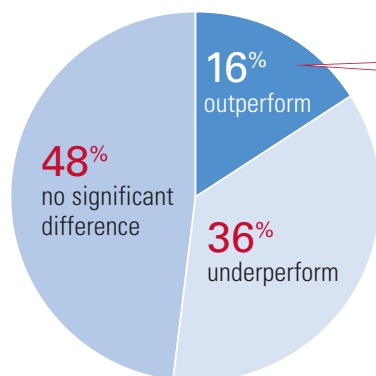


The Asset Allocation Debate: What Really Matters

What are the odds of active outperformance?

An analysis of 40 years of performance for 189 balanced funds found the odds of active managers outperforming a market benchmark were slim.



What traits do the 16% of the study sample have in common?

- Lower average expense ratio: 1.11% versus 1.23%.
- Lower turnover, averaging 74.4% versus 100.4%.
- More assets under management: \$1.9 billion, on average, versus \$538 million.

Outperforming funds beat their benchmarks by an average of 2.88% per year. Underperforming funds lagged their benchmarks by an average of 2.02% per year.

Source: University of Chicago Center for Research in Security Prices Survivor Bias-Free US Mutual Fund Database. Vanguard calculations.

Past performance is no guarantee of future returns.

The importance of asset allocation

A portfolio's performance depends on three interrelated decisions: security selection; market-timing; and an investor's policy, or long-term, asset allocation. Studies through the years have attempted to pin down the relative importance of each decision in investment outcomes.

An analysis of 40 years of performance for 189 balanced funds¹ concluded that:

- Asset allocation was the most important determinant of return volatility and long-term total returns in broadly diversified portfolios with limited market-timing.

- As active management increased, the impact of asset allocation on the portfolios' returns declined.
- Market-timing and security selection were unable to produce enough value to overcome operating expenses and transaction costs for the average actively managed balanced fund.
- A small percentage (16%) of actively managed balanced funds were able to consistently outperform their policy portfolios, which used broad market indexes to measure performance for the same asset allocations.

¹ The Vanguard Group, 2007. *The Asset Allocation Debate: Provocative Questions, Enduring Realities*. Valley Forge, Pa.: Investment Counseling & Research, The Vanguard Group.

Conclusion

The goal of active management is to increase the risk-adjusted returns of a portfolio. However, active strategies tend to have a high skill hurdle, less stable and less predictable relative returns over time, and higher costs. When investors do not have a strong belief in their ability to select active managers who will deliver higher risk-adjusted net returns, they should focus on selecting an asset allocation appropriate to their unique circumstances and on constructing broadly diversified portfolios with limited market-timing. To the extent that active management plays a role in a portfolio, investors should consider selecting active funds where the hurdles—for example, costs—that must be overcome by skill, are lower.

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