SUMMER 2010

In The Vanguard®

Vanguard®

Joseph H. Davis

Do higher deficits mean higher rates? Not necessarily, history tells us

As federal and state governments grapple with soaring budget deficits, many investors expect interest rates to rise soon, which would affect bond prices.

Many people think that when faced with large deficits, federal and state governments tend to issue more bonds. With more supply, bond prices will be driven down, pushing up their yields.

But history suggests that higher government deficits don't necessarily lead to higher interest rates. Instead, inflation expectations and demand for bonds have been the dominant drivers of long-term interest rates.

Joseph H. Davis, Vanguard's chief economist, said his research team looked at U.S. deficits and interest rates during most of the country's history to see whether higher interest rates occurred at times when debt levels were high compared with GDP (gross domestic product).

"This might surprise many people, but we found that there's no clear link between deficits and rates," Mr. Davis said. "We also looked at debt-to-GDP levels and interest rates in other countries, and again, we found no relationship."

Deficits and rates took different paths

In the past 100 years, the U.S. economy experienced two periods when deficits or interest rates spiked dramatically higher, as shown in the chart on page 4. The federal deficit soared when the United States entered World War II, but interest rates stayed low because a high U.S. savings rate helped fund the war effort.

In the 1970s, high inflation bedeviled the U.S. economy. Yet government debt levels were restrained in relation to GDP.

"Higher deficits can bring the potential for higher interest rates," Mr. Davis said. "After all, when a government has higher financing needs, it's going to issue more debt. Assuming all else is equal, greater supply equals lower prices, so the result would be higher interest rates. But in economics, you rarely find all other factors being equal.

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FUND NEWS

Vanguard Convertible Securities Fund reopens to new individual investors

Vanguard reopened its $1.8 billion Convertible Securities Fund (VCVSX) to new individual investors in May. In addition, the $25,000 annual investment limit for existing accounts was removed.

Vanguard had closed the fund and limited investments in June 2009 because of concerns that continuing strong cash inflow could impede the advisor's ability to effectively manage the portfolio. Cash inflow has since subsided. ■

Vanguard will add new index and ETF offerings

Vanguard has announced plans to expand its index fund family, introducing new funds with ETF Shares to provide investors with additional low-cost stock and bond choices. The expansion includes ETF Shares of Vanguard 500 Index Fund.

The new ETFs will be available commission-free to Vanguard Brokerage clients* and will feature expense ratios substantially below those of competing products (source: Morningstar, March 31, 2010). Over the next year, these new funds and ETFs will add indexed municipal products to our fixed income lineup and present investors with the option of an international real estate fund and ETF. ■

*Trading limits, fund expenses, and a minimum investment may apply. See the Vanguard Brokerage Services Commission and Fee Schedules for full details. Also see the related article on page 15 for additional information.

About that Roth IRA conversion—four things you may not know

Many investors probably know that changes in federal tax law for 2010 make converting a traditional IRA to a Roth IRA worth a look. For example, if you convert to a Roth IRA this year, you can choose to spread the reporting of any taxable income associated with the conversion evenly across tax years 2011 and 2012 (an option that's available only this year), or you can report the income with your 2010 tax return.

If you're still unsure about whether to convert to a Roth, here are some lesser-known points that may help you decide.

If you're married and file a joint tax return, you and your spouse can convert your IRAs in 2010 and agree to disagree on when to report the income.

If you and your spouse each have a traditional IRA, you can make separate tax-reporting decisions if you both convert to Roth IRAs in 2010. For instance, one spouse can choose to recognize income for 2010, while the other can defer until 2011 and 2012.

If you're retired, a Roth conversion may affect your Social Security benefits and Medicare premiums.

After converting to a Roth IRA, you could see a one-year increase in the taxable portion of your Social Security benefits. Here's why: A conversion raises your total income for Social Security purposes, which is defined as half of your benefits plus any other income, including tax-exempt income—and this income level determines the taxable percentage of your benefits (0%, 50%, or 85%). However, *distributions* from a Roth won't affect the taxation of your Social Security benefits, which may help you in the long run.

Medicare premiums are a little different. They depend on your modified adjusted gross income (MAGI) from the previous two years, which means that your 2008 MAGI determines your 2010 premiums. Because a conversion this year will increase your 2010 MAGI (if the income is reported this year), your Medicare premiums might rise in 2012.

Note that most retirees pay the standard Medicare Part B premium—about 25% of the total cost—with the U.S. government paying the rest. If your MAGI exceeds certain levels, your premium will likely be higher.

Still not sure whether converting to a Roth IRA is right for you? We have a tool that can help at **vanguard.com/rothcalculator**.

A conversion could allow your heirs income-tax-free access to assets.

Whether you have a traditional IRA or a Roth IRA, your beneficiaries will have to take annual distributions from the account—but with a Roth, they won't owe income tax on the distributions, whereas with a traditional IRA they would. That's one of the big estate-planning benefits of a Roth: By paying the income tax on the conversion today, you're passing on an asset without attached income-tax liability. (Note that tax could be owed on earnings from a converted Roth IRA if you don't satisfy a five-year holding requirement.)

You have a chance for a "do-over" if you change your mind.

You can undo a Roth IRA conversion through what's called a recharacterization, in which the amount of the conversion—plus any earnings or minus any losses—goes back into a traditional IRA.

