%) should be invested in an industry-specific fund. Your core portfolio should still provide an appropriate balance of risk and return based on your unique investment needs and your investment personality.

You could also vary the investment approach: If your portfolio consists primarily of index funds, then you might consider also investing in actively managed funds.

If you decide to take on additional risk by investing in a specific market segment or industry, make certain that you understand the risks involved—and that you are comfortable with those risks. Investors who do not understand what to reasonably expect from an investment are usually disappointed in its performance.

## *How* **Vanguard** *can help*

Vanguard offers four mutual funds that will help you diversify your asset mix through a “fund of funds” approach. Our four LifeStrategy® Funds invest in as many as five other Vanguard funds. Each of the funds consists of a different mix of stocks and bonds. Such a balanced fund may be suitable for an investor who has a limited amount to invest for a particular goal but who still wants a properly allocated investment portfolio. Call **1-800-662-7447** to order a prospectus.

# Before you invest . . .

## Consider index funds or actively managed funds

Once you have selected an asset allocation, you can carry out your planned asset mix through two basic investment approaches. You may choose index funds or actively managed funds—or both. Each type of fund has specific advantages and disadvantages.

Index funds seek to match the performance of a specific target market index (or benchmark) that measures the total market capitalization of the stock or bond market or a segment of the stock or bond market. Perhaps the best-known index is the Standard & Poor's 500 Index, or S&P 500 Index. A sampling of other benchmarks appears in **Figure 8**.

In trying to match a market index, the manager of an index fund buys and holds all (or a representative sample) of the securities in a particular market index. In contrast, managers of actively managed funds seek to surpass the performance of indexes. Using various methods, active fund managers choose stocks or bonds that they find attractive, then sell them when they appear to have reached their highest potential.

Some investors favor an actively managed fund in hopes that it will provide above-market returns. Others prefer a low-cost index fund because few professional managers can beat the market consistently. Over the last ten years, the overall U.S. stock market (as represented by the Wilshire 5000 Total Market Index) outperformed 61% of all actively managed stock funds.

Figure 8

### Some well-known stock and bond benchmarks

All U.S. stocks	Wilshire 5000 Total Market Index
Large-cap U.S. stocks	Standard & Poor's 500 Index
Small- and mid-cap U.S. stocks	Wilshire 4500 Completion Index
Small-cap U.S. stocks	Russell 2000 Index
International stocks (excluding emerging markets)	Morgan Stanley Capital International Europe, Australasia, Far East (EAFE) Index
Emerging markets	Morgan Stanley Capital International Emerging Markets Free Index
All U.S. bonds	Lehman Aggregate Bond Index
Short-term investment-grade bonds	Lehman 1–5 Year Government/Credit Index
Intermediate-term investment-grade bonds	Lehman 5–10 Year Government/Credit Index
Long-term investment-grade bonds	Lehman Long Government/Credit Index

Some investors are unsure which investment approach is best, so they hedge their bets by owning both actively managed and index funds. Vanguard suggests that at least 50% of a long-term investor's stock portfolio should be invested in broadly diversified index funds.

Index funds have definite advantages that include:

- **Consistency.** Index fund returns attempt to provide returns that closely parallel the returns of fund benchmarks (less the cost of investing). The returns of actively managed funds are far more unpredictable relative to their target benchmarks.
- **Broad diversification.** Wide diversification minimizes the impact of a dramatic drop in a specific security or industry. The holdings of an actively managed fund may be concentrated in far fewer securities.
- **Low costs** The low expense ratios and low turnover rates, as compared with actively managed funds, have helped index funds beat actively managed funds eight out of the last ten years.\*
- **Simplicity.** Index funds have clear investment policies—stock index funds only invest in stocks, bond index funds only in bonds—unlike many actively managed funds whose investment strategies may change.
- **Tax efficiency.** Index funds' buy-and-hold strategies make them less likely than actively managed funds to incur taxable gains from the sale of securities, increasing after-tax earnings.
- **Competitive performance** Over the last ten years, the average broad stock market index fund has outperformed the average general equity fund by nearly 0.57%.\*\*

There is a potential disadvantage as well. It's possible for an active fund manager to outperform a market index, sometimes by a considerable margin. But such market-beating performance is rarely achieved consistently, and it's difficult to pick a top-performing manager in advance.

