

Understanding Indexing

Vanguard INVESTMENTS™



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Note: Unless otherwise stated data sources are Vanguard, using market data.

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Introduction

There are as many ways to build an investment portfolio as there are investors. And while some investors are right at home making their own direct investments, others prefer the ‘managed fund’ approach, so they can gain access to diversified portfolios, different types of assets and management expertise.

However, not all managed funds are the same. There are traditional ‘active’ fund managers, who pick individual shares or industry sectors in an attempt to outperform the market index. And there are index funds which provide market returns.

Index funds were once only available to institutional investors with large sums of money, such as large superannuation funds. Now many individual investors are starting to use indexing as part of their investment portfolios.

Vanguard’s Investor Funds and Personal Superannuation Plan were created to enable individual investors to enjoy the advantages of index investing.

In this guide, we explain what indexing is and how index funds provide simple and powerful solutions for long-term investors.

What is an index?

Very simply, an index is a way of measuring the change in value or ‘performance’ of a market over time. For instance, a share index measures the change in value of the shares of those companies included in the index.

Indexes have been around for years. Today, they cover almost every industry sector and asset class, including Australian and international shares, property, bonds and cash. They’re an important measure because they track the market's performance.

You’re probably already familiar with the Australian All Ordinaries Index (the All Ords), which accounts for around 99% of the Australian share market value.

The indexing strategy

Institutional investors have used indexing for many years. In fact, 8 out of Australia's top 10 corporate super funds use index funds as part of their portfolio.

Indexing is one of the simplest investment strategies that anyone – from an institutional investor to an individual – can employ. Here's why.

Unlike an active fund manager, an index manager will make no attempt to analyse which shares, bonds or other securities are likely to go up or down in value.

Instead, they simply build a portfolio that comprises all – or in the case of very broad indexes, a representative sample – of the assets in an index. The index manager's task is to design a portfolio that closely tracks the market indexes.

Indexing is not a short-term investment strategy. Index funds typically buy assets in an index and then hold them for the long-term. Indexing is not about 'timing markets' or picking 'hot' stocks.

Instead, the emphasis is on broad diversification within a specific index and low portfolio turnover through what is known as a 'buy and hold' approach. One of the major benefits is that this approach can significantly reduce the cost of investing over time. And lower costs lead to better returns.

The benefits of indexing

Index funds are an excellent foundation for a long-term investment strategy and offer some substantial benefits:

Competitive long-term performance - Active fund managers continuously buy and sell securities in an attempt to outperform the market index. Unfortunately, over the past seven years, in each of the major categories, the majority of retail managed funds have under-performed their comparable market indexes.*

An index fund manager's approach is quite different, aiming simply to capture the market return. As a result, the fund returns should be equal to the market return, less fund fees. With the added advantages of reduced transaction costs and low management fees, we believe index funds will provide very competitive performance over the long-term.

Diversification - Index funds effectively allow you to 'buy the market index'. Being so broadly diversified means you're less exposed to the performance fluctuations – either good or bad – of any one share or security.

Instead of trying to outsmart the market in the short term, it's generally better to be well diversified across the market, so that you can share in the rises and the falls of different market segments. The overall effect is that you moderate the volatility of your portfolio and 'smooth out' your investment returns over time.

Manager risk - This is the risk that the fund chosen will under perform their benchmark or market index due to poor security selection by the manager. Index funds minimise such risk as they simply attempt to track the benchmark or index. They do not try to 'pick winners' or attempt to time the markets. Indexing takes out the guesswork, as you don't have to try and analyse the strategy of various managers to choose one you think can outperform the market on a consistent basis. Nothing ensures absolute returns, but with index funds you can be confident your investments will perform in line with the market.

Low cost - One of the key benefits of indexing is its low cost approach to investing. An index fund manager will aim to minimise transaction costs by adopting a buy and hold approach. These savings are then passed on to investors in the form of lower management fees.

By contrast, many active fund managers trade frequently in their search for added performance, incurring substantial transaction costs and in the process, often realising untimely taxable capital gains for investors.

* Source: Vanguard using Mercer Retail Data as at September 2002.

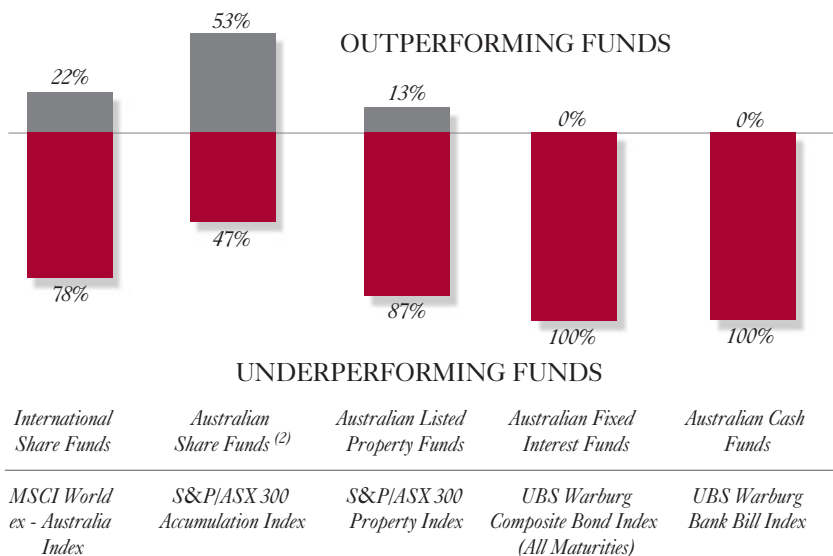
Competitive performance

If long-term investing is important to you, the results speak for themselves. After taking costs into account, managers have had a lot of trouble outperforming their market indexes. In fact, market data for the seven years to 30 September 2002 illustrates that the majority of retail managed funds have underperformed their comparable indexes.⁽¹⁾

The reason is simply that the high costs of active investing make it hard for managers to get ahead of the index.