The deadline to recharacterize is April 15 following the year of conversion if you file your tax return by the due date, or October 15 if you file under an extension. If you're planning to reconvert to a Roth IRA later, remember that you must wait 30 days after the recharacterization or until the beginning of the next calendar year after the original conversion, whichever is longer. ■

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"It's not that deficits don't matter. But there are a lot of other factors that can influence the level of interest rates."

What are those other factors? Mr. Davis and his team found that while short-term rates are linked primarily to a central bank's policies for controlling the supply of money, a number of forces influence intermediate- and long-term interest rates in the bond market (see the accompanying table).

For a more in-depth look at this topic, you can download *Deficits, the Fed, and rising interest rates: Implications and considerations for bond investors*, a Vanguard research paper, at **vanguard.com/deficitsinterestrates**.

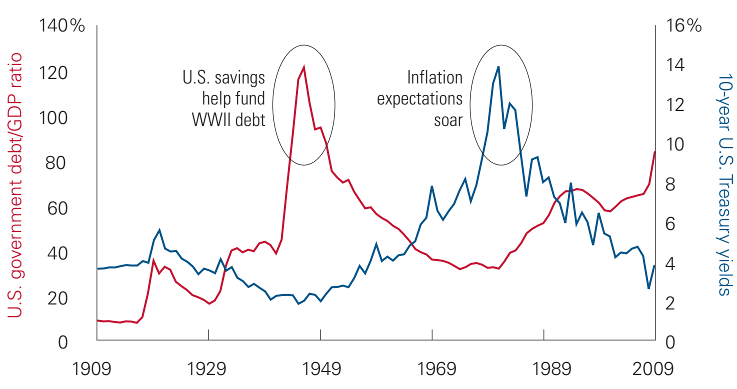
Inflation expectations are key

One of the most important factors is investors' expectations for inflation. In the early 1980s, the Fed's aggressive tightening of the money supply tamed inflation after it had peaked at 14%, yet investors remained wary for the rest of the decade. Those fears translated into 10-year bond rates that stayed above 5%, even though the inflation rate fell below 2% by the mid-'80s.

"One reason interest rates are not as high as some would expect is that inflation expectations are well-anchored within the Fed's comfort zone of 2% to 2.5%," Mr. Davis said.

Another factor that helped keep a lid on interest rates last year was increased buying of U.S. Treasuries by both U.S. and foreign investors.

Deficits and rates have taken different paths



Source: Vanguard calculations based on yearly data from Global Financial Data, the Federal Reserve Board, the U.S. Census Bureau, and the U.S. Bureau of Labor Statistics.

The factors that determine interest rates

	1980–1989	2009
Long-term inflation expectations	+5.3%	+2.4%
Uncertainty over inflation expectations (inflation risk premium)	+1.1	+0.5
Expected future Federal Reserve policy (inflation-adjusted federal funds rate)	+2.2	–0.8
Expected GDP growth (adjusted for inflation)	+0.2	+0.2
Effects from investment in Treasury bonds by U.S. investors	–0.4	–1.3
Effects from investment in Treasury bonds by non-U.S. investors	–0.1	–0.6
Effects of changes in the bond supply (structural deficit)	+2.2	+2.9
Net effect: Average yield on 10-year U.S. Treasury bonds	**10.6%**	**3.3%**

Note: Figures are subject to rounding.

Source: Vanguard calculations based on data from the Congressional Budget Office, the Federal Reserve Board, the Federal Reserve Bank of Philadelphia, the U.S. Bureau of Labor Statistics, and the U.S. Census Bureau.

"Higher saving rates have translated into a strong demand for U.S. Treasuries, which has compensated almost entirely for any upward pressure on rates," Mr. Davis said.

Take predictions with a grain of salt

Nonetheless, some prognosticators think that bond prices are headed for a fall. Investors fearing this outcome could be tempted to sell their bond holdings, or at least steer their money to shorter-term maturities, where bond prices are less volatile.

Mr. Davis says such preemptive moves could be misguided.

"The future direction of interest rates is notoriously hard to predict," he said. "If a portfolio is broadly diversified across the entire U.S. bond market, then if short- or long-term rates do rise, investors who maintain diversified bond allocations can receive higher yields, which, when reinvested, can more than compensate over time for declines in bond prices." ■

Note: The performance data shown represent past performance, which is not a guarantee of future results. Diversification does not ensure a profit or protect against a loss in a declining market.

Low interest rates have you down? CFP professionals share views

The Federal Reserve has held its target for short-term interest rates at 0% to 0.25% since December 2008, and yields on money market funds have been correspondingly low.

As a result, many investors wonder how to generate current income without taking on additional risk. And if a little extra risk is necessary, they want to know about their options.

We asked three Certified Financial Planner™ professionals from Vanguard's Advice Services Group—Glen Morrison, John Pilkington, and Kobi Laker—how they respond to Vanguard clients who pose questions such as these. The three participate in Vanguard's "Ask a CFP professional" service, which is available to members of Flagship and Voyager Select Services.

What do you tell clients about money market funds, low yields, and taking on additional risk?

Mr. Morrison: If you need the money in the short term—and by short term I mean one year or less—you may not want to take any more risk. Even if you're getting a low yield, you want to preserve that principal above all.

Mr. Pilkington: From my vantage point, the single most important thing is whether the money has a short-term purpose or whether it's for a long-term purpose and your real concern is market volatility. More commonly than not during the past two years, the latter of the two tends to be the driving force—and investors can assume more principal risk with their long-term assets.