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\*Source: Lipper Inc.

\*\*Source: Derived from data provided by Lipper Inc.

# Step 3

## CONSTRUCT A PORTFOLIO

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### *myth*

#### The best fund to invest in is today's top performer.

Past or present performance—whether good or bad—offers no guarantee of a fund's future rate of return. In fact, it's common for a fund to lose a top ranking from one quarter or year to another. You do have to consider a fund's returns, of course. But consistency against its benchmarks and comparable funds over long time periods is a better measure. (Again, there's no assurance of future returns.) More important than return, however, is whether the fund's objective fits into your planned asset allocation.

We've provided a worksheet on page 23 that can help you to evaluate the allocations in an existing portfolio or to plan the allocations in a new portfolio. The listing of Vanguard funds on pages 25 and 26 shows the *primary* investment focus of each Vanguard fund; this can help you to determine your existing allocations—or to select funds as you revise or create a portfolio. These tools are intended to give you a general overview of your portfolio—not to guide you to a specific sub-asset allocation.

By paying attention to sub-asset allocation, you can ensure that a portfolio is properly diversified among market segments, and you can avoid having two or more funds that invest in the same market segment using the same investment style.

*Keep in mind that you do not need to invest in all or even most of the fund types listed on the worksheet.* For instance, a younger person investing for a retirement that is many years away might reasonably design a portfolio with large- and mid-cap stock funds and no bond funds at all. Or the bond portion of a portfolio might consist solely of an intermediate-term corporate bond fund. Of course, before selecting any fund, you should read its prospectus carefully.

Some individual funds span several segments of an asset class, and some investors might choose such a fund to cover an entire asset class. For instance, Vanguard® Total Stock Market Index Fund seeks to match the performance of the entire U.S. stock market, including small-, mid-, and large-cap stocks, as well as both the growth and value styles of investing. Vanguard Total International Stock Index Fund seeks to match the performance of foreign stock markets with investments in both developed and emerging markets. Vanguard® Total Bond Market Index Fund tracks the entire U.S. bond market by investing in high-quality government and corporate bonds, as well as mortgage-backed securities.

Not all funds will fit neatly into the worksheet provided. For instance, some balanced funds may change the percentages of bonds and stocks they hold, while some global funds may alter the percentages of foreign and domestic securities that they hold. In addition, some specialized (industry-specific) funds may invest in a changing mix of securities. You can check a fund's most recent annual or semiannual report for information on its mix of assets.

**Note:** Before selling any fund shares, consider the tax consequences as well as any fees or commissions you might incur. You may be able to reach a desired asset allocation within a short time (such as a year or two) simply by directing new investments to specific funds—without selling any shares. Vanguard suggests that you not adjust your asset allocation unless it is at least five percentage points off your target asset allocation. (If your desired asset allocation is 25%, do not rebalance the portfolio until the actual asset allocation is more than 30% or less than 20%.)

## Developing your portfolio

The first two columns, *Current sub-allocation*, is where you list the amount you have invested in each type of fund, as well as the percentage of your total portfolio that investment represents. Under the heading *Proposed sub-allocation*, enter your strategic asset allocation percentages in the shaded boxes. Then fill out the rest of the two columns based on your desired sub-asset allocation. Finally, figure out the differences between your current sub-asset allocation and your proposed sub-asset allocation to complete the last column, *Changes*. Keep in mind that you do not need to invest in all or even most of the fund types listed.

