Two bubbles, two busts in one decade: What lessons can investors learn?

We asked four of our veteran fund managers to talk about what’s been learned—or should be learned—from the historic ups and downs of the past ten years.

Investors have needed strong stomachs during the past decade. First, the tech stock bubble burst in 2000, triggering a painfully long bear market. Then, as stocks finally regained ground by mid-decade, housing prices rose so sharply that consumers and bankers succumbed to the temptation to take on too much debt. The result: a worldwide credit crisis and “Great Recession.”

“These have been the two most significant economic stories of our time, so it’s hugely important to try to understand what has happened,” said James K. Anderson, a portfolio manager for Vanguard International Growth Fund and chief investment officer at Baillie Gifford Overseas Ltd.

“More people were telling me tech stocks were a bubble in 1996 than in 1999,” said Mr. Anderson. “Much the same thing happened in the credit crunch. It was when people stopped worrying about rising housing prices that investors should have been concerned. A bubble occurs when people don’t think it’s risky any longer.”

Howard Marks, chairman of Oaktree Capital Management, L.P., the investment advisor for Vanguard Convertible Securities Fund, agreed. “Investors took on too much leverage and committed too much capital to illiquid investments,” he said. “It all happened because they believed they were living in a low-risk world.”

The importance of liquidity

Perhaps the most memorable lesson of the crisis is something that these fund managers know very well, but that too many other investors seemed to forget: the importance of liquidity. As the crisis deepened, the ability to buy or sell assets was severely constricted, threatening the entire financial system.

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CEO McNabb assumes chairman’s role
Vanguard President and CEO F. William McNabb III succeeded John J. Brennan as chairman of the investment management company and the Vanguard funds, effective January 1.

Mr. McNabb became chief executive officer in August 2008 under a previously announced transition plan. He will continue as president and CEO while serving as the third chairman in Vanguard’s 34-year history.

“Bill has done an extraordinary job leading Vanguard during this tumultuous period, and the board of directors and I have full confidence in his ability to steer Vanguard’s future course,” said Mr. Brennan.

FUND NEWS
Vanguard plans new active small-cap equity fund
Vanguard has filed a registration statement with the Securities and Exchange Commission to offer its first actively managed fund investing primarily in small- to mid-capitalization U.S. value stocks.

The new fund, to be called Vanguard Explorer™ Value Fund, would employ three advisory firms, each taking a bottom-up, fundamental approach to stock selection.

It is expected that each advisor will initially manage a third of the fund’s assets.

Vanguard Explorer Value Fund will require a minimum initial investment of $10,000.

Seven bond index ETF offerings broaden lineup
In November, Vanguard introduced seven bond index ETFs covering government, corporate, and mortgage-backed segments of the bond market. The ETFs are share classes of Vanguard funds that seek to track benchmarks focusing on those segments. Each new ETF features an expense ratio of 0.15%.

The new bond ETFs, managed by Vanguard Fixed Income Group, are the company’s first to trade on the Nasdaq stock exchange. Vanguard’s 39 other ETFs continue to trade on the NYSE Arca exchange; some are cross-listed in Australia and Mexico.

You can learn about all of Vanguard’s ETFs at www.vanguard.com/etf-by-name.

A registration statement relating to these securities has been filed with the Securities and Exchange Commission but has not yet become effective. These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective. This communication shall not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of, these securities in any state in which such offer, solicitation, or sale would be unlawful prior to registration or qualification under the securities laws of any such state.

Note: Mutual funds are subject to risks, including possible loss of principal. Prices of mid- and small-cap stocks often fluctuate more than those of large-company stocks. Investments in bond funds are subject to interest rate, credit, and inflation risk.
INVESTING YOUR MONEY

Don’t overlook bonds’ potential to temper your portfolio’s risk

Investor cash has poured into bond funds over the past two years, no doubt in part because bonds generally provided solid positive returns through the stock market’s harrowing ups and downs from 2007 to 2009.

Bonds deserve attention, no doubt about it, but recent performance isn’t what makes them so valuable. It’s their ability to moderate a portfolio’s risk—to act as a cushion for the ups and downs that go along with owning stocks.

Recall how the stock market’s 6% gain in 2007 morphed into a −37% plunge in 2008, only to reverse direction and jump 29% in 2009. Bonds, which can lose money to be sure, returned an average 6% a year during that time.

Performance comes and goes. But bonds’ potential cushioning benefits for a stock portfolio endure. Importantly, supplementing bonds’ diversifying potential is diversification within the bond market.

Stocks, styles, and sectors

Many investors are more familiar with stocks than bonds, so a comparison to stocks may be helpful.

For investment purposes, stocks can be categorized by “style” (such as growth and value, or large-, mid-, and small-capitalization) and sector (industrials or financial services, for example). Within the general rise or fall of the broad stock market, these styles and sectors may fluctuate differently.

Because it’s impossible to foresee which parts of the market will do best—and because the financial markets can change direction with cobra-like swiftness—we have traditionally recommended that a stock portfolio be diversified across styles and sectors.

