



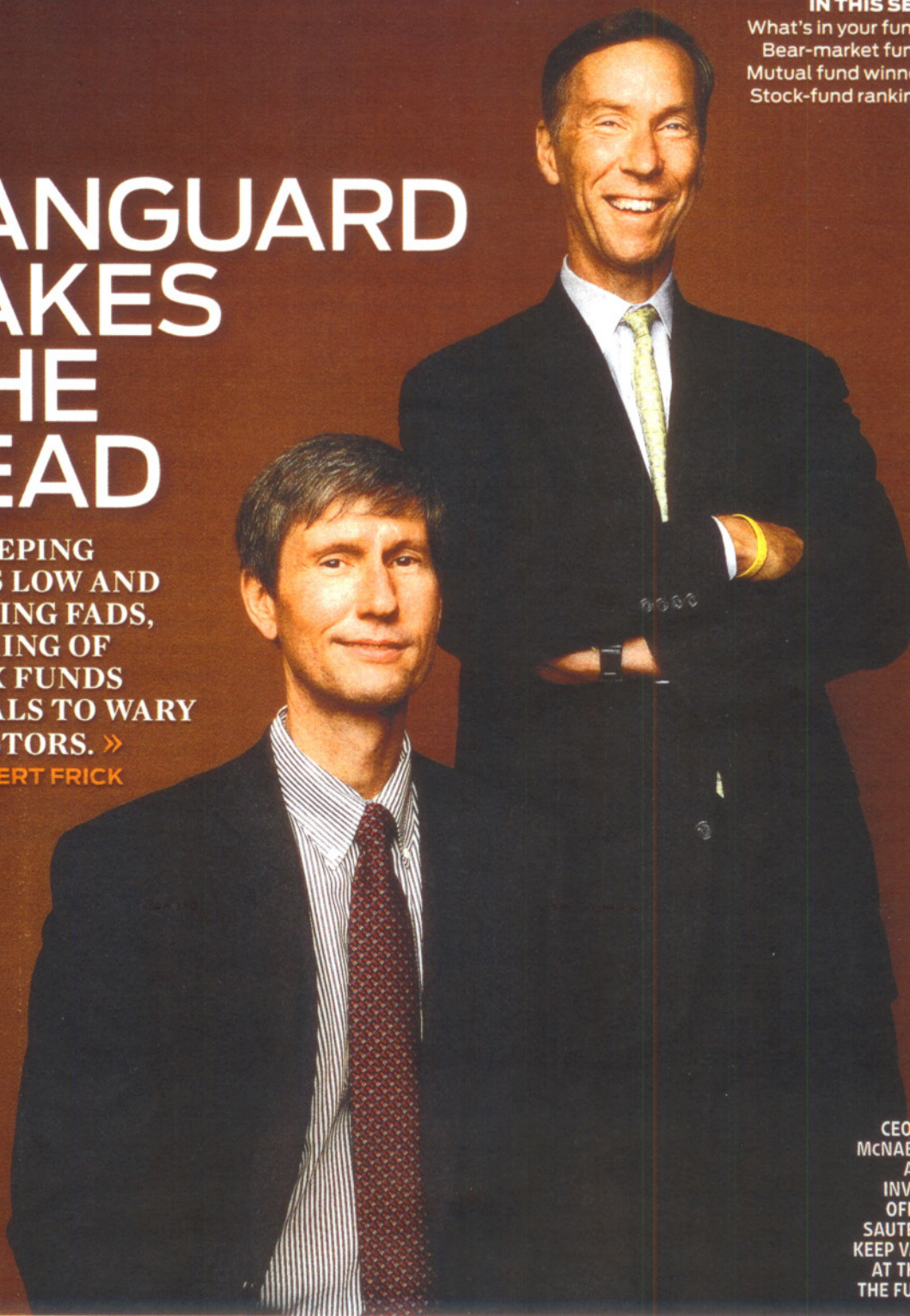
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VANGUARD TAKES THE LEAD

BY KEEPING COSTS LOW AND AVOIDING FADS, THE KING OF INDEX FUNDS APPEALS TO WARY INVESTORS. »

BY ROBERT FRICK



CEO WILLIAM MCNABB, RIGHT, AND CHIEF INVESTMENT OFFICER GUS SAUTER AIM TO KEEP VANGUARD AT THE TOP OF THE FUND HEAP.