Strategic asset allocation						
(From Figure 4, page 9)						
		Stocks <input type="text"/> %	Bonds <input type="text"/> %	Cash <input type="text"/> %		
	Current sub-allocation		Proposed sub-allocation		Changes	
	Dollar value	Percentage of portfolio	Dollar value	Percentage of portfolio	Dollar value	
<b>Stocks</b>						
<b>Domestic</b>						
Large-cap value	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Large-cap blend	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Large-cap growth	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Mid-cap value	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Mid-cap blend	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Mid-cap growth	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Small-cap value	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Small-cap blend	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Small-cap growth	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
<b>International/Global</b>						
Developed markets	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Emerging markets	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
<b>Stock Total</b>	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
<b>Bonds</b>						
Taxable short	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Taxable intermediate	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Taxable long	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Corporate high-yield	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Municipal short	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Municipal intermediate	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Municipal long	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
Municipal high-yield	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
<b>Bond Total</b>	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %	+/- \$ <input type="text"/>	
<b>Cash Investments</b>						
<b>Cash Total</b>	\$ <input type="text"/>	<input type="text"/> %	\$ <input type="text"/>	<input type="text"/> %		
<b>Portfolio Total</b>	\$ <input type="text"/>	100%	\$ <input type="text"/>	100%		

## A listing of Vanguard® funds

### Stock funds

#### Domestic

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##### *General*

500 Index Fund  
Calvert Social Index™ Fund  
Convertible Securities Fund  
Equity Income Fund  
Growth and Income Fund  
Growth Index Fund  
Morgan™ Growth Fund  
Strategic Equity Fund  
Tax-Managed Capital  
Appreciation Fund  
Tax-Managed Growth and  
Income Fund  
Total Stock Market Index Fund  
U.S. Growth Fund  
U.S. Value Fund  
Value Index Fund  
Windsor™ Fund  
Windsor™ II Fund

##### *More aggressive*

Capital Opportunity Fund\*  
Explorer™ Fund  
Extended Market Index Fund  
Growth Equity Fund  
Mid-Cap Index Fund  
PRIMECAP Fund\*  
Selected Value Fund  
Small-Cap Growth Index Fund  
Small-Cap Index Fund  
Small-Cap Value Index Fund  
Tax-Managed Small-Cap Fund

##### *Industry-specific*

Energy Fund  
Gold and Precious Metals Fund  
Health Care Fund  
REIT Index Fund  
Utilities Income Fund

##### *International/global*

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Developed Markets Index Fund  
Emerging Markets Stock Index Fund  
European Stock Index Fund  
Global Equity Fund  
International Growth Fund  
International Value Fund  
Pacific Stock Index Fund  
Tax-Managed International Fund  
Total International Stock Index Fund

\*Closed to new investors.

### Bond funds

#### Taxable

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##### *Short-term*

Inflation-Protected Securities Fund  
Short-Term Bond Index Fund  
Short-Term Corporate Fund  
Short-Term Federal Fund  
Short-Term Treasury Fund

##### *Intermediate-term*

GNMA Fund  
High-Yield Corporate Fund  
Intermediate-Term Bond Index Fund  
Intermediate-Term Corporate Fund  
Intermediate-Term Treasury Fund  
Total Bond Market Index Fund

##### *Long-term*

Long-Term Bond Index Fund  
Long-Term Corporate Fund  
Long-Term Treasury Fund  
Preferred Stock Fund

#### Tax-exempt

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High-Yield Tax-Exempt Fund  
Insured Long-Term Tax-Exempt Fund  
Intermediate-Term Tax-Exempt Fund  
Limited-Term Tax-Exempt Fund  
Long-Term Tax-Exempt Fund  
Short-Term Tax-Exempt Fund

##### *State-specific*

California Insured Intermediate-Term  
Tax-Exempt Fund  
California Insured Long-Term  
Tax-Exempt Fund  
Florida Insured Long-Term  
Tax-Exempt Fund  
Massachusetts Tax-Exempt Fund  
New Jersey Insured Long-Term  
Tax-Exempt Fund  
New York Insured Long-Term  
Tax-Exempt Fund  
Ohio Long-Term Tax-Exempt Fund  
Pennsylvania Insured Long-Term  
Tax-Exempt Fund

### Balanced funds

#### Domestic

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Asset Allocation Fund  
Balanced Index Fund  
LifeStrategy® Conservative  
Growth Fund  
LifeStrategy® Growth Fund  
LifeStrategy® Income Fund  
LifeStrategy® Moderate  
Growth Fund  
STAR™ Fund  
Tax-Managed Balanced Fund  
Wellesley® Income Fund  
Wellington™ Fund