Similar returns, dissimilar reasons

The bond market also has its styles, in terms of differing maturities and credit ratings, and sectors, such as Treasury bonds and corporate bonds. As with stocks, diversifying among these can be a strength, because weakness in one style or sector can be tempered by strength in another—as has happened over the past two years.

The broad investment-grade bond market returned about 5% in 2008, when stocks plummeted, and about 6% in 2009, when stocks soared. Those returns were somewhat similar, but the dynamics differed: The 2008 result reflected returns of about 14% for Treasury securities and about −3% for corporate bonds. The roles were reversed in 2009: Treasuries declined, returning about −4%, while corporates rose about 16%.

What happened? As the financial crisis seemed to worsen in 2008, fearful investors stampeded to the perceived safety of Treasuries, sharply boosting their returns. Investors shunned corporate bonds, driving down their returns. In 2009, government programs to combat the crisis began taking hold, prompting many investors to embrace riskier investments, such as corporates, which then saw strong gains. The returns of Treasuries fell as demand was siphoned away.

Lessons and a caution

One lesson from these examples is that past performance isn’t a reliable guide to future results—which makes performance-chasing a terrible idea.

Another lesson: A diversified helping of bonds along with your stock investments could go a long way toward reducing the overall volatility of your portfolio.

Sources for returns cited: MSCI US Broad Market Index and Barclays Capital bond indexes.
“Everyone from individual investors to fund managers was reminded how important liquidity management is,” said Christopher W. Alwine, head of Vanguard’s Municipal Bond Group. “We saw that it was essential to have a sufficient amount of cash or highly liquid securities in a crisis.”

So are investors—on Wall Street and elsewhere—sufficiently chastened that they’ll resist taking on too much risk in the future?

Mr. Marks doesn’t think the hard lessons of the past decade will forestall future bubbles. “You can’t prevent them,” he said. “Human nature makes dramatic cycles inevitable. Markets will always eventually go to extremes.”

Already some analysts are wondering whether speculation in emerging-market stocks and gold, to name two examples, is reaching bubble levels. Many emerging markets have rebounded almost 100% from their March lows, while the price of gold has more than doubled over the past four years.

But our veteran fund managers, while acknowledging the need to stay on guard, cautioned against applying the bubble label too quickly.

“How to find some protection

The managers agreed that sticking to time-tested principles such as balance and diversification is still the best way to buffer your portfolio during market swings. That means choosing a suitable mix of stocks and bonds, then staying with it.

“While equity markets went down tremendously in 2008, if you had established an asset allocation that included bonds as well as stocks, the losses more likely weren’t a deal-breaker,” said George U. Sauter, Vanguard’s chief investment officer. “And if you didn’t cash out of your stock holdings, you participated in the big rally we’ve had since March.”

The goal, Mr. Sauter said, is finding the right balance between taking enough risk to reach your long-term growth goals and staying conservative enough to avoid losing sleep when markets tank.

“Yes, it’s essential to have a long-term plan, and it’s desirable to stick to it,” Mr. Marks said. “But in placid times people overestimate their ability to stick with their plan in the rocky times. So I say, never forget about the man who was six feet tall, but who drowned crossing the river that was five feet deep on average.

“As an investor, it’s not sufficient to plan to survive on average. You have to prepare to survive the tough times. Instead of putting all your money in stocks, you’ll put, for example, 60% in them. As a result, you shouldn’t expect maximum returns, but you won’t be tempted to panic and get out at the bottom of a bear market either, which is the cardinal sin of investing.”

For an expanded version of this article, go to www.vanguard.com/bubbles.
A writer examines the ‘myth’ of a rational stock market

Among the theories that have dominated modern finance over the past century is the assumption that markets are rational—that they’re efficient and are essentially always right.

In fact, some critics now charge that it was in part reliance on this “efficient market” theory that enabled the global financial crisis that began in 2008.

A new book, The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street, takes an in-depth look at this theory from its early days—when it helped prompt the creation of the first index mutual fund—to its current, somewhat disfavored state. The author is Justin Fox, editorial director at the Harvard Business Review and a former columnist for Time magazine.

Mr. Fox recently talked about his book with In The Vanguard.

What is the efficient-market theory, and how did it come about?

The efficient-market theory, stated most simply, is that everything that could possibly be known about the value of a stock is already embedded in the price. . . . But a related idea that arose in the late 1960s, and really gained a lot of strength in the ’70s and ’80s, was that you could say that the prices were in some fundamental way “right”—that the prices prevailing in the market were really close to the fundamental values of the stocks.

Why is the concept of a rational market so attractive to both individual investors and academics?

It creates lots of straightforward, simple ways to deal with investing and risk management that wouldn’t exist if you thought markets had some strange tendencies toward boom and bust or irrational exuberance and pessimism.

Has faith in the market’s supremacy benefited investors?

