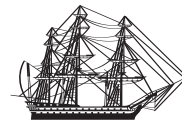


The Benefits of Active-Passive Combinations

INVESTOR | research



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Indexing and active management may seem like opposite sides in a debate. For some investors, if one strategy is right, the other must be wrong. In reality, combining the two very different approaches to portfolio construction can add value.

Broad-market index funds combine diversification with low costs, a strategy that has historically outperformed most actively managed funds. On the other hand, because active managers veer from the market-cap weightings typical of most indexes, they provide the opportunity of outperforming their benchmarks, as well as the risk of lagging them.

Under the right circumstances, active and passive components can complement each other by moderating the swings between the extremes of relative performance. Such a combined strategy can help avoid the pangs of regret that your clients might otherwise experience when one approach trumps the other.

The case for indexing

The benefits

Approximating the returns of the target market. Index funds are straightforward tools in executing your allocation strategy and capturing the return of the target asset classes. Given successful tracking, index funds should only underperform their target benchmarks by the amount of operating and trading costs—an inherent performance advantage over most active strategies, which typically entail higher expenses. In the past, index funds have outperformed the majority of active funds over the long term.

Most U.S. equity mutual funds lagged relevant indexes December 31, 1998–December 31, 2008

	Value	Blend	Growth
Large	77.01%	61.05%	25.91%
	(2.22%)	(1.40%)	(0.11%)
Medium	65.75%	50.00%	35.90%
	(1.71%)	0.60%	0.46%
Small	63.81%	55.20%	67.33%
	(0.63%)	(0.46%)	(1.84%)

- Percentage of funds outperformed by index
- Difference in annualized returns

The following indexes were used: MSCI US Prime Market Value, MSCI US Prime Market 750, MSCI US Prime Market Growth, MSCI US Mid Cap Value, MSCI US Mid Cap 450, MSCI US Mid Cap Growth, MSCI US Small Cap Value, MSCI US Small Cap 1750, and MSCI US Small Cap Growth Indexes. Please see the back of this brochure for disclosures about MSCI back-tested performance.

Sources: Derived from data provided by Lipper Inc. and MSCI. Data as of December 31, 2008.

All investments are subject to risks, including the possible loss of principal. Prices of mid- and small-cap stocks often fluctuate more than those of large-cap stocks. Foreign investing involves additional risks, including currency fluctuations and political uncertainty. Diversification does not guarantee a profit or protect against a loss. Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Applicability to virtually any market segment or asset class. The same strengths that make indexing a good strategy for broad asset class exposure also apply to market segments within those asset classes. Because investments in small-cap and international markets entail higher costs, the active manager has to overcome a higher hurdle to add value, making indexing an attractive alternative.

Transparency. Because they are designed to track an index and hold the same securities (or a representative sample), index funds are transparent and easy to understand.

Tax-efficiency. Depending on the index, passive strategies typically realize lower capital gains than comparable active funds, making them potentially more tax-efficient.

Diversification within a market segment. Index funds often have more securities than a typical active fund.

Other aspects to consider

Settling for market returns. For these benefits, index investors are willing to forego the key value that only active management can offer, which is the possibility—though with low probability—of outperforming the market.

Index construction. Index investors should also consider the differences in index construction, which can mean substantial differences in performance between benchmarks supposedly tracking the same market segment. Each index provider has its own definition of growth and value, as well as different parameters for large-cap versus mid- or small-cap.

The case for active management

The benefits

The opportunity for outperformance. As long as investors make behavioral and informational errors, there will be opportunities to outperform the market. Many investing decisions are emotionally driven. On any given day, investors may underreact or overreact to news, trading securities at prices unequal to their real values.

Investors also vary considerably in their ability to assimilate and interpret data, and in their discipline and insight. These behaviors and the range of investors' sophistication create inefficiencies in the marketplace.

A disciplined, insightful manager who can identify enough of these opportunities to overcome the higher costs of active management can add value.

Other aspects to consider

The difficulty of identifying a winner in advance.

As hard as it can be to find successful active managers, it may be even more difficult to pinpoint those who will be consistently successful.

The drag of high costs. The real value of active management depends on manager talent and competitive costs—and both demand effective due diligence from the financial advisor or the investor. When selecting managers, consider whether they can effectively implement a sound strategy and not lose too much of the potential return to costs, which include management fees, transaction costs, and taxes.

Historical evidence suggests that mutual fund performance tends to be inversely related to fund expenses, as seen in the following table, and the underperformance of active managers in the aggregate can be explained by higher costs, and not necessarily by any lack of stock-picking skill.