While past performance obviously doesn't guarantee future returns, does it help to see how bond funds behaved in similar interest rate environments?

Mr. Morrison: I think so. People may say they don't want to go into bond funds because interest rates may go up. While you can see a drop in the capital return when interest rates rise, you shouldn't forget that a bond fund's return includes capital return and income return. In 2003, the federal funds rate was 1%; by 2006, it was at 5.25%. During this time period, the increase in yield from bond funds helped compensate for a drop in price. Of course, the caveat today is we don't know where rates will go, or when.

Does it make sense to ensure the client's time horizon meets or exceeds the duration of a bond fund?

Mr. Laker: Yes. As your readers may know, duration is a measure of a bond fund's sensitivity to changes in interest rates: The greater the average duration of a fund's holdings, the more its share price will fluctuate when interest rates change.

Mr. Pilkington: So when we talk with clients, a common approach is to match duration to time horizon. Let's use duration to balance risk and reward. If you have a bond fund with a duration of one year and the client has a one-year time horizon, you might have a good match. But it's important for clients to know that there truly is principal risk that goes along with investing.

Which maturity of bonds do you prefer for longer-term retirement goals?

Mr. Pilkington: Our research suggests that intermediate-term bonds may suit long-term investors. Historically, they've delivered greater returns than short-term bonds and have less interest rate sensitivity than longer-term bonds.* Some of my colleagues refer to intermediate-term bonds as "the sweet spot," because that's where they believe the risk-return trade-off is most favorable. ■


Glen Morrison


John Pilkington


Kobi Laker

*Based on average annual returns for the Barclays Capital U.S. 1–5 Year, 5–10 Year, and Long Government/Credit Indexes from 1979 through 2009.

Note: This information is educational only and does not take into consideration your personal circumstances or other factors that may be important in making investment decisions. It is not a recommendation to buy or sell a particular security.

Ask a CFP professional is a service provided by Vanguard Advisers, Inc., a registered investment advisor.

Mark Twain and active managers: Something in common

The active-passive debate is one of the most hotly contested in investment management. Fans of active management say that superior stock-picking is the key to investment success, while proponents of indexing believe that its pursuit of market-tracking returns is the most effective strategy. Some have even claimed that active management is obsolete.

But to echo Mark Twain: Rumors of the death of active management are greatly exaggerated. In fact, Vanguard believes that choosing between actively managed and indexed funds is not an either-or decision. There is room for both in an investor's portfolio. The key is to focus on the long term when you search for managers who have the potential to beat the market (and the average return of peer funds). And be aware that there are ways to increase the odds of successfully identifying such managers.

A smaller slice for active funds

In recent years, actively managed funds have been capturing a smaller share of investors' dollars. On March 31, active funds represented about 82% of the $8 trillion of industrywide mutual fund assets (excluding money market funds), down from more than 90% about a decade ago. In 2009, actively managed stock funds had net cash *outflows* while stock index funds had net inflows.*

The reason lies partly in the soaring popularity of low-cost exchange-traded funds (ETFs), which have attracted more assets to indexed strategies. Another explanation is investors' increasing recognition of just how difficult it is to beat the market consistently.

I win, you lose—and vice versa

The "zero-sum game," a basic concept of investing, is a real challenge for active managers.

Any market, such as the U.S. stock market, consists of the aggregate holdings of all investors. Now consider the average return of all those holdings. If one investor's dollars outperform the average in a given time period, then some other investor's dollars must underperform, so that ultimately the dollar-weighted returns of all investors will equal the market's return. A simple example: If there were only two managers, and Manager One topped the market's return, then Manager Two must have lagged it, because their combined results equal the market average.

Unlike a market, fund managers incur trading, research, and administrative costs that are passed on to shareholders. Those costs raise the bar: For an investor in an actively managed fund to earn an above-market return, the manager must outperform by more than enough to cover all costs.

Vanguard's approach to active management

Even though the deck appears to be stacked against active managers, many can and do outperform their market benchmark. The key is to identify those who have shown they can do so by following a well-defined investment strategy, rather than by relying on luck.

In choosing external advisors for funds, Vanguard uses a detailed, extensive screening process. We evaluate investment management firms on the basis of several important factors, including:

- The ownership and viability of the firm.
- The experience of its investment professionals.
- Its record of managing portfolios consistently with a well-articulated investment philosophy and process.
- Its performance.

*Source for industry data: Strategic Insight Simfund Mutual Fund Database.

Only a few advisory firms worldwide meet these strict criteria. Today, 29 external advisors participate in the management of Vanguard funds, which together represent about one-quarter of the company's total assets under management.

Vanguard's rigorous screening process and focus on keeping costs low have helped our externally managed funds to perform competitively. You can compare our funds' performance with the average returns for their peers by visiting Vanguard.com (on a fund's Profile page, click the Price & Performance tab). As we often remind investors, short-term results usually don't tell the full story, so it's especially important to review the longer-term track record when you evaluate any fund.

Your checklist for actively managed funds

If you are considering investing in an actively managed fund, be sure to do some homework:

- Look at a fund's long-term track record. Chasing performance by yesterday's winning manager could be a disappointment tomorrow.
- Look for a fund whose advisors have a thoughtful, well-defined investment strategy and adhere to it, even during volatile markets.
- Always pay attention to costs.
- And—just as Vanguard does with its external advisors—plan to keep an eye on your fund to be sure the advisor remains true to the fund's stated objective, so that the fund can play its intended role within your portfolio.