PHOTOGRAPHS BY MIKE MCGREGOR

LAST YEAR, VANGUARD GROUP BECAME THE NATION'S LARGEST PROVIDER OF MUTUAL funds, overtaking Fidelity Investments. Benefiting from its focus on index funds, its super-low fees, and growing investor disenchantment with funds that shine for a time and then blow up, the company has seen its assets surge over the past decade. // Now that it's on top, Vanguard wants to protect its position. In an internal memo,

chief executive William McNabb acknowledged Vanguard's ascendancy not with fanfare but with a cautionary note: "We are always just one mistake away from ruining that trust and that reputation....Our ranking and our reputation do not earn us a free pass." Says Dan Wiener, editor of a newsletter that tracks Vanguard funds: "The overarching strategy at Vanguard is not to screw up the franchise."

Fund companies can screw up in a number of ways. They can offer slipshod service, which by all accounts Vanguard does not do. They can charge too much, which isn't a problem at Vanguard, the fund industry's low-cost leader. And, of course, they can perform poorly—the quickest way to drive away investors. Just look at Legg Mason Value Trust and Fidelity Magellan, two onetime behemoths that crashed and took a piece of their sponsors' goodwill along with them. But because Vanguard focuses on index funds—products that seek only to match a market's return—most of the

firm's assets are insulated from the risk that they will lag their benchmarks substantially.

How Vanguard became a juggernaut—it now sucks up \$100 billion in new assets every year—says a lot about today's investment landscape. Vanguard's success speaks to a growing distaste for funds that charge exorbitant fees and a loss of trust in companies that lure us into funds that chase the hot investment theme du jour. Vanguard's index funds are cheap and anything but faddish. Yet, in what might be called the Vanguard paradox, the firm also peddles a large stable of actively managed funds. For the most part, those funds have delivered decent returns.

●● **A DIFFERENT APPROACH**

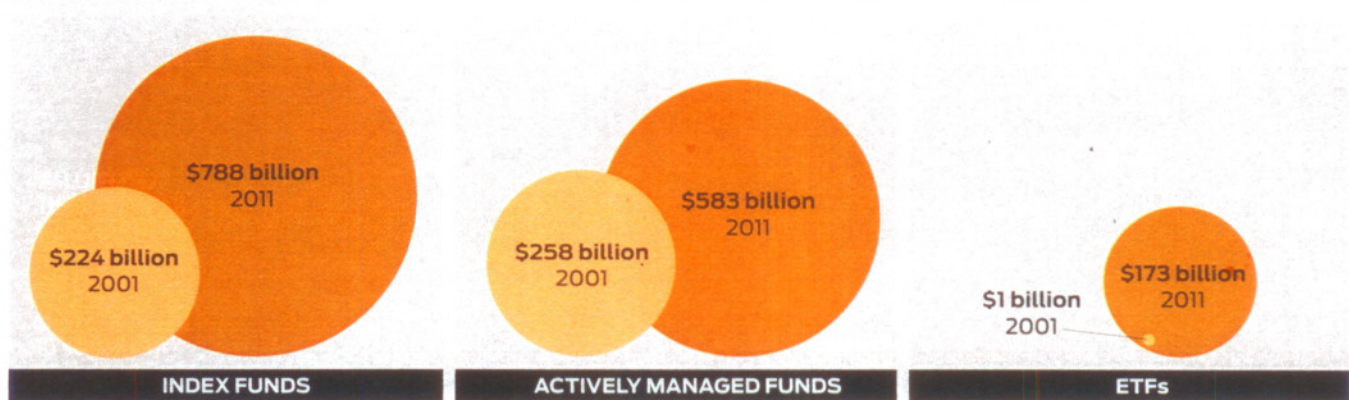
From the day John Bogle started the firm in 1975, after being fired by Wellington Management, Vanguard was a different kind of fund company. Instead of being owned by a money-management firm (or a bank or an