I don’t think we would have gotten index funds, or at least not when we did, without these academic theories of efficient markets. But there’s a great argument for index funds that has nothing to do with the market being rational—it’s just the simple math—and Vanguard’s founder Jack Bogle talks about it all the time: If you buy an index fund, you’re getting the market’s performance minus the cost of running an index fund. Because that cost is in most cases—though not invariably—vastly lower than for most actively managed funds, you start out with an edge over non-index investors.

So how did the efficient-market theory help lead to the creation of index funds?

Wells Fargo offered the very first index fund, but it was only for large institutions, not individuals. And that was completely inspired by one of the members of the family that owns Samsonite. He had gone to the University of Chicago business school and had heard these theories of the efficient market, and said, “Hey, why don’t we do a fund that just owns the market?” Then there were several articles in investing and academic journals about this subject and a couple in Fortune magazine. That made it much easier for Vanguard to be able to get the fund started. [Vanguard 500 Index Fund was launched in 1976.]

If it’s really difficult to beat the market, why bother to hire a professional investment advisor?

Yes, it’s really hard to beat the market, but it is not impossible, and not everyone who beats the market consistently is just lucky. It’s not so much having information that other people don’t have that allows you to beat the market—it’s much more being willing to stick with certain investing strategies. But very often, if you identify one of those rare professional investors who has figured out something and is able to stick to it and can outperform the market, their price gets bid up. It gets really hard, when you’re hiring professional managers, to beat the arithmetic: The more you pay in fees, the lower your performance.

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Retiring director reflects on Vanguard, investing, and the ‘loser’s game’

Charles D. Ellis, a member of Vanguard’s board of directors since 2001, recently retired from the board. Mr. Ellis founded the strategic business consulting firm Greenwich Associates in 1972. He has taught investing at Harvard and Yale, and has written 15 books. *In The Vanguard* spoke with Mr. Ellis in December.


A loser’s game is a game in which the outcome is controlled by the loser, not the winner. If you use the analogy of tennis, Venus and Serena Williams play spectacular tennis, and they win points. When my wife and I play, we have a nice time, but we lose points. For example, I hit the ball into the net more often than I hit the perfect shot down the sideline. For me to win, I have to keep the ball in play and let the other guy lose.

In investing, far too many people try to win by doing things that are really hard. It would be better if they would minimize errors and costs and then simply let the economy and markets do the work.

Just as there are people as good as the Williams sisters, there are individual investors—Warren Buffett being the iconic example—who are actually better than the market. But, like the Williams sisters, they are few. The chances that I will become one of the Williams sisters in tennis, or Warren Buffett in investing, are zero. A little bit of modesty goes a long way in investing.

The cost of making a mistake in investing is much larger than the benefit of getting it right. I don’t like playing in games where heads I win, tails I lose twice.

*The book’s lessons have withstood the test of time. But is there anything you would add in the wake of the financial crisis?*

The addendum is that everybody should know what the winner’s game is. Every one of us could be a winner. All you have to do—and it’s not all that complicated—is think carefully about who you are and your most important long-term financial and investment priorities. Then, design a simple portfolio to meet those priorities, and stick with it. If you invest for the right objective—your objective—you’ve got a high probability of being a winner. Just don’t screw it up by trying too hard along the way.

*You served on Vanguard’s board of directors during one of the most tumultuous periods in market history. Which events stand out?*

I’m going to surprise you on this one. What really stood out for me is the consistency of Vanguard: the consistency of the commitment to low costs, to high-value services, and to helping investors “get it right.” We’ve had some fabulous challenges in the markets. But through up days and down days, up years and down years, Vanguard’s consistency is what’s really stood out.

*What has your experience as a Vanguard director meant to you?*

They say that when you get up close to something, you learn a lot, and it’s usually disappointing. I’ve had very high regard for Vanguard for a very long time. I’ve been a Vanguard investor for 25 years. I’ve known Jack Bogle, Jack Brennan, and Bill McNabb all the way back, and knew them to be good leaders. What surprised me when I joined the board was that they were even better than I thought. They’re better than I thought at maintaining disciplined cost management, at delivering terrific services, and at remaining utterly committed to clients.
How would you describe the “typical” Vanguard investor?
Individuals are very personal in their investing, of course, but I’d make a few sweeping generalizations, because you can watch how a population behaves. The first is, Vanguard investors are obviously smart people, because they’ve figured out that getting low costs really does matter over a long period of time. Secondly, they must be extraordinarily well-informed, because they seem almost always to be doing sensible things. Finally, I’m sure that they have not been disappointed in Vanguard’s role on their behalf—nor should they be. It’s been a very nice thing to witness up close.

Are there things that investors have gotten better at over the past few decades?
They’ve really gotten better at paying attention to the cost of investment management services. I also think that investors have gained an appreciation for the importance of diversifying internationally. And that’s been just as true for Australians and Canadians and Europeans as it has been for Americans.