By following these criteria, you may stand a better chance of winning the zero-sum game. ■

Playing defensively in 2010 could provide future tax benefits

While changes to tax laws are nothing new, this year is a bit different from usual. On December 31, 2010, a few key investment-related tax measures are set to expire or "sunset"—and investors will want to pay close attention to what Congress does, or doesn't do, as the measures sink toward the horizon.

"We're not sure how tax rates will change, but we're pretty confident that they won't go down from where they are now," said Joel Dickson, a principal in Vanguard's Quantitative Equity Group. "As investors, we have time to adjust and plan accordingly for what's to come."

Ready, set, tax hikes?

The Economic Growth and Tax Relief Reconciliation Act, or EGTRRA as it's often referred to, became law in 2001. Its purpose was to help stimulate the nation's economy, but it was written with many provisions scheduled to expire at the end of 2010. A later law, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (known as JGTRRA), was also designed to spur growth and included many similar expiration dates.

So, at the end of this year, the tax provisions in those laws—such as tax breaks on capital gains, dividends, and estates—are set to expire.

Congress could still act to extend the EGTRRA and JGTRRA rules, allow some but not others to expire—in which case the affected tax rates would revert to earlier rates—or even adopt new tax measures. But if Congress does nothing, here's what investors can expect, and may want to consider in their planning. (Bear in mind that you should consult with a qualified tax or financial advisor before making any decisions for your own portfolio.)

A timing question for long-term gains

The tax rate on capital gains held for longer than one year is currently 0% for those in the two lowest income brackets and 15% for all other taxpayers; that's set to expire at the end of this year. If Congress makes no change, on January 1 the long-term capital gains tax rate will revert to 20% for all but those in the lowest income bracket.

If you expect to realize long-term gains at some point in the near future, you may want to realize them before January 1. You could be doing yourself—and your wallet—a big favor.

"The capital gains tax rate won't decrease at the end of the year, but there's a definite possibility it could go up," said Mr. Dickson. "In this case, if you're going to realize some investment gains eventually anyway, it may make sense to realize those gains now. If you do, you could wind up saving yourself a lot of money in taxes."

Depending upon the amount of realized gains, the tax savings could be sizable. For example, in the simplest circumstances, if you realize $100,000 in capital gains this year, you would owe $15,000 in tax. If you waited until next year to realize the same gains, your tax bill could be $20,000 or, possibly, even more. That's a saving of at least $5,000 that you could invest somewhere else.

Dividends may become less rewarding

Qualified dividends are currently taxed at 15% for those in higher income brackets, just as capital gains are.* However, because dividend tax rates are also a part of those earlier tax laws, they're also set to expire at the end of this year—meaning that the previous rates could return on January 1.

*Generally, for a dividend to be classified as qualified, you must have held that stock unhedged for at least 61 days out of the 121-day period that began 60 days before the ex-dividend date. For certain preferred stocks, the relevant holding period is at least 91 days out of the 181-day period beginning 90 days before the ex-dividend date.

Under the previous rates, dividends were taxed at an investor's ordinary income tax rate. If this becomes the rule again, as Mr. Dickson and others think likely, dividend-focused investments may seem less appealing. In that case, you may want to consider restructuring your portfolio to include investments that are more tax-friendly.

Develop a game plan for your estate

At the start of this year, the federal estate tax rate fell to zero. It was still there as of late June, but nearly everything about it remained uncertain.

This situation stemmed from EGTRRA, which gradually reduced the estate tax rate to 45% from its 2001 level of 55%, and gradually increased the amount of an estate exempt from federal tax to $3.5 million, up from $1 million in 2001. As a kicker, the law also eliminated federal estate tax altogether for 2010.

This appears to be a boon for heirs who receive estate proceeds in 2010. But if Congress allows the law to sunset at the end of the year, the estate tax may revert to pre-EGTRRA levels. In other words, it's possible that in 2011 heirs to estates will be taxed at the 55% rate, with only $1 million exempt.

With that said, it's also possible that Congress could restore the estate tax at any point this year, or possibly attempt a retroactive restoration to last January. Even if the estate tax stays absent for the rest of 2010, it will most likely return in some form next year.

Regardless of what happens with the estate tax—or, for that matter, any of the other tax rates set to sunset at the end of the year—now is as good a time as any to get your estate in order. ■

Key federal tax rates affecting investors

	2010	2011 (assuming no action by Congress)
Long-term capital gains	0% (lowest two tax brackets)	10% (lowest tax bracket)
	15% (all others)	20% (all others)
Qualified dividends	0% (lowest two tax brackets)	Taxed at investor's ordinary income tax rate.
	15% (all others)	
Estate tax	No estate tax.	55%, with a $1 million exemption.

You can download *Mutual fund ratings and future performance*, a Vanguard research paper, at **vanguard.com/fundratings**.

Is your fund a star? Congratulations—enjoy it while it lasts

Ratings may help us quickly and easily assess our options when deciding what movie to see or which car to buy. But when it comes to choosing investments for your portfolio, you should consider more than just fund ratings.

That's because most mutual fund ratings are largely backward-looking indicators based on past performance, although they may include some other factors, too. And past performance is a poor predictor of future results.