#### International/global

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Global Asset Allocation Fund

### Money market funds

#### Taxable

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Admiral™ Treasury Money  
Market Fund  
Federal Money Market Fund  
Prime Money Market Fund  
Treasury Money Market Fund

#### Tax-exempt

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Tax-Exempt Money Market Fund

##### *State-specific*

California Tax-Exempt  
Money Market Fund  
New Jersey Tax-Exempt  
Money Market Fund  
New York Tax-Exempt  
Money Market Fund  
Ohio Tax-Exempt Money  
Market Fund  
Pennsylvania Tax-Exempt  
Money Market Fund

## Vanguard funds by market segment

Domestic stock funds									
	Large-cap growth	Large-cap blend	Large-cap value	Mid-cap growth	Mid-cap blend	Mid-cap value	Small-cap growth	Small-cap blend	Small-cap value
500 Index		X							
Calvert Social Index	X								
Capital Opportunity*				X					
Equity Income			X						
Explorer							X		
Extended Market Index					X				
Growth and Income		X							
Growth Equity	X								
Growth Index	X								
Mid-Cap Index					X				
Morgan Growth	X								
PRIMECAP*	X								
Selected Value						X			
Small-Cap Growth Index							X		
Small-Cap Index								X	
Small-Cap Value Index									X
Strategic Equity					X				
Tax-Managed Capital Appreciation		X							
Tax-Managed Growth and Income		X							
Tax-Managed Small-Cap								X	
Total Stock Market Index		X							
U.S. Growth	X								
U.S. Value			X						
Value Index			X						
Windsor						X			
Windsor II			X						

Convertible Securities Fund invests primarily in corporate bonds and preferred stocks that are convertible into shares of common stock.

\*Closed to new investors.

International/global funds		
Stock funds	Emerging markets	Developed markets
Developed Markets Index		X
Emerging Markets Stock Index	X	
European Stock Index		X
Global Equity		X
International Growth		X
International Value		X
Pacific Stock Index		X
Tax-Managed International		X
Total International Stock Index		X
Balanced funds		
Global Asset Allocation Fund invests in stocks, bonds, and cash investments from around the world, including the United States. The fund uses a proprietary computer analysis to shift asset and country allocations in seeking the highest returns.		

Industry-specific funds	
These specialized portfolios are for investors who recognize the potential rewards—as well as the potential risks—associated with an investment concentrated in a single industry.	
Holdings	
Energy	Stocks of foreign and domestic companies whose activities relate directly to energy production, transmission, marketing, research, or experimentation.
Gold and Precious Metals	Stocks of foreign and domestic companies that explore, mine, or distribute gold and other precious metals and minerals.
Health Care	Stocks of foreign and domestic companies engaged in the development, production, or distribution of health care products and services.
REIT Index	Stocks of U.S. equity real estate investment trusts (REITs)—companies that own and operate commercial real estate.
Utilities Income	Stocks and bonds of U.S. utility companies, including electrical, gas, and telephone companies.

Balanced funds*	Stocks			Bonds		
	Large-cap growth	Large-cap blend	Large-cap value	Short-term	Intermediate-term	Long-term
Asset Allocation		X				X
Balanced Index		X			X	
LifeStrategy Conservative Growth		X			X	
LifeStrategy Growth		X			X	
LifeStrategy Income		X			X	
LifeStrategy Moderate Growth		X			X	
STAR			X			X
Tax-Managed Balanced		X			X	
Wellesley Income			X			X
Wellington			X			X