Are there areas in which investors can improve?
The most important thing any investor can do is to understand herself or himself really well, understand their financial situation, and invest within that context. That’s where I hope we see some real improvement. I think people are moving in that direction—just at a glacial speed.

How can investors overcome their natural tendencies to react to recent market events?
Study history. Older psychiatrists are seldom totally surprised by anything, because they’ve spent a lot of time getting to know and understand human beings. Investors could do themselves a lot of good by studying the way markets have behaved—and misbehaved—throughout history. It’s like the difference between weather and climate. If you understand the climatology of investing—what markets are like and why they are that way—you won’t get sidetracked by fair or foul weather.

Looking ahead, which trends in investing concern you?
I think that, by and large, the fund industry has charged too much in fees. There’s got to be a way of bringing the total cost structure lower. I also worry about too much salesmanship in the investment industry, and firms that place too much emphasis on making an entrepreneurial profit rather than—like Vanguard—understanding that the funds are managed for the benefit of the investors.

Which trends or recent developments are good for investors?
Life-cycle and target-date funds have been a good development. They allow people to make one sensible decision and not have to worry about the details after that. I also think the full array of index funds and ETFs provide a wonderful freedom of choice for investors. Tax-managed funds are another nice development, with just an extra thoughtfulness about tax implications.

Mr. Ellis and former Vanguard board member Burton Malkiel have co-authored a new book, The Elements of Investing. Mr. Ellis says of the book: “Deliberately very short, it covers all the basics in just two hours of straight talk.”

Notes: Life-cycle funds invest in broadly diversified funds and are subject to the risks associated with those underlying funds. Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in the target-date fund is not guaranteed at any time, including on or after the target date. It is possible that tax-managed funds will not meet their objective of being tax-efficient.
Roth IRA conversions: Opportunities and options

Beginning this year, more taxpayers are eligible to convert a traditional IRA to a Roth IRA. Previously, individual taxpayers and married couples filing joint returns couldn’t make such a conversion if their modified adjusted gross income in a year was more than $100,000. Married couples filing separate returns were restricted from doing a Roth conversion. On January 1, these limitations were removed. Now anyone can make a Roth conversion, regardless of income or filing status.

In addition, a special provision applies to 2010 conversions that gives you the option of postponing the tax bill and paying it off over two years. If you choose this route, the taxable income that results from the conversion will get split evenly between 2011 and 2012. But be aware that income tax rates are scheduled to go up in 2011, barring any new legislation.

Of course, you don’t have to postpone the tax. You can choose to recognize all the conversion income in 2010.

“These are significant changes that open the door for a lot more people to take advantage of a Roth IRA conversion,” said Theresa O’Hara, a senior manager in Vanguard Asset Management Services™.

Is converting to a Roth IRA right for you?
Converting may be beneficial if you:
- Can pay the conversion taxes without using retirement assets.
- Expect your tax rate to be higher in the future.
- Plan to keep the money invested for at least five years.

It may not be beneficial if you:
- Would have to draw on your IRA assets to pay the taxes.
- Expect your tax rate to be lower in the future.
- Expect to withdraw the money within five years.

Understand the impact of converting
Before you decide to convert assets from a traditional IRA to a Roth IRA, be sure you understand how differences between the two accounts could affect your tax returns. There are various factors to consider, so you should consult with a qualified tax advisor.

Generally, investment contributions to a traditional IRA are tax-deductible, depending on your income and whether you participate in an employer-sponsored retirement plan. You don’t owe tax on your deductible contributions or potential earnings until you take withdrawals.

With a Roth IRA, you invest on an after-tax basis—that is, you invest money after you’ve paid tax on it. Your investment can grow tax-free and you won’t owe any tax on qualified withdrawals in retirement. That means converting to a Roth IRA might make sense if you’re likely to be in a higher income tax bracket during retirement.

Another feature of a Roth IRA is that you aren’t required to make any withdrawals during your lifetime. With a traditional IRA, the IRS says you must make withdrawals—called required minimum distributions, or RMDs—after you reach 70½.

However, if you expect to withdraw converted assets from a Roth IRA within five years of the conversion, then converting may not be a wise
move. The IRS may levy a 10% penalty on withdrawals taken within five years of the conversion unless you are at least 59 1/2 years old or are covered by another exception. (A separate five-year period applies to each conversion.)

Paying tax due: Now or later?
You will owe tax on money you convert from a traditional IRA. For example, if your federal income tax bracket is 33%, you could owe $33,000 on a conversion of $100,000. (After-tax contributions made to the traditional IRA would not be taxed, but any earnings on those contributions would be subject to income taxes.) State tax treatment may vary from federal tax treatment, and converting may subject a taxpayer to estimated quarterly taxes. Whatever your tax bill, it’s more beneficial to pay the bill without tapping your IRA assets. The bigger benefit of using outside assets to pay the tax is that you get to put the entire IRA balance into the Roth, which effectively increases the size of the IRA.