insurance company), it was set up essentially as a co-op, to be owned by the shareholders of its funds. Unlike other fund companies, Vanguard makes no profit. It sells all of its funds without loads, or commissions, and the company insists on ultra-low fees because that's what the owners want and because lower costs lead to better results. The alignment of Vanguard's interests with those of its customers is the foundation of the trust the firm engenders among its clients.

Bogle's first product at Vanguard was Index Trust, the first mutual fund available to the general public to track Standard & Poor's 500-stock index. One of the beauties of index funds is that because they are basically unmanaged, they don't have to pay big management fees. That gives them an edge over actively run funds, which bestow fat salaries on managers and analysts. Knowing that over time a low-cost index stock fund beats the returns of three-fourths of actively managed stock funds, Bogle became

HOW VANGUARD HAS GROWN

ASSETS IN INDEX FUNDS, ACTIVELY MANAGED FUNDS AND ETFs TODAY AND IN 2001.



■ CHRIS McISAAC AND HIS TEAM PICK MANAGERS FOR VANGUARD'S ACTIVE FUNDS. THEY SEEK INVESTORS WHO THEY THINK CAN BEAT THEIR BENCHMARKS.

HOW VANGUARD'S ACTIVE STOCK FUNDS FARED OVER 5 YEARS

10

OUTPERFORMED THEIR CATEGORY

8

UNDERPERFORMED THEIR CATEGORY

5

TIED THEIR GROUP*

1

LESS THAN 5 YEARS OLD

HOW VANGUARD'S ACTIVE STOCK FUNDS FARED OVER 10 YEARS

10

OUTPERFORMED THE MARKET

3

UNDERPERFORMED THE MARKET

6

TIED THEIR GROUP*

5

LESS THAN 10 YEARS OLD

a champion of the concept and never stopped firing salvos at the fund industry for what he deemed high fees and excessive profits.

Even as Vanguard grew steadily, critics dismissed Bogle as a fanatic, maybe even a bit of a kook. When the stock market took off in the 1990s, he continued to sing the praises of indexing and steadfastly refused to endorse any new Vanguard funds that would focus on torrid tech stocks. In fact, in 1994 Bogle eliminated a Vanguard tech fund by merging it into another fund.

The '90s turned out to be a banner decade for indexing; from 1990 through the end of 1999, the fund now called Vanguard 500 Index (symbol VFINX) produced an astounding return of 18.1% annualized. But, geez, with the Internet thing ushering in a New Era, even 18% a year seemed paltry—or so the thinking went when Bogle left Vanguard in 1999 at the firm's mandated retirement age of 70.

●● **A HUMBLING DECADE**

Fast forward to 2011. In an office on Vanguard's sprawling campus in Malvern, Pa., chief investment officer Gus Sauter reminisces about the late '90s. "I can't tell you how many letters I received from investors who wanted a Nasdaq 100 fund," he says, referring to an index that then contained many of the raciest Internet stocks. Of course, the Net bubble burst in 2000, and the Nasdaq 100 fell by roughly one-third in each of the next three years. "Just because investors want us to do something doesn't mean we're going to do it," Sauter says.

The people who run Vanguard believe that investors' whims can undermine their quest for good results. Market volatility, for example, plays to our worst instincts, prompting us to buy high and sell low. So Vanguard does not create funds that ride the latest fad or hot sector.

The collapse of Internet stocks in 2000, followed by the bursting of the real estate bubble a few years later and

the horrific 2007-09 bear market, shook the faith of many investors. Given investors' tendency toward "huge inertia," says Vanguard strategist Francis Kinniry, it took major market setbacks to get them to reevaluate their strategies and principles.