Fixed income funds			
<i>Funds with high credit-quality ratings</i>			
Taxable fixed income funds	Short-term	Intermediate-term	Long-term
GNMA		X	
Inflation-Protected Securities	X		
Intermediate-Term Bond Index		X	
Intermediate-Term Corporate		X	
Intermediate-Term Treasury		X	
Long-Term Bond Index			X
Long-Term Corporate			X
Long-Term Treasury			X
Short-Term Bond Index	X		
Short-Term Corporate	X		
Short-Term Federal	X		
Short-Term Treasury	X		
Total Bond Market Index		X	
Tax-exempt fixed income funds			
California Insured Intermediate-Term		X	
California Insured Long-Term			X
Florida Insured Long-Term			X
Insured Long-Term Tax-Exempt			X
Intermediate-Term Tax-Exempt		X	
Limited-Term Tax-Exempt	X		
Long-Term Tax-Exempt			X
Massachusetts Tax-Exempt Fund			X
New Jersey Insured Long-Term			X
New York Insured Long-Term			X
Ohio Long-Term			X
Pennsylvania Insured Long-Term			X
Short-Term Tax-Exempt	X		
Other fixed income funds			
High-Yield Corporate		X	
High-Yield Tax-Exempt			X
Preferred Stock			X
<b>Note:</b> High-Yield Corporate Fund and High-Yield Tax-Exempt Fund invest in bonds having medium and low credit-quality ratings.			

\*Global Asset Allocation Fund (listed under International/global funds) is a balanced fund that invests in domestic and international securities.

# Before you invest . . .

## Consider taxes

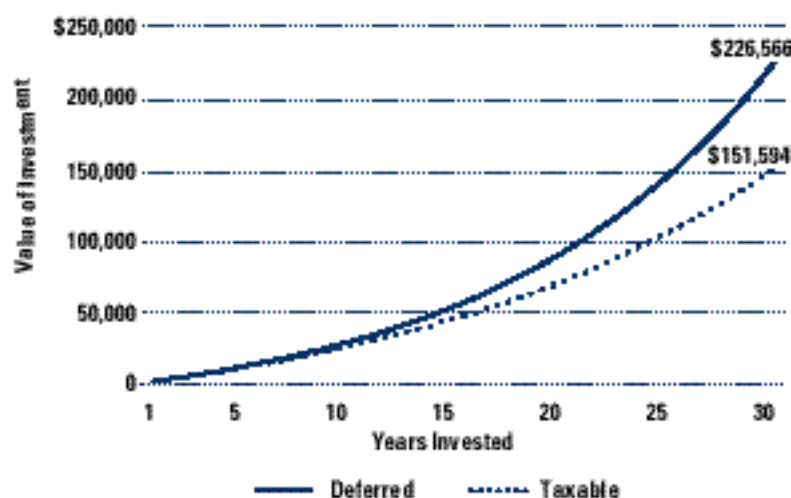
When it comes to investing, what counts is the money you get to keep after paying all taxes due. Different types of mutual funds and investment accounts (such as IRAs and 401(k) accounts) have varying tax advantages and/or disadvantages. Keep in mind that tax considerations are less important than maintaining proper asset allocations for each of your investment portfolios.

Dividend distributions from mutual funds in taxable accounts are considered ordinary income and are taxed at the investor's regular rate. Capital gains distributions from your mutual fund—which can occur when a fund sells an investment at a profit—may be taxed at a lower rate, depending on how long the investment was held. You may also incur taxable capital gains on your own by selling shares of a stock or bond fund.

The following section offers some suggestions on how you might want to use different types of funds in your various fund accounts.

Figure 9

### The long-term benefit of deferring taxes



Retirement accounts typically allow you to defer taxes on earnings—which is a powerful way to save compared with a taxable investment, as the chart shows. The example assumes annual contributions of \$2,000, an 8% annual return, and a tax rate of 28%. The tax-deferred balance would drop from \$226,566 to \$163,128 if you withdrew all your savings from the tax-deferred account and paid taxes at a rate of 28% at the end of 30 years. (In a Roth IRA, of course, withdrawals may be tax-free.) However, most retirees withdraw their retirement savings through periodic payments. This chart is only an illustration and does not imply the returns that may be available on any particular investment.

## Manage tax liabilities

Here are some ways to decrease your tax liabilities on income from taxable fund accounts:

- **Keep growth funds in taxable accounts rather than tax-deferred retirement accounts.** Invest in funds that produce relatively little ordinary income for your taxable accounts. The primary return from growth funds is in the form of capital gains.
- **Watch turnover rates.** The turnover rate indicates how much buying and selling of securities is done by a fund. Lower turnover rates should translate into longer-term capital gains and, thus, lower taxes. (A lower turnover rate could also lead to reduced trading costs.)
- **Consider index funds.** A by-product of index investing is a relatively low turnover rate. So, by their very nature, index funds tend to be tax-efficient.
- **Invest in tax-managed funds.** Tax-managed funds rely on low turnover and various other techniques to reduce the taxes shareholders have to pay.