Much may depend on what your tax bracket is now and what you think it will be in the future, Ms. O’Hara said. “If you think you’ll be in a higher tax bracket when drawing down assets, it may be beneficial for you to convert,” she said. “You might want to pay the taxes now.”

At the same time, you need to be careful that a conversion doesn’t push you into a higher tax bracket—which could happen because the converted assets are treated as ordinary income. In this regard, spreading the income on a 2010 conversion over tax years 2011 and 2012 may be beneficial—but, as noted, you need to bear in mind that federal income tax rates are scheduled to rise in 2011.

“Spreading the converted income over two years isn’t such a slam dunk, because we could be in a higher tax structure,” Ms. O’Hara said. Because you might be uncertain about both your future tax rate and next year’s tax rates, you could consider converting just some of the assets in a traditional IRA, a strategy known as tax diversification.

“It’s not all or nothing,” Ms. O’Hara said. “Partial conversions are advantageous to many investors. When you have to withdraw retirement assets, you can do what’s best for your tax situation at the time.”

Estate planning
A final consideration is estate planning. Because you don’t have to take distributions from a Roth IRA during your lifetime, you can leave the entire accumulated balance to your beneficiaries. The beneficiaries will be able to make tax-free withdrawals, even though they may have to take required distributions. (A spouse can roll over the account to his or her own Roth IRA and will not be required to take distributions.)

Talk to your estate planning attorney if you intend to leave some of your IRA assets to a charity. Your attorney can advise you on the beneficiary designation. Keep in mind that if a charity is the beneficiary of an IRA, the charity does not pay taxes. In this situation, a conversion may not be beneficial.

Get started on tax diversification without converting

Just open a Roth IRA with contributions made from after-tax dollars, assuming your income is below the ceiling for these accounts. You can still contribute for 2009 by April 15 of this year.

The amount you are allowed to contribute for 2009 depends upon your income, but it cannot exceed $5,000 ($6,000 if you’re age 50 or above). You cannot contribute more than your earned income. In addition, the amount you can contribute decreases as you approach certain income ceilings: modified adjusted gross income of $120,000 if you’re a single tax filer or $176,000 for couples filing jointly.
Has the efficient-market theory played a role in the recent market crisis?

My sense is it’s not that lots of individuals were led wildly astray because of their belief in the efficient-market hypothesis. It’s much more about how the theory affected our approach to thinking about financial regulation and what the Federal Reserve’s job is. That thinking may have been led somewhat astray by this idea that markets always go up and down for a reason, and that the more financial markets and the more securities and ETFs and other things you have out there, the better it is.

On a policy level, then, what lessons were learned?

There is certainly a lot more talk about trying in the future to do something to work against what seem to be bubbles in asset prices. But I haven’t seen any regulators doing anything along those lines yet. The historical pattern is that the lessons of a crash are always learned by the people who experience it, and then never learned by the next generation, who go on and make all the same mistakes again a few decades later.

You devote a chapter to mutual funds and Jack Bogle in particular. Why?

There are many positive things that have come out of this academic rational-market obsession, and this [index mutual funds] was one of them. And beyond that, Bogle just is such a font of interesting lessons about the market.

It sounds like you agree with some of Vanguard’s key principles of investing: Have a well-balanced portfolio, think long-term, consider your time horizon and risk tolerance.

Yes, I totally agree. There may be 5% of people out there who would be better off if they actually followed their own ideas. But that’s a pretty small percentage, and I am not one of those people. One of the lessons I got very clearly from years working on this book is that I am not one of those market-beaters! I invest passively.
What everyone can learn from investment committees

Relatively few investors serve on an investment committee for a large corporate pension plan, a university endowment, or even a small, community nonprofit organization. But learning from the behavior of these groups could potentially benefit many investors’ portfolios.

More than 110 respondents to a 2009 Vanguard survey gave insights into how investment committees operate. Among the key findings:

Committees maintained a firm focus on asset allocation, but sometimes overemphasized past performance and lost sight of what mattered most to their organizations. The responses also reinforced our understanding of “best practices.”

Numerous studies by Vanguard and others have shown that strategic asset allocation—the mix of stocks, bonds, cash, and other investments—is the most important determinant of a diversified portfolio’s total return and risk. Almost half of the respondents did follow a disciplined approach to strategic asset allocation, typically making changes only every two to three years. Even when faced with “extraordinary” market events, roughly the same number said they stayed with their plan.

“These investors set an example for all investors,” said Catherine D. Gordon, head of Vanguard Institutional Advisory Services. “Set your asset allocation based on long-term expectations, and only modify it if the objectives change—not in reaction to the markets’ near-term twists and turns.”

On the other hand, investment committees spent a surprisingly large amount of meeting time—40%, on average—on past performance. Ms. Gordon thinks that’s too much.

“Considering that market performance is an area totally out of one’s control, this is not the best use of a committee’s—or an investor’s—time,” she said. “More time should be spent on areas you can control, such as risk assessment, portfolio makeup, and cost.”

