Learn about indexing

Investor education

Vanguard®

Plant the seeds of a successful portfolio

Many financial advisors use index funds as the foundation in many of their clients' portfolios.

This guide will help you better understand the benefits of indexing and help make your consultations more productive as you work with your financial advisor to build a successful investment portfolio.

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What is indexing?

Indexing is an investment approach that seeks to track the performance of a specific benchmark, or index.

Index funds do this by holding all (or a representative sample) of the securities in the index being tracked. This "passive" investment approach emphasizes broad diversification, limited trading of the securities held in the portfolio, and low costs. In indexing, no bets are made on individual securities.

The benefits of indexing

Index investing can offer several significant benefits, including diversification, low costs, competitive performance, simplicity, and the potential for tax-efficiency.

Diversification

Maintaining a well-diversified portfolio is an essential part of a successful investment plan. Indexing can be an ideal way to achieve diversification.

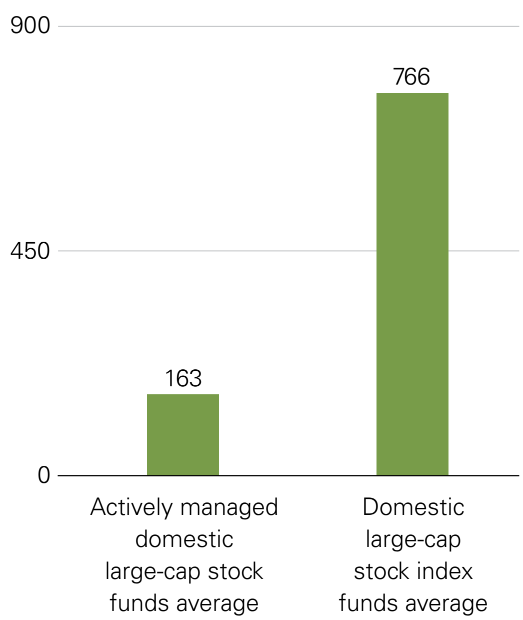
It's difficult for actively managed funds to compete with index funds when it comes to diversification relative to a market segment, because index funds generally hold most or all of the securities in their target indexes.

An actively managed fund typically holds a much smaller selection of securities that the fund manager believes will outperform its index.

Although the diversification that index funds offer can't protect you against broad market declines, it can reduce the risk posed by a dramatic decline in any one security or economic sector.

The chart below illustrates the typical difference in the average number of securities held by domestic large-capitalization stock index funds and actively managed domestic large-cap stock funds.

Number of securities held



Source: Morningstar, Inc., as of December 31, 2011.

Low costs

Index funds have a powerful advantage over actively managed funds—lower costs.

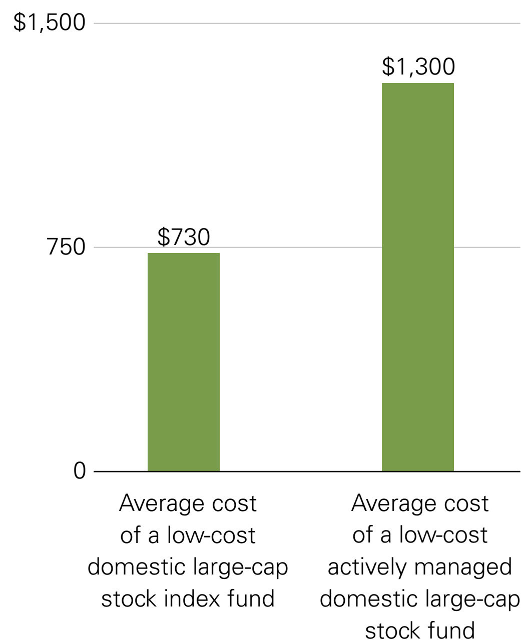
There are two main reasons that indexing costs less:

- **Lower management fees.** It simply costs less to manage and operate an index fund. That's because index funds don't have to employ highly paid fund managers and their staffs to analyze and select stocks.
- **Lower transaction costs.** Index funds use a fundamental buy-and-hold approach, which means that index fund managers generally turn their portfolios over far less often than active fund managers. This reduces the brokerage, commission, and other expenses associated with trading securities, and results in lower trading costs.

Here's the bottom line: A low-cost stock index fund costs approximately 0.73% annually—$0.73 for every $100 invested. That's more than half of the 1.30% average cost of actively managed U.S. stock funds in 2011, according to Lipper Inc.