For your retirement accounts, such as IRAs or 401(k) plans, you can use the tax laws to your advantage as follows:

- **Emphasize income-producing funds in tax-deferred retirement accounts.** To the extent possible, confine investments that produce ordinary income, such as bond funds, to tax-deferred accounts.
- **Contribute as much as you can to tax-deferred accounts.** Because taxes don't have to be paid until you start making withdrawals, tax-deferred accounts are a powerful way to accumulate money, as **Figure 9** on page 27 illustrates. (For eligible investors, the Roth IRA can provide *tax-free* investment earnings.)

## Consider municipal bond funds

Yet another approach to tax savings is to invest in municipal bond funds. Municipal bonds are issued by state and local government entities, and most are exempt from federal income taxes—and often from state and local income taxes as well. Typically, municipal bond funds pay lower interest than taxable bond funds with comparable maturities. But, when the taxable bond fund's interest yield is adjusted for taxes, the resulting yield may be lower than the municipal bond fund's interest rate. If so, the municipal bond fund is the better deal—as typically happens for people in the 28% or higher tax brackets. For people in lower tax brackets, the taxable bond fund is typically the better alternative, even after paying taxes.

All investors should periodically reassess their portfolios. There are two reasons for doing so: a change in one or more of the factors (such as your time horizon) that shaped your strategic asset allocation, or fluctuations in the stock and bond markets that have altered the planned mix of assets.

# Step 4

## MONITOR YOUR PORTFOLIO

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### Keep your portfolio on target

The mix of stocks, bonds, and cash investments you have chosen for your portfolio should be based on an assessment of your goals, time horizon, tolerance for risk, and personal financial situation. But a change in any of these factors can change your strategic asset allocation.

For example, as your time horizon shortens, you will have less time to recoup losses from any sudden market downturns. Therefore, you might consider a more conservative asset mix. In contrast, some investors may want a portfolio that contains more risky assets than their current portfolio. This could come about because their personal financial situation has markedly improved or because they've become more comfortable with riskier assets, such as stocks.

Fluctuations in the financial markets may also necessitate a reassessment of your portfolio. For example, because of a bull market, you may find that your planned mix of 65% stocks and 35% bonds has become 80% stocks and 20% bonds. If so, you should probably modify the percentage holdings of stocks and bonds to bring your allocation back to the original target. The investor in this example could wind up with higher total returns over the long run compared with the original portfolio. However, the new portfolio has become riskier than the investor originally intended.

### Reallocate, reinvest, or rebalance

As a general rule of thumb, you should consider altering your asset mix whenever it deviates from your plan by five percentage points. You can adjust an asset allocation in three ways:

- **Reallocate** Invest additional money in the asset class you wish to augment.
- **Reinvest dividends** Use dividends from one class of funds to buy shares in the class you want to build up.
- **Rebalance** Shift money from one asset class to another (by selling shares in stock funds and buying shares in bond funds, for example).

Be careful: When selling shares, there may be tax consequences if the fund isn't in a tax-deferred account. (This even holds true for municipal bond funds.) If you must sell fund shares at a gain, try to make them long-term gains to take advantage of the lower capital gains tax rates. Make sure you know the "cost basis" of the shares to be sold—that is, the price at which you bought the shares. If you don't know, the fund company may be able to help.

### *myth*

**I'll know when to move in and out of the market.**

Some investors try to "time the market" by investing when they think stock and bond prices are about to rise, and withdrawing assets when they think prices are about to fall. But predicting when the markets will rise or fall is exceedingly difficult. Both academic studies and hard-earned experience show that buying and holding investments for the long term works far better than trying to time the market.