Higher ratings ≠ higher returns

A common misconception among investors is that owning only highly rated funds (or avoiding poorly rated funds) will surely provide higher returns.

However, Vanguard found the opposite when we analyzed Morningstar's mutual fund ratings* and compared them against the rated funds' subsequent performance. The recent Vanguard research paper *Mutual fund ratings and future performance* showed that, on average, just 39% of five-star funds outperformed their benchmark indexes in the three years following the initial rating, while 46% of one-star funds outperformed their benchmarks during the same period. In addition, the highest-rated funds were found to post the lowest average returns versus their respective benchmarks.

"Markets are cyclical, and investment styles go in and out of favor," said Christopher B. Philips, CFA, a senior analyst in Vanguard's Investment Strategy Group. "If there are certain factors driving a fund's performance in this period, they may not be a factor in the next period. Predicting those changes is very difficult, regardless of the skill level of the investor or fund manager."

Mr. Philips pointed out that market volatility also can lead to inconsistency in fund ratings.

Five-star today, one-star tomorrow?

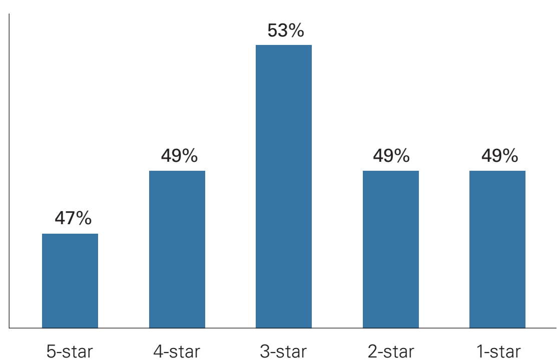
Vanguard's analysis showed that a year after the initial Morningstar rating, most funds had less than a 50% chance of earning the same rating again. And the probability was lowest for five-star funds.

"Constructing a portfolio solely on mutual fund ratings based on performance can be detrimental to portfolio wealth," said Mr. Philips. "If you're constantly cycling through funds and trying to maintain a 'five-star portfolio,' you run the risk of creating extreme turnover in your portfolio, incurring additional taxes and transaction costs."

Dig a little deeper

Just remember that knowing whether a fund has one star or five stars offers you very little information by itself. But if you can learn more about the fund, understand what it does, and figure out why it's rated high or low—you may be on your way to finding an investment that complements your portfolio and your goals.

Percentages of funds that maintained their Morningstar ratings for at least 12 months



Source: Vanguard calculations based on rating data from Morningstar, Inc.

*There are many mutual fund rating systems, each of which uses quantitative or qualitative metrics, or both, to evaluate funds. The Morningstar system measures how funds have performed against their category peers on a risk-adjusted basis (using a formula that adjusts returns for the specific risks assumed by each fund). Morningstar calculates ratings for 3-, 5-, and 10-year periods, then takes an average of those results to create its overall rating for a fund. Five stars is the highest rating.

Some tips for tuning up your retirement savings

If you're like most Vanguard investors, you didn't panic during the extreme market volatility of the past few years and make rash changes to your retirement portfolio.

Only a small fraction—3% of about 3 million retirement investors—abandoned their equity holdings between September 2007 and December 2009, according to the Vanguard Center for Retirement Research. The vast majority of Vanguard's 401(k) and IRA investors rode out the storm.

As equity markets have rebounded, you may be wondering what, if anything, you should do with your retirement investments.

Vanguard still believes that long-term investors should resist reacting to the markets' ups and downs. However, once or twice a year, regardless of market conditions, you should make time to evaluate your retirement goals and long-term investment strategy.

Five steps to consider

Here are five quick steps that could help you tune up your portfolio:

Boost your savings. "The central factor influencing retirement outcomes is how much you save," said Stephen P. Utkus, director of the Center for Retirement Research. As a guideline, consider saving 12% to 15% of your income (including matching contributions) for retirement.

Does 12% sound daunting? If you're in a company retirement plan, first try to match your employer's contributions and then add more money on special occasions, such as your birthday, or when you get a raise or bonus. Also consider signing up for an automatic annual increase to your retirement contribution.

If you have a traditional or Roth IRA, you may consider setting up automatic transfers from your bank account to the IRA.

Diversify your portfolio. Research shows that as much as 90% of your portfolio's performance over time is determined by the way you allocate your assets among stocks, bonds, and cash—not by your selection of individual investments.*

In general, avoid extremes in asset allocation; be wary of holding an all-stock or all-bond portfolio.

"Diversify within each asset class, too, by holding, say, long-term and short-term bond funds, or stock funds with companies of various market capitalizations," said John Ameriks, head of Vanguard Investment Counseling & Research.

Keep an eye on your risk exposure. Because of the markets' recent swings, it's likely your mix of stocks, bonds, and cash has shifted away from where you initially set it.

If your portfolio has drifted more than 5% from your target, it may be time to rebalance. You can do this on your own or find a financial advisor who can assist you for a fee.

Avoid excessive company stock. How much of your retirement savings is in your employer's stock? As a rule of thumb, experts suggest that you hold no more than 20% of your portfolio in company stock.

"With large amounts in company stock, your retirement savings are correlated with your salary," said Mr. Utkus. "If the company suffers, your 401(k) does—and your risk of layoff or job loss does too."