The cost advantage of index funds

The cost in 2011 of a $100,000 investment



Source: Lipper Inc. as of December 31, 2011.

Competitive performance

Thanks to their diversification and low costs, index funds can be an effective way to achieve competitive returns over the long run (although past performance is no guarantee of future returns).

Potential for tax-efficiency

As noted earlier, index funds typically have much lower portfolio turnover than actively managed funds. Therefore, most index funds tend to realize and distribute only modest capital gains. This is particularly important if you hold index funds in taxable accounts.

Simplicity

There's nothing complicated about how index funds are designed or how they operate. They have a precise, easily understood objective—to track the performance of a specific index. With index funds, you always know how your money is invested.

What are the risks?

As with any investment, it's important to remember that mutual funds (including index funds) are subject to risk, including possible loss of principal. In addition, diversification does not ensure a profit or protect against a loss in a declining market. Finally, investments in bond funds are subject to interest rate, credit, and inflation risk. That's why index investors should make a long-term investment commitment.

Whether you and your financial advisor are looking for exposure to domestic or international markets, small-cap or large-cap stocks, or a specific sector, you'll likely find an index fund that fits your needs.

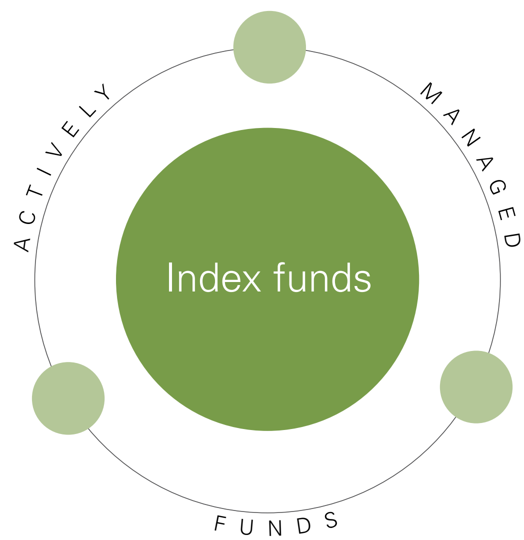
Putting indexing to work

Indexing is an excellent foundation

While there are a number of ways that your financial advisor can use index funds as part of your investment program, one of the most common applications is as the core holdings in your portfolio.

As the illustration shows, often a selection of broadly diversified stock and bond index funds is supplemented with a mix of actively managed funds to form a portfolio that fits a given investor's needs.

The active-passive investment approach



Common indexes

The Dow Jones Industrial Average. The oldest barometer of the U.S. stock market and the one most often quoted in the media. The Dow tracks the stocks of 30 major companies from a variety of industries.

Standard & Poor's 500 Index. Synonymous with the "U.S. stock market," the S&P 500 tracks the stocks of 500 leading U.S. companies.

Dow Jones U.S. Total Stock Market Index. A measure of the entire U.S. stock market, the Dow Jones U.S. Total Stock Market Index includes large, midsize, and small companies.

Russell 2000 Index. The Russell 2000 represents the smallest two-thirds of the 3,000 largest U.S. companies.

The Nasdaq Composite Index. The Nasdaq Composite Index includes the stocks of more than 3,000 companies listed on the Nasdaq Stock Market, including the stocks of many widely followed technology companies.

Morgan Stanley Capital International Europe, Australasia, Far East Index. Designed to measure developed markets equity performance outside North America, the MSCI EAFE Index tracks more than 1,100 stocks traded on 21 exchanges in Europe, Australasia, and the Far East.

Barclays Capital U.S. Aggregate Bond Index. A measure of the taxable, investment-grade U.S. bond market, including U.S. Treasury and corporate bonds, the Barclays Capital Aggregate Bond Index excludes low-quality bonds whose issuers are considered more likely to default.

The Dow Jones Industrial Average and the S&P 500, the Nasdaq Composite, the Dow Jones U.S. Total Stock Market, and the Barclays Capital U.S. Aggregate Bond Indexes each reflect a collection of stocks or bonds that represents all or a part of the market.

The power and appeal of indexing are undeniable. That is why investors have placed billions of dollars in index funds. Consult with your financial advisor about how indexing can fit into your plan.

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For more information about index investments, contact your financial advisor to obtain a prospectus. Investment objectives, risks, charges, expenses, and other important information are contained in the prospectus; read and consider it carefully before investing.

Investors cannot invest directly in an index. All investments are subject to risk.

Financial advisors: visit advisors.vanguard.com or call 800-997-2798.

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

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