## myth

**The market's doing great. Now's the time to invest.**

If you invest regularly and steadily over the long term, any time is a good time to invest. Dollar-cost averaging—investing a set amount at regular intervals for a long time—lets you put time and the market's natural volatility to work for you. You can thus buy more shares when prices are low (but fewer shares when prices are high). And you reduce the risk of loss if the market declines sharply just after you make a single large investment.

**Note:** Keep in mind that dollar-cost averaging does not guarantee that an investment will be profitable, nor does it protect against losses when stock or bond prices are falling. Before embarking on a dollar-cost averaging strategy, you should consider whether you will be financially and emotionally willing to continue investing during a long downturn in the market.

## Some final points

As you develop your investment program, consider these final points:

- **Focus on asset allocation.** Your allocation is the key to future returns and risk. Choose it carefully, monitor it periodically—perhaps once a year—and rebalance when necessary.
- **Expect years with losses.** A portfolio of stocks and bonds will fluctuate in market value over time. Short-term risks have proven well worth taking in the past. However, if you can't accept the idea of interim losses on your investments, you shouldn't be investing in stocks or bonds at all.
- **Don't overreact.** If the markets worry you, don't overreact by suddenly liquidating a losing investment. Instead, select a more conservative asset mix, and change your portfolio gradually over time.
- **Think in portfolio terms.** Don't evaluate your individual fund investments in isolation; think instead of your overall portfolio. The reason for holding a diversified portfolio is that gains from one investment may help offset losses in another. In the long run, what matters is the total value of your portfolio, not short-term losses in one fund or another.
- **Don't invest in too many funds.** You can build a well-diversified portfolio with a small number of mutual funds, or even just one fund. Many funds span a number of market segments—such as small-, mid-, and large-cap stocks or short-, intermediate-, and long-term bonds—so just one of those funds may provide exposure to all segments of an asset class. By using too many funds, you may incur unnecessary expenses (such as low-balance fees) or create unnecessary work for yourself in tracking many funds and reporting all their taxable distributions.

# A VANGUARD INVITATION

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For more information about Vanguard® funds and services, to learn more about investing, or to open an account online, visit our website at [www.vanguard.com](http://www.vanguard.com). There you'll find our complete Plain Talk® Library, Retirement Center, and our popular Education Center. Register for immediate secure access to our online investment-management center, and you can monitor your accounts, conduct transactions, trade securities, and invest in both Vanguard and non-Vanguard funds—24 hours a day.

Or you can speak with a Vanguard associate by calling us at **1-800-662-7447** on business days from 8 a.m. to 10 p.m. and on Saturdays from 9 a.m. to 4 p.m., Eastern time. Our associates are always pleased to answer your questions or provide information about our funds and services.

Vanguard also invites you to take advantage of the broad selection of programs and services we offer that can teach you more about investing and help you stay on track toward reaching your financial goals.

## **Vanguard® Personal Financial Planning Services** **1-800-567-5162**

At an affordable fee, this service offers customized one-time analysis and advice on investment, retirement, and estate planning.

## **Vanguard® Asset Management and Trust Services** **1-800-567-5163**

Individuals who have a minimum of \$500,000 in investable assets can receive comprehensive, ongoing wealth management services at a very reasonable fee.

## **Vanguard Brokerage Services®** **1-800-992-8327**

Through VBS®, you can invest in individual stocks, bonds, options, and more than 2,600 non-Vanguard mutual funds. You can open an account and trade on our website as well.

## **Retirement Resource Center** **1-800-205-6189**

Our experienced retirement specialists can provide a wealth of information to help you plan or manage your retirement investments.

## **Individual Retirement Plans** **1-800-823-7412**

Self-employed individuals and small-business owners can find out how to establish and administer retirement plans for themselves and/or their employees.

## **Vanguard® Variable Annuity Plan** **1-800-522-5555**

For investors who can benefit from an annuity's tax advantages, the Vanguard Variable Annuity Plan offers a wide variety of low-cost investment portfolios and a selection of payout options.

## *How Vanguard can help*

Vanguard offers special services for clients who have substantial assets.