Consider your tax liability. IRAs and employer-sponsored plans are sheltered from current taxation, but your savings in other accounts probably are not. "Make sure you have the right assets in the right place," said Mr. Ameriks.

Consider holding more tax-efficient investments, such as tax-managed, index, and tax-exempt funds, in your taxable accounts, and keeping tax-inefficient investments in your IRA or company plan account. ■

*For a list of research sources and Vanguard's own findings, see *The Asset Allocation Debate: Provocative Questions, Enduring Realities,* available at **vanguard.com/allocationdebate**.

Notes: When taking withdrawals from an IRA before age 59½, you may have to pay ordinary income tax plus a 10% federal penalty tax. It is possible that tax-managed investments will not meet their objective of being tax-efficient.

Vanguard ETF or fund: Demystifying the choice

Conventional Vanguard index fund shares or Vanguard ETFs®?

That's a question a growing number of individual investors are asking these days in the wake of Vanguard's move in May to offer our clients commission-free transactions on Vanguard ETFs held through Vanguard Brokerage Services®.*

When it comes down to which one to choose, the answer for investors truly may lie within. "Whether ETFs make sense for your portfolio depends on your needs and priorities," said Donald G. Bennyhoff, CFA, a senior investment analyst with Vanguard Investment Strategy Group.

For more information, visit our website, where you'll find our Plain Talk on ETFs (at **vanguard.com/plaintalketf**) as well as a cost comparison tool (at **vanguard.com/costsetf**).

Two ways to index

"The important thing to remember is that ETFs are a tool like any other investment," Mr. Bennyhoff pointed out. "If you are looking to implement your asset allocation with index investments, you essentially have two tools—conventional fund shares or ETF shares."

At Vanguard, ETFs are another share class of our funds, so an ETF and a conventional share in the same fund will have many similar traits. Because of the common underlying portfolio, it may be more meaningful to focus on benefits and features than on investment performance.

Unlike index fund shares, ETFs are traded on stock exchanges, so they are bought and sold like individual stocks, through a brokerage account. And they trade at market prices that change throughout the day—unlike traditional shares, which are bought and sold at net asset value (NAV), calculated just once at the end of each business day.

The trade-offs

Some hands-on investors are eager to move to ETFs, but others who value the familiarity of conventional fund shares would rather not. For example, if you're used to transacting in dollars rather than shares—making a $10,000 purchase rather than buying 100 shares, say—you may not want to switch, because ETFs generally cannot be bought or sold in fractions of a share.

Another personal preference relates to the services commonly available with mutual funds. If you use features like direct deposit, automatic investment, and automatic exchanges, ETFs may not be a good choice, because they typically don't offer those conveniences.

If you're comfortable with switching to a brokerage product, then the next considerations are cost and trading flexibility. Again, those could argue for ETFs—or not, depending on your priorities.

Costs. If no commissions are involved, the primary cost issue for a long-term investor is the expense ratio. ETFs generally have somewhat lower expense ratios than comparable index mutual funds do.

But there's an additional wrinkle if you're eligible for Vanguard Admiral™ Shares, which are available to clients whose investments meet certain size and tenure requirements.** Expense ratios for Admiral and ETF Shares of a given fund may be identical.

If an ETF has significantly lower expenses than a conventional fund share, it could be a wise choice. But if the two have nearly identical expense ratios, the conventional share could turn out to be more cost-efficient, given other costs associated with owning and trading ETFs, such as:

- Account maintenance or other administrative fees charged by the brokerage firm.
- The bid-ask spread.

A bid-ask spread is the difference between the price a dealer is willing to pay for a security (the bid price) and the somewhat higher price at which the same dealer is willing to sell it (the ask price). Although a small, or narrow, spread might seem

*Trading limitations, fund expenses, and a minimum investment may apply.

**You're eligible for a fund's Admiral Shares if you either (1) have $100,000 or more invested in a single account in the fund, or (2) have owned for at least ten years a single fund account that now has a balance of $50,000 or more, and you're registered for online access to your Vanguard accounts.

immaterial to a long-term buy-and-hold investor, it's important to remember that the spread is per-share; thus, the more shares traded, the more significant the cost may become.

Another potential consideration is the difference between market price and NAV. Mutual fund shareholders are accustomed to paying NAV. But with an ETF, an investor will pay the prevailing market price, which may be more or less than the NAV.

If you invest systematically—for example, making a regular purchase every month—you could incur the bid-ask spread and, possibly, a market premium cost on every ETF purchase. You would not incur those costs with conventional fund shares.

Trading flexibility. An ETF investor can do many of the things that can be done with an individual stock, including transacting at any point during the trading day and using market, limit, and stop orders.

The ability to transact throughout the day and know the trading price with more certainty could be an important attraction for some investors. Because conventional mutual fund shares are priced only after the market's close each day, you can't know with certainty what price you'll receive when you request a purchase or sale.

A matter of choice

Given the trade-offs, choosing between ETFs and fund shares is often a personal choice—just like buying a car, said Mr. Bennyhoff. "Who's to say that any one particular car is right for everyone? Some people care most about fuel economy, while others care about performance or seating capacity. Knowing which features matter most to you will help you decide the ETF question." ■

The flash crash and ETFs

On May 6, the stock market suffered what came to be known as the "flash crash"—a large, sudden drop in prices followed by an almost equally sudden recovery.

The flash crash affected both stocks and exchange-traded funds (ETFs). In some cases, prices declined to one cent per share. Stocks and ETFs with higher-than-normal trading volume were hit particularly hard.

