

# Learn About Active and Passive Investing



# Agenda

- How actively managed mutual funds work
- How index mutual funds work
- Understanding indexes

## How actively managed funds work

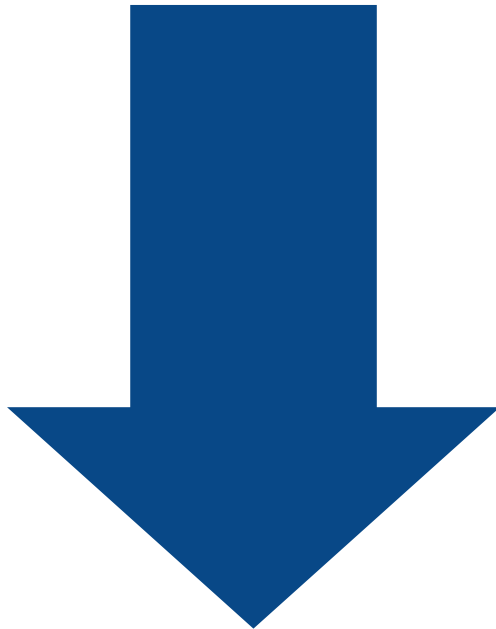
### Advantages:

- In-depth analysis by fund managers
- Opportunity to earn higher-than-market returns

# How investment managers try to beat the stock market

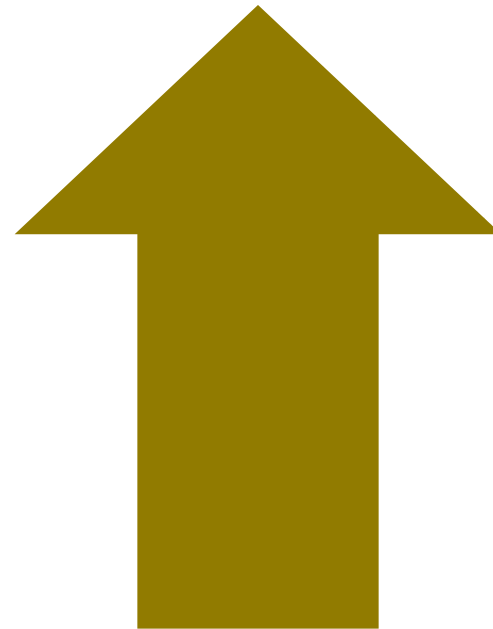
Two approaches:

**Top down**



- Examine economic trends
- Identify promising industries
- Find winning companies

**Bottom up**



- Identify promising companies in any industry

## What about actively managed bond investing?

- Find the best companies
- Analyze for creditworthiness
- Anticipate interest rate changes and adjust maturities of bonds held in managed funds

# It's not easy to pick a winner

## Most U.S. equity mutual funds lagged relevant indexes in 1997–2007

	Value		Blend		Growth	
Large	5.99%		4.43%		4.03%	
		7.70%		6.15%		4.27%
	(1.71%)		(1.72%)		(0.24%)	
Medium	9.14%		10.03%		7.60%	
		10.77%		10.02%		7.83%
	(1.63%)		0.01%		(0.23%)	
Small	8.95%		8.95%		6.68%	
		9.61%		9.60%		8.50%
	(0.66%)		(0.65%)		(1.82%)	
Average fund returns						
Index total returns						
Out-(under-) performance*						

Source: Vanguard Investment Strategy Group.

Please see the Disclosures page at the end of this presentation for information on MSCI backtested performance data.

Derived from Lipper data using MSCI benchmarks for equities and Lehman benchmarks for bonds.

\* "Out- (under-) performance" is a close approximation of active funds' relative returns and may actually understate their relative performance. Actively managed funds account for all but a small minority of the equal-weighted average fund return.

# It's not easy to pick a winner

History shows that top performing funds could not sustain their positions

Top five funds		Rank after ten years
1987–1997		1997–2007
1	→	6,656
2	→	446
3	→	6,138
4	→	5,033
5	→	5,014

1,223 funds included in study from December 31, 1987 through December 31, 1997 with 10-year history.  
6,725 funds included in study from December 31, 1997 through December 31, 2007 with 10-year history.  
Source: Lipper.