- **Voyager Service®**, for clients investing more than \$250,000 in Vanguard mutual funds, offers the expert assistance of a special service team.
- **Flagship Service**, for clients whose Vanguard mutual fund investments exceed \$1 million, offers personal service from a dedicated representative.

Eligible clients are invited to call Vanguard at **1-800-337-8476** for more information.

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## **Invest with a leader**

The Vanguard Group traces its roots to the opening of its first mutual fund, Wellington™ Fund, in 1929. The nation's oldest balanced fund, Wellington Fund emphasized conservatism and diversification in an era of rampant market speculation. Despite its creation just before the worst years in U.S. financial history, Wellington Fund prospered and within a generation was one of the largest mutual funds in the nation.

The Vanguard Group was launched in 1975 solely to serve the Vanguard mutual funds and their shareholders. From its start as a single fund in an infant industry, Vanguard has become one of the largest investment management firms in the world. Today, some \$550 billion is invested with us in more than 100 investment portfolios. And some 11,000 crew members now serve millions of shareholders who have entrusted their investment assets—indeed, their financial future—to a company that they believe offers the best combination of investment performance, service, and value in the industry.

## Plan your financial future with Vanguard

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### **Vanguard® Online Planner, [www.vanguard.com/?planner](http://www.vanguard.com/?planner)**

A free, interactive tool that you can use to create a comprehensive financial plan, whatever your financial goals.

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### **Vanguard® Personal Financial Planning Service, 1-800-567-5162**

At an affordable fee, this service offers customized one-time analysis and advice on investment, retirement, and estate planning.

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### **Vanguard® Asset Management and Trust Services, 1-800-567-5163**

Individuals who have a minimum of \$500,000 in investable assets can receive comprehensive, ongoing wealth management services at a very reasonable fee.

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### **Literature online, [www.vanguard.com/?funds](http://www.vanguard.com/?funds)**

You can order or review prospectuses and reports for our funds online. From our homepage, click on the "Funds" tab, or go directly to our Funds Directory at the address above.

## It's easy to get information about Vanguard's funds and services

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The Vanguard Variable Annuity Plan is a flexible-premium, multifunded variable annuity issued by Peoples Benefit Life Insurance Company, Form No. Series NA100A (in Florida, Form No. NA100A-FL; in Oregon, Form No. NA100A-OR) and, in New York State only, by AUSA Life Insurance Company, Inc., Form No. AV423 101 109 498 CRT, without agent representation. The Vanguard Group administers the Vanguard Variable Annuity Plan for its issuers.

Neither The Vanguard Group, Peoples Benefit Life Insurance Company, nor AUSA Life Insurance Company, Inc., provides tax advice. Investors are encouraged to consult a tax adviser for information on how annuity taxation applies to their individual situations.

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## An update on tax rates on capital gains

Effective January 1, 2001, federal income tax rates have been reduced on certain capital gains known as “qualified five-year gains.”

- For taxpayers in the 15% bracket, the tax rate on capital gains from the sale of assets that have been held more than five years will drop from 10% to 8%. Tax rates on capital gains from the sale of assets held five years or less are unchanged.
- For taxpayers in the higher brackets (28%, 31%, 36%, and 39.6%), the tax rate on capital gains from the sale of assets *purchased after January 1, 2001*, and held longer than five years (that is, the assets are not sold until 2006 or later) will drop from 20% to 18%. Tax rates on capital gains from the sale of assets held five years or less are unchanged.

Taxpayers in the higher brackets (28% or higher) can elect to make future gains eligible for the 18% rate by treating assets held on January 1, 2001, as having been sold and reacquired at their closing prices on January 2, 2001. By “marking assets to market” in this way, a taxpayer recognizes capital gains (but not losses). The gains are taxable and must be reported to the IRS in a statement filed with the investor’s tax return. Later increases in the value of that asset are eligible for the 18% rate if the asset is sold in 2006 or later.

**Note:** If a large capital gain is recognized by marking to market, an investor could incur a significant tax liability in 2001 in exchange for a potential small reduction in tax rates five years or more in the future.

We recommend that you consult a tax or financial adviser about whether marking to market would be beneficial in your individual situation. You should also consider state and local income taxes in making any decision.

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