Vanguard's chief investment officer, George U. Sauter, says that the problem did not lie with the ETFs themselves.

"I would note that it was not a flaw in the function of the ETF," he said. "It was a market-structure problem that impacted exchange-traded funds, but also impacted stocks. And it was really just a question of how much selling pressure there was for a given security."

The Securities and Exchange Commission (SEC) responded in June with a pilot program for the stocks in the Standard & Poor's 500 Index that will require a five-minute pause in trading when volatility gets too high. This program applies across the entire stock market, not just on one exchange. The SEC is also extending the program to many ETFs, a move that Vanguard endorses.

Mr. Sauter said Vanguard might support other changes as well, possibly including restricting some types of trade orders, implementing rules to bolster liquidity, and clarifying what constitutes a "clearly erroneous" trade.

Second quarter 2010

Most global stock and bond markets took a roller-coaster ride during the second quarter, fueled by worries about sovereign debt and the endurance of an economic recovery. In the United States, a weak housing market, persistent joblessness, and pending financial reform dominated headlines amid signs of underlying growth.

A "flash crash" in the U.S. stock market on May 6 punctuated the volatility that typified the quarter, which saw a general retreat by equity indexes. Bonds, meanwhile, ended the quarter with broadly positive returns.

U.S. stocks

- The broad market, as represented by the Dow Jones U.S. Total Stock Market Index, returned –11.2% in the second quarter. Smaller-capitalization stocks didn't do as poorly as larger-caps, and value-oriented securities suffered a bit less than growth-oriented ones, but all market segments retreated in near lockstep.
- 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.

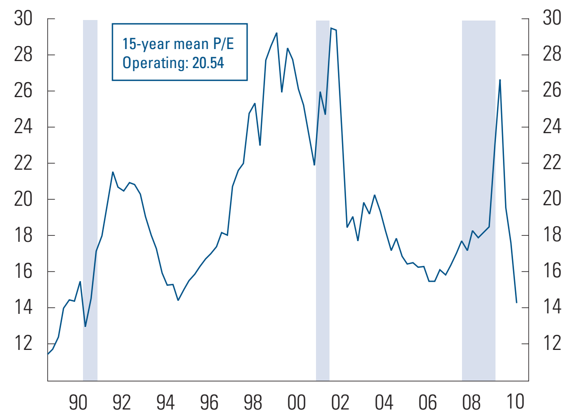
Global equity markets

- Developed markets, as represented by the MSCI EAFE Index, returned –14.0% in the second quarter in U.S. dollars. Emerging markets, as measured by the MSCI Emerging Markets Index, returned –8.4%.

U.S. bonds

- The yields of U.S. Treasury securities fell at all but the shortest maturities as investors sought safety amid worries about possible fallout from Europe's sovereign debt problems.
- U.S. government bonds set the pace for other segments during the second quarter, returning 4.2% as measured by the Barclays Capital U.S. Government Index. The Barclays Capital U.S. Aggregate Bond Index, a broad measure of taxable investment-grade U.S. bonds, returned 3.5%.

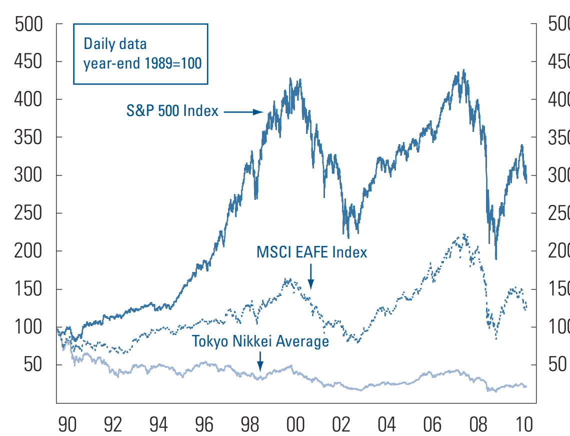
S&P 500 operating price/earnings ratio



Last observation: June 2010. Shaded areas indicate U.S. recessions; latest recession is preliminary.

Sources: Standard & Poor's Corporation; data are Crandall, Pierce & Company.

International equities



Last observation: June 30, 2010.

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

U.S. Treasury issue yields

Maturity	Dec. 31, 2009	Mar. 31, 2010	June 30, 2010	Year-to-date change (percentage points)
3 Months	0.05%	0.15%	0.17%	+0.12
2 Years	1.14	1.02	0.60	–0.54
5 Years	2.68	2.54	1.77	–0.91
10 Years	3.84	3.83	2.93	–0.91
30 Years	4.64	4.71	3.89	–0.75

Source: Vanguard.

We've got commission-free trades

We've lowered the cost of managing your portfolio by substantially reducing the investing costs for Vanguard ETFs and stocks. We now offer:

- **Commission-free Vanguard ETF transactions.** Vanguard brokerage clients can make commission-free transactions in our entire lineup of low-cost ETFs—the largest suite of ETFs available without commissions.
- **Ultralow equity commissions.** Most Vanguard brokerage clients will pay $2 or $7 to trade stocks and non-Vanguard ETFs. (Some clients will receive 25 commission-free trades; others will pay $20 after 25 transactions, as shown in the accompanying table.)