Morningstar category quartile rankings by expense ratio

Quartiles sorted by expense ratio	Large-cap funds		Mid-cap funds		Small-cap funds	
	Median expense ratio	Median return	Median expense ratio	Median return	Median expense ratio	Median return
Quartile 1	0.69%	-1.17%	0.90%	3.21%	0.96%	4.21%
Quartile 2	1.03%	-0.59%	1.18%	2.74%	1.26%	3.98%
Quartile 3	1.27%	-0.99%	1.40%	1.82%	1.50%	3.51%
Quartile 4	1.89%	-1.55%	1.99%	0.85%	2.11%	2.42%

All returns are 10-year annualized. Data as of December 31, 2008. Analysis includes only funds in the Morningstar universe that have ten-year data. Large-cap funds consist of the Morningstar categories for large blend, large value, and large growth. Mid-cap funds consist of the Morningstar categories for mid-cap blend, mid-cap value, and mid-cap growth. Small-cap funds consist of the Morningstar categories for small blend, small value, and small growth. Past performance is no guarantee of future results.

Sources: Morningstar and Vanguard Investment Strategy Group.

Factors in choosing an active manager

As noted earlier, low costs increase the probability of outperformance, but there are other important factors to consider when selecting an active manager.

Benchmark sensitivity

Some active managers are highly index-oriented or "index-sensitive," typically targeting a modest amount of excess return and acceptable deviation from the benchmark. However, "index-agnostic" managers attempt to add as much alpha (excess return relative to a benchmark) as possible with little concern for volatility. Others are in-between, following an "index-aware" approach. All are legitimate strategies. Advisors need to decide which managers align best with their clients' objectives and portfolios.

Consistency

A clearly defined investment philosophy and a consistent approach, regardless of market cycles, are important. Consider a manager's long-term performance record relative to the appropriate benchmarks.

Combining well-chosen active managers with indexing can provide a Goldilocks effect—not too hot, not too cold—that might be appropriate for some of your clients.

The case for active-passive

Despite the numerous advantages of indexing, investors' assets are far less balanced between index and active funds than one might suspect: According to Lipper Inc. data as of December 31, 2008, 74% of equity fund assets were invested in actively managed funds.

There is a strong argument in favor of combining the two approaches: In addition to reducing costs, adding indexing to active-oriented portfolios can help temper risk as well.

As the table below illustrates, the three hypothetical 50-50 active-passive portfolios had no periods over a 23-year time frame when they were the best performers in this group, but they

were never the worst. And they sacrificed little or nothing in long-term annualized returns—a plus for benchmark-aware investors.

While a 50-50 split between indexing and active management can be a reasonable starting point, the most appropriate combination for a portfolio depends on a number of factors, particularly the investor's goals, objectives, and tax circumstances, both across and within asset classes.

Once an appropriate percentage of indexing versus active management is chosen, careful attention must be paid to manager selection and cost control. Both are critical in improving the chances of obtaining the desired results from a combined strategy.

Adding indexing to active portfolios can help temper risk

		Number of times best performer	Number of times worst performer	Annualized return 1985–2008
6 month non-overlapping periods	100% Index Portfolio	23	10	9.69%
Active portfolios	Active A	11	14	8.93%
	Active B	10	11	9.22%
	Active C	4	13	8.88%
Active-passive combinations	50% Index/50% Active A	0	0	9.32%
	50% Index/50% Active B	0	0	9.46%
	50% Index/50% Active C	0	0	9.29%

Analysis of seven possible portfolios in 48 semiannual periods during 1985–2008. A spliced index—the Dow Jones Wilshire 5000 Composite Index through April 22, 2005, and the MSCI US Broad Market Index thereafter—representing the overall U.S. stock market at all market capitalization levels was used as a proxy for a broad-market index portfolio. (Index performance does not reflect real-world operating costs, which could alter the results.) The active portfolios were well-diversified combinations of Lipper fund category averages in proportions roughly approximating the market capitalization of the broad market. (See table below.) Past performance is no guarantee of future results. These hypothetical examples are not exact representations of any particular investment, as you cannot invest directly in an index or a fund-group average.

Portfolio weights	100% Index portfolio	Active A	Active B	Active C	50% Index/ 50% Active A	50% Index/ 50% Active B	50% Index/ 50% Active C
DJ Wilshire 5000/MSCI Market Index	100%	0%	0%	0%	50%	50%	50%
Average Large-Cap Growth Fund	0%	0%	35%	45%	0%	17.5%	22.5%
Average Large-Cap Value Fund	0%	0%	35%	45%	0%	17.5%	22.5%
Average Mid-Cap Core Fund	0%	0%	15%	0%	0%	7.5%	0%
Average Small-Cap Core Fund	0%	0%	15%	10%	0%	7.5%	5%
Average Multi-Cap Growth Fund	0%	50%	0%	0%	25%	0%	0%
Average Multi-Cap Value Fund	0%	50%	0%	0%	25%	0%	0%

Indexing and active management are not necessarily mutually exclusive. Many investors may be better off with all-index portfolios, particularly in taxable accounts. But there will be some who might prefer an opportunity to outperform, without the potentially higher costs and risks that are associated with all-active portfolios.



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Note on MSCI US Indexes: MSCI started calculating and maintaining the above US equity indexes on December 2, 2002 with a base level of 1,000 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. Past performance is no guarantee of future results.

Investors cannot invest directly in an index.

For more information on Vanguard funds, 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.

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