“When they devise portfolios, Vanguard planners suggest splitting assets between index funds and active funds.”

Markets in the century's first decade "were like a perfect storm for us, but in a good way," he says. After enduring the debacle of the '00s, many people find plain-vanilla, low-fee funds pretty appealing nowadays.

Two other developments have helped Vanguard. The first was the growth of 401(k) plans. Plan providers see Vanguard funds as safe and popular choices for their employees. Vanguard has become a "major, respected player" in the retirement field and has played a major role in educating retirement-plan sponsors, as well as investors, about the virtues of index funds, says Ed Ferrigno, of the Profit Sharing/401k Council of America.

The second development was a shift in how many financial advisers are compensated. Instead of making money from mutual fund loads and stock-trading commissions, more have begun charging a percentage of the size of the portfolios they manage for clients. Because compensation grows as a portfolio expands, this "fee-based" approach does a better job of aligning the interests of clients and advisers. The percentage of advisers who generate all or most of their revenues from fees has risen from 34% in

2005 to 66% last year, according to a study by Cerulli Associates.

Before the shift, Vanguard didn't bother courting a whole class of advisers. "Their interests didn't intersect with anything Vanguard had to offer," says Martha King, who heads the unit that deals with advisers. But then came the rise of the exchange-traded fund, a type of investment that Vanguard began to embrace in 2001. ETFs, which are typically index funds that trade like stocks, appeal to advisers who assemble portfolios, as well as to brokers, who can charge commissions on ETF trades.

As Vanguard has grown, its economies of scale have allowed it to drive down costs. For instance, Vanguard charges an average of 0.13% for its diversified domestic stock index funds, compared with 0.84% for similar index funds from other managers. The average expense ratio for all diversified domestic stock funds is 1.34%. The expense ratios for Vanguard's ETFs are microscopic—as low as 0.06% a year for the ETF version of 500 Index.

●● **THE VANGUARD PARADOX**

But if Vanguard is so wedded to indexing, why does it sell actively managed funds? About 20% of its \$1.7 trillion in assets is in actively managed products, mostly stock and balanced funds run by 29 outside money managers. About one-fourth of its assets is in actively managed bond funds and money market funds, nearly all of which are managed in-house.

When they devise portfolios for clients, Vanguard planners suggest splitting the assets 50-50 between index funds and active funds. Wiener, editor of the newsletter *Independent Adviser for Vanguard Investors*, calls this hypocritical. "If you really believed in indexing, you wouldn't be putting active funds in portfolios," he says.

The job of selecting and monitoring outside fund managers falls to Chris McIsaac and a team of 40 analysts. McIsaac explains the rationale for

offering actively managed funds this way: "In our opinion, most active managers don't have a chance at beating the market. But we think there are some who stand a reasonable chance of beating it. Those are the managers we hire."

McIsaac's portfolio review group scrutinizes its stable of managers intensely for such things as strategy, performance and consistency. The analysts will follow a boutique management firm for years before hiring it. Even then, they may give a newbie just a small slice of a fund to manage. "We hate surprises," says McIsaac.

●● THE BIGGEST CLINKER

McIsaac says he and his team are pretty good at picking managers, but, he admits, "we're not perfect." Vanguard's sorriest actively managed fund is U.S. Growth (VWUSX), a large-company growth fund with \$3.9 billion in assets. Over the past ten years through June 30, the fund essentially broke even, compared with a 2.7% annualized gain for the S&P 500. Moreover, U.S. Growth has been remarkably consistent—and that's not meant as a compliment. From 2000 through 2010, the fund trailed the index in eight calendar years and beat it only three times. Vanguard replaced the fund's longtime managers with AllianceBernstein in 2001, then added a team from William Blair in 2004. After a decade of exceptionally poor results, Vanguard fired AllianceBernstein last year and split the money it managed between two new firms.