"For 35 years, Vanguard has been committed to reducing the cost of investing in mutual funds for our clients. Now, Vanguard is expanding our low-cost commitment to ETFs," said CEO Bill McNabb. "Importantly, Vanguard offers a greater choice of ETFs with expense ratios that are among the lowest in the industry."

And unlike at some of our competitors, the same rates apply whether you trade online through Vanguard.com or by phone with a brokerage associate. ■

New commission rates for ETFs and stocks

Assets invested in Vanguard funds and ETFs	Commissions for Vanguard ETF transactions[1]	Commissions for equity transactions
Less than $50,000 (standard rate)[2]	Free	$7 for the first 25 (subsequent trades $20)[3]
$50,000–$500,000 (Voyager®)	Free	$7
$500,000–$1 million (Voyager Select®)	Free	$2
$1 million or more (Flagship®)	Free	First 25 free (subsequent trades $2)[3]

1 Trading limits, fund expenses, and a minimum investment may apply. See the Vanguard Brokerage Services Commission and Fee Schedules on Vanguard.com for full details.

2 A $20 account service fee is charged annually. The fee is waived for Voyager, Voyager Select, and Flagship members.

3 The reduced commissions or commission-free trades will apply to the first 25 transactions in each calendar year to any combination of stocks and non-Vanguard ETFs. The number of these transactions is limited to 25 per client as identified by the primary Social Security number on the account. For Flagship members, the 25 commission-free transactions can also be applied to option and transaction-fee fund transactions. A separate commission schedule may apply to certain Flagship Services members. Vanguard Brokerage reserves the right to end the offer at any time.

Note: If you buy and sell the same Vanguard ETF in a Vanguard Brokerage account more than 25 times in a 12-month period, you may be restricted from purchasing that Vanguard ETF through your account for 60 days. Vanguard Brokerage reserves the right to end the offer at any time.

Certain ESA benefits set to expire in December

If you have a Coverdell education savings account (ESA), you should be aware that certain provisions in the accounts are set to expire at the end of this year unless Congress acts.

Without legislative action, in 2011 ESA owners will no longer be able to:

- Withdraw ESA funds tax-free to cover expenses for students in grades K through 12.
- Contribute more than $500 to the account per year. The current annual limit is $2,000.
- Withdraw ESA funds tax-free if they claim a Hope or Lifetime Learning tax credit in the same year.

In addition, the income threshold for married contributors will decrease to between $150,000 and $160,000, depending on the couple's modified adjusted gross income.

No one knows, of course, whether Congress will enact legislation extending the current benefits. One thing to keep in mind is that if these provisions do expire, other college savings options are available to you.

For more information about ESAs and other options, visit **vanguard.com/college.** ■

So what's the big deal about client ownership?

In almost any business, there is a tension between the interests of clients and owners. But what if clients and owners are one and the same, as they are at Vanguard? Their interests can reinforce one another in ways both obvious and subtle. Some examples:

Low costs, big profits. Vanguard is owned by the Vanguard funds, which are owned by our clients. When clients are owners, a business *can* reconcile the client's desire for low costs and high quality with an owner's pursuit of profits. Vanguard resolves this tension by providing its services to the Vanguard funds "at cost." Our profits are returned to client-owners in the form of expense ratios that are among the industry's lowest.

In 2009, the average expense ratio of Vanguard funds was 0.23%. For the fund industry as a whole, the average was 1.19%, according to Lipper Inc. If Vanguard had charged the industry's average expense ratio, some $11 billion would have vanished from our client-owners' pockets.

No legerdemain. Although the mutual fund industry's average expense ratio has remained above 1% for years, price competition is ferocious in some corners of the industry. Index fund providers try to undercut each other's already low expense ratios by a basis point or two to secure low-cost bragging rights. That *seems* like great news for clients, but don't forget—a company's owners are going to get paid somehow, and sometimes in ways that aren't fully apparent.

Consider securities lending. Many mutual funds earn extra income by lending a fund's stocks or bonds to borrowers who need the securities to facilitate a transaction. The fund continues to own these stocks and bonds and, ideally, should keep the income earned from lending them. That's not always the case.

"Some fund managers, acting as lending agent, keep 50% or more of the income from securities lending; there is no legal limit," wrote *The Wall Street Journal*'s Jason Zweig in a May 2009 column.*

At Vanguard, the funds that lend the securities retain all the income from those loans, net of Vanguard's costs, helping to maximize the returns of our client-owners.

Respect for risk. When you put your money at risk, you want your fund manager to appreciate what's at stake. Sometimes, however, what's at stake for the client isn't the same as what's at stake for the owner.

In the fixed income market, for example, you can boost a bond fund's yield by cutting costs or by taking more risk. For the client, cutting costs is the more attractive option. For a fund company owner, the temptation to keep fees intact and goose yields by taking a little more risk is strong. When client-owners are calling the shots, low costs rule.

So what does client ownership mean? At Vanguard, just about everything. ■

*Jason Zweig, "Is Your Fund Pawning Shares at Your Expense?" May 30, 2009, *The Wall Street Journal*; http://online.wsj.com/article/SB124363555788367705.html.

For information about Vanguard funds, Vanguard Brokerage Services®, or your account, call us toll-free Monday through Friday from 8 a.m. to 10 p.m. and on Saturday from 9 a.m. to 4 p.m., Eastern time: **800-600-4827**.

For automated fund and account information 24 hours a day, 7 days a week, call Vanguard Tele-Account®: **800-662-6273**.

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