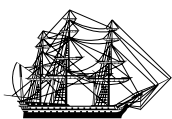


Learn about active and passive investing

Investor education



Vanguard[®]



Active, passive or both: Which is right for you?

Portfolios can be built using actively managed and index mutual funds either individually or in combination. This brief guide will help you understand the importance of both investment strategies so you can better appreciate how your financial advisor approaches investing your assets.

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How actively managed funds work

Managers of actively managed funds attempt to beat the market by picking and choosing among specific investments. Managers employing an indexing—or passive—strategy, on the other hand, simply try to mimic the return of a certain index by buying and holding all, or a representative sample, of the securities in the index.

Actively managed stock mutual funds have the advantage of in-depth analysis of securities by fund managers. An actively managed stock fund also gives you the chance to earn higher-than-market returns.



Whatever a fund's objective, there are several techniques active stock fund managers use to try to beat the market. One is to be a smart stock picker. Typically, this is done by using either a top-down or a bottom-up approach.

Top-down managers start by looking at economic trends to help them predict which industries will prosper in the future. Once they've identified promising industries, they look within them to find the best companies.

Bottom-up managers look for outstanding companies in any industry, assuming that a great company will do well even if it's in an industry that's not thriving at the moment.

What about actively managed bond investing?

Active bond fund managers are a lot like active stock fund managers in that they must sift through the market to find the companies that offer the best odds of delivering positive returns. However, active bond managers must also consider other factors.

Active bond managers can try to beat the market through careful analysis of bonds' creditworthiness or by anticipating changes in interest rates and adjusting the maturities of the securities held in the portfolios they manage.

While bond prices move in the opposite direction from interest rates, the prices of shorter-term bonds are usually less sensitive to interest rate changes than those of longer-term bonds. A fund manager who expects interest rates to rise may buy shorter-term bonds—within the fund's stated maturity range. And a manager who expects interest rates to drop may buy longer-term bonds.

It's not easy to pick a winner

While actively managed funds offer the opportunity for higher returns, finding an active manager who can identify tomorrow's successful stocks—let alone pick stocks that will perform well consistently—can be a difficult proposition.

Don't forget about investment costs

The true value of active management depends on a manager's talent and on competitive costs. It's important that an active fund manager be able to implement a sound investment strategy and not lose too much potential return to costs such as management fees and transaction costs.

Costs are a critical factor in determining fund performance. In fact, the under-performance of a mutual fund relative to its benchmark can often be the result of higher costs, rather than a manager's inability to pick strong-performing stocks.

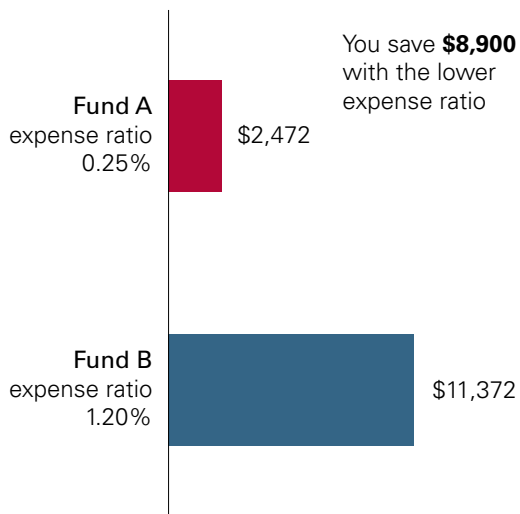
Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments.

Investments in bonds are subject to interest rate, credit, and inflation risk.

Too often costs are overlooked. The chart below illustrates just how much investment costs can add up over time. Funds A and B each invest \$100,000 for ten years. Fund A has a comparatively low expense ratio of 0.25%, whereas Fund B has an expense ratio of 1.20% that's closer to the industry average.*

Costs matter

How much it costs to invest \$100,000 in a low-cost fund and a higher-cost fund



This hypothetical illustration does not represent any particular investment.

*Source: Lipper, a Thomson Reuters Company. The industry average expense ratio was 1.11% as of December 31, 2012.

Ask these questions when evaluating an active manager

- How much experience does the manager have? As with any profession, experience counts.
- What is the manager's investment philosophy and does he or she consistently follow that philosophy? Knowing a manager's investment philosophy is the best way to avoid surprises.
- What is the manager's track record? Look for managers whose funds have outperformed their benchmarks over the long term.

How index funds work

Index funds are straightforward investments designed to match the returns of their target markets. To do this, their managers use one of two indexing techniques—replication or sampling.

The replication approach

The managers of many stock index funds—but not of bond index funds—use the replication method to track the performance of their funds' target indexes. This method means that a fund holds every security in its target index in the same proportion as in the index. For example, if a company's stock made up 1% of the value of the Standard & Poor's 500 Index, then the manager of an S&P 500 Index fund would invest 1% of fund assets in that stock.

The sampling approach

Managers of index funds that use the sampling method select a representative

sample of securities from the target index that resembles the index in terms of key risk factors and other characteristics. For instance, if a particular industry makes up 10% of the target index, the manager of a stock index fund might invest 10% of fund assets in that industry—even though the fund might not hold every one of the index's underlying stocks.

Managers of stock index funds use sampling when the target index is so large that it's too expensive and inefficient to buy all of the stocks in the index, while managers of bond index funds typically use sampling to track bonds in a broad index that are not traded often enough to be obtained at a fair price.

Understanding indexes

An index is a collection of stocks or bonds chosen to represent a portion of the market. Investors use indexes to track market performance.

Most indexes measure companies based on market capitalization.¹ For example, if a company's market cap is \$1 million and the value of all the stocks in the index is \$100 million, then the company would be worth 1% of the index.

Some indexes, however, are price-weighted. This means that each stock influences the index in proportion to its price per share. Higher-priced stocks will be given more weight and will have greater impact on the index's performance. The Dow Jones Industrial Average is an example of a price-weighted index.

Here are some common indexes

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.

S&P 500 Index—Synonymous with the "U.S. stock market," the S&P 500 tracks the stocks of 500 leading U.S. companies.

Wilshire 5000 Index—A measure of the entire U.S. stock market, the Wilshire 5000 Index includes large, midsize, and small companies.

¹ Market capitalization is a determination of a company's value, calculated by multiplying the total number of company stock shares outstanding by the price per share.

CRSP US Total Market Index—

Represents approximately 100% of the investable U.S. stock market and includes large-, mid-, small-, and microcap stocks regularly traded on the New York Stock Exchange and Nasdaq.

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

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.

MSCI EAFE Index—Designed to measure developed markets equity performance outside North America.

FTSE Global All Cap ex US—Designed to measure the developed and emerging markets throughout the world, excluding the United States.

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

There are many ways to construct portfolios using active and index funds. Work closely with your financial advisor to learn more about indexing and active management strategies and the ways in which they may fit in your portfolio.

Prices of mid- and small-cap stocks often fluctuate more than those of large-company stocks. Investments in stocks issued by non-U.S. companies are subject to risks including country/regional risk and currency risk. Diversification does not ensure a profit or protect against a loss.





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For more information about index mutual funds and other investment products, contact your broker 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.

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 account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.

Investors cannot invest directly in an index.