Committees also appeared to place too much emphasis on evaluating performance relative to benchmarks or peers. Vanguard’s experts recommend that committees instead measure success against well-defined goals specific to their organization.

The same applies to individual investors: Define clearly what you are investing for and when you will need your money. Measure success against what really matters to you—say, retiring early, or maximizing gifts to your grandchildren—not on whether your investments perform as well as other people’s.

The survey shows that even savvy investors can encounter potholes, such as behavioral biases, on the path to success. For example, committees may seek out information that supports their own views while disregarding conflicting data, a tendency known as confirmation bias. Individuals do the same when they gather information only from reinforcing sources, such as family and friends.

“Whether you are an individual investor, an investment committee member, or both, a few basic best practices can make you more successful,” said Ms. Gordon. “Define your goals, plan an investment strategy and portfolio mix to achieve them, stick to a clear spending rule, and tune out the daily ‘noise.’”
From the online Bogleheads, a book on retirement planning

When members of the online community of investors known as the Bogleheads decided to produce a book about retirement planning, they chose to take the same collaborative approach they’ve practiced online for more than a decade. So in a sense, The Bogleheads’ Guide to Retirement Planning is a “wiki” in book form. A wiki is a website that allows a group of people to work together on writing and editing interlinked Web pages on a range of topics. The online encyclopedia Wikipedia is perhaps the best known example.

The group began its online association on a discussion board, Vanguard Diehards, hosted by mutual fund data provider Morningstar, before developing the Bogleheads site, which takes its name and inspiration from Vanguard founder John C. Bogle. The group’s wiki and online forum are at www.bogleheads.org. (The Diehards and Bogleheads sites are independent of Vanguard.)

The online community trades information about all sorts of personal finance subjects. And that spirit carried over to the book. “Overall, about 40 people contributed to the book,” said Mel Lindauer, one of the founders of the community and a co-editor of the retirement planning guide. “In addition to the individual chapter authors, we had proofreaders, fact-checkers, and topic experts. Basically it was a community effort.”

The result, the authors hope, is that readers can benefit from the group’s collective experience and knowledge about IRAs, Social Security benefits, withdrawal strategies, insurance, and more. “This book could not have been written by any one author,” said Taylor Larimore, also a co-editor and founding Boglehead, who has been investing for more than 50 years.

The authors are donating royalties from the book to the National Constitution Center, a Philadelphia museum for which Mr. Bogle served as chairman.

A decade-plus of learning and teaching

Mr. Lindauer, Mr. Larimore, and other Bogleheads began their running dialogue on investing and other personal finance issues in 1998. Many members of the online community are self-taught investors who learned through experience and by reading books by Mr. Bogle and other investment experts. Still others have more formal credentials. The estate-planning chapter of the retirement guide, for example, was written by an estate-planning attorney.

“We want to show people who wonder whether they can be do-it-yourself investors that it’s not only possible, but it’s actually being done at a very low cost by many Vanguard investors,” Mr. Lindauer said. “We also want to let people know that there is a lot of unbiased information available if they need a little help.”

Get ready for retirement

In 2006, the group published its first book, The Bogleheads’ Guide to Investing. In it, the authors advocated long-term and low-cost investing, values that Vanguard has championed for decades. They decided to produce a second book devoted to retirement investing because they’re concerned that many people aren’t financially ready for the time when they’ll stop working.

The new Guide “is a grassroots call to action,” the editors write in the book’s preface. “It encourages a broad individual response to prepare for retirement.”

The steep stock-market decline of 2008 has made retirement planning more challenging, as many people saw their 401(k) and IRA balances plummet, bringing investment risk to the fore in a visceral way—especially for those nearing or in retirement. The Guide contends that you can help smooth the road to recovery of retirement balances by embracing low-cost investing and getting the right mix of stocks, bonds, and cash in your portfolio.
One clear lesson of the market downturn is the importance of adjusting your asset mix, or allocation, as you get closer to retirement, Mr. Lindauer said. Generally, this involves increasing bond holdings and trimming the allocation to stocks.

“What happens a lot, I think, is that people just go along with one asset allocation throughout their working years, and they don’t take time to periodically re-evaluate to make sure it’s still the right allocation,” Mr. Lindauer said. “The damage may already be done when they finally do say, ‘Oh, maybe I should take a look at this.’”

Early retirement?
Perhaps optimistically, given 2008’s bruising market, the book includes a chapter on retiring early. Early retirement can be a real possibility if you save aggressively and live below your means, the Bogleheads assert. If you are considering early retirement, the book cautions, keep in mind that you should plan on taking very modest withdrawals from your portfolio to make your money last.

It’s also important that your retirement plans, early or otherwise, not hinge on expectations of double-digit gains on your investments, Mr. Lindauer said. “People need to be realistic in terms of what their portfolio can provide for them,” he said. “If they need a 10% or 12% return every year to just get by, I think they’re fooling themselves. They may get it, but they may also get their heads handed to them.”