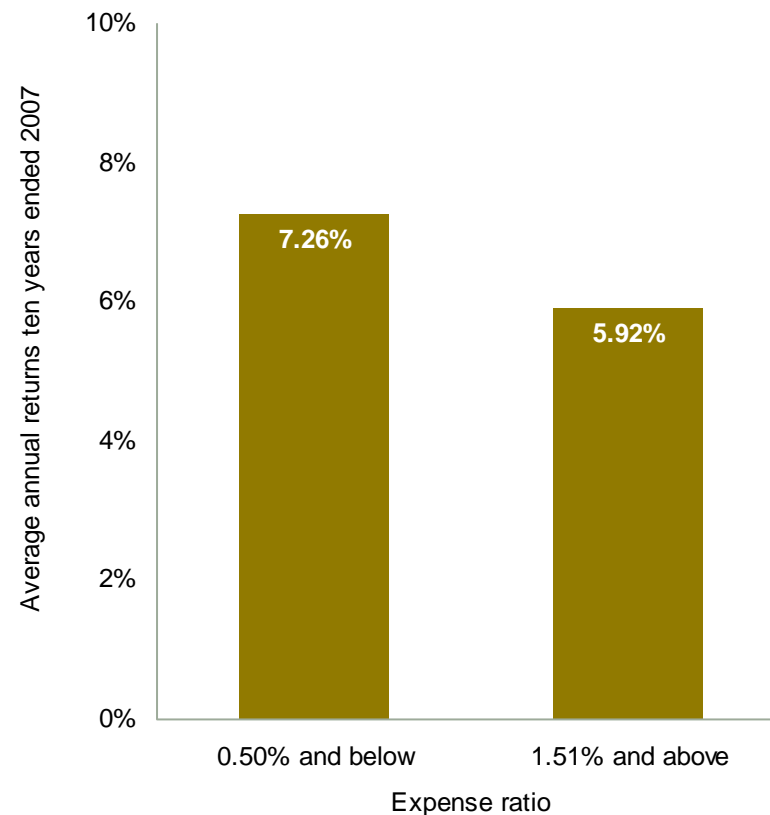
> 7



**Vanguard**

# Don't ignore investment costs

## Average actively managed equity fund returns by expense ratio



Past performance is not a guarantee of future results.  
Source: Lipper. As of December 31, 2007



# What to look for in an active mutual fund manager

- Experience
- Straightforward investment philosophy
- Successful track record

## How indexes work

Index funds use two approaches to match their benchmark returns:

- Replication—Hold every security in the target index in the same proportion as the index
- Sampling—Hold a representative sample of securities that resembles the target index

## What is an index?

Collection of stocks or bonds chosen to represent a portion of the market

- Tracks market performance
- Mirrors the change in prices of securities held in the index
- Measures companies based on market capitalization

## Common indexes

- Dow Jones Industrial Average
- S&P 500 Index
- Dow Jones Wilshire 5000 Total Market Index
- Russell 2000 Index
- Nasdaq Composite Index
- Lehman Brothers Aggregate Bond Index
- Morgan Stanley Capital International (MSCI)

# Disclosures

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

Like all investments, mutual funds are subject to risk, including possible loss of principal. Fluctuations in the financial markets and other factors may cause declines in the value of your accounts. Prices of mid- and small-cap stocks often fluctuate more than those of large-company stocks. Foreign investing involves risks including currency fluctuations and political uncertainty. Investments in bond funds are subject to interest rate, credit, and inflation risk.

*Vanguard* and the ship logo are trademarks of The Vanguard Group, Inc. All other marks are the exclusive property of their respective owners.

Connect with Vanguard > [advisors.vanguard.com](http://advisors.vanguard.com)

© 2008 The Vanguard Group, Inc. All rights reserved.