But most of Vanguard's active funds beat their benchmarks, helped considerably by well-below-average expense ratios, and a number of them are worth owning (see the box at right for our favorites). Vanguard's use of outside managers isn't more successful than, say, rival T. Rowe Price's reliance on homegrown talent. But its system works well enough that if you invest with Vanguard, you'll probably want a few of its actively managed funds in your lineup. ■

Our Picks of Vanguard Active Funds

CONVERTIBLE SECURITIES invests mostly in hybrids that are part debt and part stock. Run since 1996 by Oaktree Capital Management, the fund has outpaced the U.S. stock market over the past 15 years. But it has done so with below-market risk. In 2008, for example, it lost 29.8%, while the S&P 500 plunged 37.0% and the average convertible fund sank 35.7%. Vanguard recently amended Convertible's charter to allow the fund to hold up to 30% of assets in overseas securities.

DIVIDEND GROWTH buys stocks of big companies with steady profit growth and executives who demonstrate they're committed to sharing the wealth through higher dividends. Wellington Management, Vanguard's favorite hired gun, has run the fund since its launch in 1992. The fund, a member of the Kiplinger 25, yields only 2.3%, so don't expect a lot of cash—just below-average volatility and solid returns.

GNMA is a classic Vanguard income fund. It charges low fees, holds down volatility and sticks closely to its mission, which is to own Ginnie Maes, mortgage securities backed by the full faith and credit of the U.S. government. Wellington has been at the helm since the fund began in 1980. Current yield: 3.3%.

HEALTH CARE has been perking up. It delivered strong gains in the first half of 2011, as many investors rotated into the perceived safe haven of health care stocks. Its

long-term record—an annualized return of 13.0% over the past 15 years—is also impressive. The lead manager is as experienced as they come; Wellington's Edward Owens has run the fund since its inception in 1984.

SELECTED VALUE is run by two firms, both of which focus on bargain-priced midsize companies. Barrow, Hanley, Mewhinney & Strauss, which looks for beaten-down stocks with high dividend yields, controls three-fourths of the assets. The rest is run by Donald Smith & Co., which looks for stocks that are cheap relative to book value (a company's assets minus its liabilities). The fund has outgained the typical midcap value fund but with less volatility.

SHORT-TERM INVESTMENT GRADE doesn't yield much these days (1.6%), but if you want to make the most money possible in a conservative, short-term bond fund, it's your best bet. One reason, of course, is expenses. The fund, run by Vanguard's own bond experts, charges just 0.22% per year, one-fourth of the average for short-term bond funds.

WELLINGTON is a classic balanced fund, with about two-thirds of its assets in the stocks of large dividend-paying companies and the rest in high-quality, medium-maturity bonds and cash. It's designed to be a one-stop investment, and it has met that challenge admirably since its creation in 1929. Over the past 15 years, the fund returned 8.5% annualized, easily beating the stock market but with only half the market's volatility. As you'd expect, Wellington Management is in charge.

SOLID RETURNS, LOW FEES

These funds won't shoot out the lights, but they should produce consistently good returns. Each fund's minimum is \$3,000.

Vanguard fund	Symbol	Total returns ^a				Exp. ratio
		1 yr.	3 yrs.	5 yrs.	10 yrs.	
Convertible Securities	VCVXS	24.6%	7.7%	7.7%	7.4%	0.68%
Dividend Growth	VDIGX	29.5	5.6	6.0	3.6	0.34
GNMA	VFHIX	4.8	7.1	7.0	5.8	0.23
Health Care	VGHCX	30.6	10.0	6.4	7.2	0.35
Selected Value	VASVX	30.9	9.3	5.3	7.9	0.47
Short-Term Investment Grade	VFSTX	3.7	4.8	5.0	4.3	0.22
Wellington	VWELX	20.6	5.4	5.9	6.4	0.30
S&P 500-STOCK INDEX		30.7%	3.3%	2.9%	2.7%	
BARCLAYS CAPITAL AGG. BOND INDEX		3.9%	6.5%	6.5%	5.8%	

Through June 30. ^aAnnualized for three-, five- and ten years. source: © 2011 Morningstar Inc.