Indeed, realistic expectations about investment returns are a fundamental part of the group’s philosophy. “We don’t claim to tell you how to get rich in ten days or less,” Mr. Lindauer said. “We may be considered boring by some people, but we’re just trying to paint an honest picture. We want to give you the information you need to make an intelligent decision.”

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<th>Milestones for retirement planning</th>
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<td>Whether you’re planning for retirement or are already there, the Bogleheads recommend that you keep in mind the following milestones:</td>
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| Age 50 | You’re eligible to start making additional “catch-up” contributions to your IRA or 401(k). |
| Age 55 | You may be able to make penalty-free withdrawals from your 401(k) if you’ve left the employer that sponsors the plan. |
| Age 59½ | You can make withdrawals from your retirement plans without having to worry about the 10% federal penalty. |
| Age 62 | You can start receiving Social Security payments, but they’ll be permanently reduced because you’re taking them early. |
| Age 65 | You qualify to receive benefits through the federal health care program Medicare. |
| Age 66 to 67 | Those born after 1942 will become eligible at one of these ages to take your “full” Social Security benefit. You also can choose to wait to claim your benefit, a step that would entitle you to higher payments in the future. |
| Age 70 | If you haven’t already, start taking Social Security. There’s no benefit to delaying beyond age 70. |
| After age 70½ | You are required by the IRS to take annual required minimum distributions from your traditional IRAs and certain other tax-deferred retirement accounts. |

Source: Bogleheads.

Notes: When taking withdrawals from an IRA before age 59½, you may have to pay ordinary income tax plus a 10% federal penalty tax. The opinions expressed are not necessarily those of Vanguard.

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MARKET BAROMETER

Fourth quarter 2009

Global stock and bond markets finished 2009 on a strong note. Less than a year earlier, these same markets seemed to be in free-fall. In early March, as policymakers and central bankers began to contain the financial crisis, markets rebounded with stunning swiftness and force.

By year’s end, signs of economic growth in the world’s major economies seemed to validate the markets’ optimism. Although some countries began to tighten monetary policy, short-term interest rates remained near 0% in the United States.

U.S. stocks

• The broad market, as represented by the Dow Jones U.S. Total Stock Market Index, returned 5.9% in the fourth quarter, bringing its 12-month return to 29.3%. From early March, the index climbed more than 60%.

• The top chart presents the price/earnings (P/E) ratio for the S&P 500 Index based on operating earnings, which exclude extraordinary items and certain other items.

Global equity markets

Developed markets, as represented by the MSCI EAFE Index, returned 2.2% in the quarter and 31.8% for the year in U.S. dollars. Emerging markets, which weathered the financial crisis much better than developed markets, returned 79.0% in 2009, as measured by the MSCI Emerging Markets Index.

U.S. bonds

• U.S. Treasury securities gave back some of the prior year’s gains in 2009 as the yields of all but the shortest-term securities moved higher. The yields of 3-month Treasury bills approached the vanishing point.

• The timeline was reversed for corporate bonds and other “credit” instruments. They tumbled in 2008, but delivered powerful 12-month returns in 2009. The Barclays Capital U.S. Aggregate Bond Index returned 0.2% for the quarter and 5.9% for the year.

S&P 500 operating price/earnings ratio

Last observation: December 2009. Shaded areas indicate U.S. recessions; latest recession is preliminary.
Sources: Standard & Poor’s Corporation; data are Crandall, Pierce & Company.

International equities

Sources: Standard & Poor’s Corporation; Dow Jones and Company; Crandall, Pierce & Company.

U.S. Treasury issue yields

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<tr>
<td>3 Months</td>
<td>0.08%</td>
<td>0.12%</td>
<td>0.05%</td>
<td>−0.03</td>
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<tr>
<td>2 Years</td>
<td>0.77</td>
<td>0.96</td>
<td>1.14</td>
<td>+0.37</td>
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<tr>
<td>5 Years</td>
<td>1.55</td>
<td>2.32</td>
<td>2.68</td>
<td>+1.13</td>
</tr>
<tr>
<td>10 Years</td>
<td>2.21</td>
<td>3.31</td>
<td>3.84</td>
<td>+1.63</td>
</tr>
<tr>
<td>30 Years</td>
<td>2.68</td>
<td>4.05</td>
<td>4.63</td>
<td>+1.95</td>
</tr>
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Source: Vanguard.
Use our online tools to help with tax prep

Income tax season is in full swing, and we’ve got the perfect partner for your tax-prep two-step: the interactive tools and services on Vanguard.com.

Visit our Tax Center (www.vanguard.com/taxcenter) for extensive information, including data about Vanguard fund distributions, links to tax-estimation calculators, and education on tax planning. While you’re there, you can log on to your account to access your personal tax information in the secure Taxes & Income area.

Here are some tips on how to partner with our website for a less stressful tax season:

**Prepare and file your returns.** Vanguard investors receive a 25% discount from Intuit for TurboTax® Online™ for the federal and state versions as well as for the Desktop Download products. This secure, user-friendly service guides you through the process and lets you file your federal and state returns online (for most states; see note below). Or you can print and mail them if you prefer.

**Track your capital gains and losses.** Our free Cost Basis Accounting Service helps you determine your capital gains and losses for taxable Vanguard mutual fund and brokerage accounts so you can complete Form 1040, Schedule D.

**Get tax information for Vanguard funds.** Looking for information about the alternative minimum tax? Need to know the percentage of a fund’s income attributable to U.S. government obligations? Our Tax Center has a wealth of essential data you can access whenever you want.

**Invest your tax refund automatically.** You can make sure the money goes to work for you right away: Sign up online for our Direct Deposit Service, and have the IRS send your refund directly to your Vanguard account.

**Tax information for brokerage clients**

Do you have a brokerage account at Vanguard? If so, the following information will help you as you do your income taxes.

**You may receive tax forms from two sources.** For the 2009 tax year, you may receive tax forms from both Pershing LLC and Vanguard Brokerage Services®. In general, Pershing will send tax forms for reportable activity that occurred from January 1 through May 23. The tax form you receive from Pershing also may reflect activity that took place after the May 23, 2009, conversion, such as dividend or interest payments, or corporate actions for trades that cleared prior to the conversion. Vanguard Brokerage, which assumed clearing-agent responsibilities from Pershing, will send a separate statement for reportable activity after May 23.

**New information you may need for filing.** This year, Pershing and Vanguard Brokerage will provide:

- An additional statement for clients holding securities characterized as “widely held mortgage trusts.” This will be mailed in March.
- An adjusted cost factor for certain unit investment trusts on Form 1099-B.

**Don’t file your return too early.** Depending on your holdings, your brokerage tax forms may be available at different times throughout January and February. Also, if you received a revised Tax Information Statement (Form 1099) in the past, you will likely receive one again this year. So you may want to file your taxes closer to the April deadline to avoid having to file an amended return.

If you plan to use TurboTax Online or Desktop download tax-preparation software, your brokerage data will not be available to import until February 26.

To find out when you can expect your tax forms, go to www.vanguard.com/taxschedule anytime. There you can learn when specific forms will be mailed and posted online.

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**Note:** Florida, Tennessee, and New Hampshire do not allow electronic tax filing. Check with your state tax authority for more information.
The folly of advertising fund performance

“Performance sells.”

Listen closely, and you can hear those words being spoken by mutual fund marketers as they hatch their plans for 2010. With tax and IRA season here, fund companies will be angling for a piece of your portfolio. You’ll see plenty of ads touting their best performers. But not from Vanguard.

Advertising at its best . . . and worst

At its best, advertising provides useful information. It can also communicate something about a company’s priorities and values, helping people determine whether they share an affinity with the advertiser. But advertising a specific fund’s performance provides only historical information. It tells you nothing useful about the future. Indeed, the implicit message—that yesterday’s top performers will be tomorrow’s too—amounts to disinformation. Research and experience have repeatedly demonstrated that superior performance tends not to persist.

Performance-advertising can also hurt a mutual fund’s existing shareholders. The ads prey on investors’ tendency to chase returns. This is like laying out the welcome mat for hot money—cash that pours in while the good times roll, then drains out when performance moderates, as it inevitably does. Hot money can increase transaction costs and sap the returns of investors who remain with the fund.

Why Vanguard advertises

Does Vanguard believe in advertising? Yes. We want to attract new investors, which can enhance economies of scale for all clients. But we want to establish these relationships on the basis of a shared understanding of what it takes to succeed as an investor.

Instead of keying in on the hype about funds that blew away the competition over an arbitrary period, we urge investors to regard past performance with a skeptical eye, and to avoid using it as the sole determinant in selecting a fund. We have a long record of closing funds to new investment if they seem to be attracting too much money from performance-chasers.

In recent ads, we’ve tried to educate investors about the “simple truths” of investing—information that can help them whether or not they become Vanguard clients. We explain that low costs maximize your share of a portfolio’s returns; that performance-chasing can be a treadmill to nowhere; and that success depends on sticking with a sensible investment plan despite the markets’ euphoria or despair.

Advertising can be an effective use of our limited marketing budget if it helps to attract new investors who share our long-term investment philosophy and who understand that costs matter. Those new investors, in turn, contribute to a virtuous cycle; a larger asset base brings economies of scale that over time have enabled us both to drive down the expense ratio of our funds and to expand the variety of services we offer.

For more information on Vanguard funds, visit www.vanguard.com, or call 800-847-4999, to obtain a prospectus. Visit our website, call 800-847-4999, or contact your broker to obtain a prospectus for Vanguard ETF Shares. Investment objectives, risks, charges, expenses, and other important information are contained in the prospectus; read and consider it carefully before investing.

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

Vanguard Brokerage Services is a division of Vanguard Marketing Corporation, Member FINRA.