Of course, there will always be some actively managed funds that outpace index funds at certain times. Whether this is due more to ‘good luck’ or good management is certainly a question worth asking.

Retail managed funds (after ongoing charges) outperforming a comparable index (before ongoing charges) for the 7 years to September 2002



(1) Source: Vanguard using Mercer Retail data

(2) Modified to exclude imputation and industrial funds

Even after studying a fund's performance for several years, no matter how impressive its history may be, this in no way indicates how it will perform next year, next month or even next week.

Long-term investing isn't about trying to pick winners. Instead, it's about participating in the ongoing success of the market. Through indexing, you get the added benefit of spreading your risks – and your gains – across a wide spread of the particular market that interests you.

Even active investors can see the merits of indexing. The following statement is indeed high praise and comes from one of the world's most respected experts on active funds management:

“Most investors, both institutional and individual, will find that the best way to own common stocks ("shares") is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) of the great majority of investment professionals.”

Warren Buffett – Berkshire Hathaway Annual Report 1996.

Indexing's cost advantage

All managed funds have expenses, but some funds are much more costly than others. And there is no evidence to suggest that higher costs lead to better performance. Fees and expenses charged by a fund directly impact on your investment return – just how much is often overlooked.

The simple fact is that costs matter – and this is the most powerful argument in favour of index funds. Costs can substantially reduce investment returns over time, so it's vital that investors understand the impact they have.

Indexing offers three main sources of cost savings:

Lower management fees - index funds have lower management expense ratios (MERs). In other words, it costs less to manage and operate an index fund. This is mainly because there's no need to employ highly paid research and investment analyst teams.

Lower transaction costs - the fundamental buy and hold approach that we discussed earlier means index managers turn their portfolios over less often than active fund managers, resulting in lower trading costs. These costs generally consist of brokerage, commissions, stamp duty, custody and the other expenses associated with trading securities.

Lower taxes - indexing's buy and hold approach also substantially reduces capital gains tax liabilities compared to most actively managed funds.

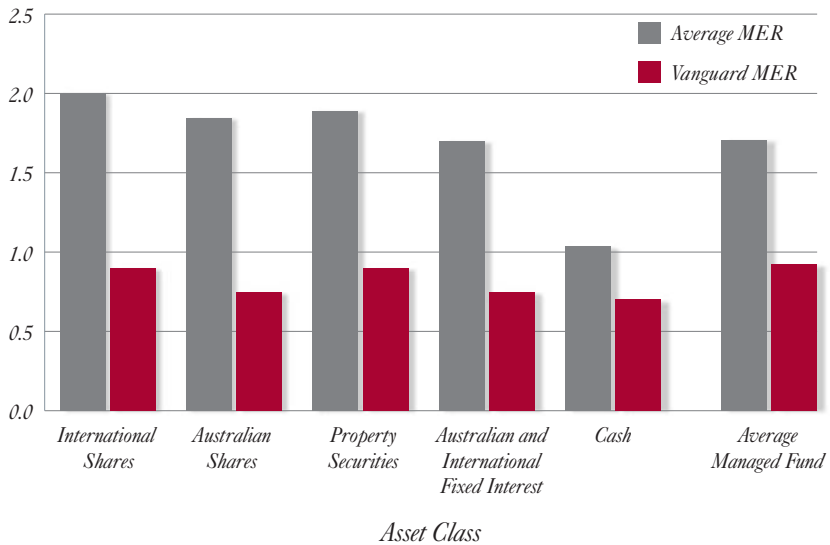
Management fees, fund expenses and transaction costs can impact on investment returns over time – often reducing performance returns by as much as 2.0% each year. This value is then even further eroded by those funds that also charge sales commissions.

Index managers, on the other hand, incur much lower costs than active managers. For instance, the total costs of an index fund should be less than 1.0% a year. Vanguard’s retail index fund MERs are well below the industry average, ranging from 0.70 to 0.90% a year.

The bottom line is that the low-cost advantages of indexing provide investors with a larger share of the investment returns – and a competitive edge over time. This is clearly shown by a cost comparison of the average MER and Vanguard's MER's.

Comparison of retail management expense ratios (MERs)*

% p.a.



* The MERs analysed are based upon an investment of up to \$50,000.
 Source: Vanguard using ASSIRT data as at November 2002

The advantage lies in simple mathematics.

As a group, investors earn the market return. For every investor who wins, another loses. Usually, the average investor will earn less than the market's average return, after costs. So the higher the costs, the greater the shortfall.

Indexing succeeds by matching a market's return and keeping costs far below those of the average investor. The strategy is a formula for above-average performance over time.

The cumulative impact of cost on a \$20,000 investment in an Australian shares fund.

Number of years invested	S&P/ASX 300 Accumulation Index return % p.a.	Investment value with MER of 1.80% p.a.	Investment value with MER of 0.75% p.a.
5	5.1	\$23,531	\$24,751
10	11.3	\$49,548	\$54,510
20	13.8	\$193,988	\$233,778

This table shows how great an impact even a small difference in costs can have on a \$20,000 investment over time.

Indexing's tax advantage

An indexing strategy has a major advantage over actively managed funds – one that's often overlooked – tax efficiency.

All managed fund returns, both index and active, are calculated *before* taxes. Because index fund managers typically turn their portfolios over less often than active fund managers, an index fund will normally distribute only modest – if any – capital gains to investors.

Because any distribution of capital gains is taxable for investors, there's a definite advantage in deferring their realisation for as long as possible. Capital gains tax legislation provides individual investors with discounted tax rates if assets are held for longer than 12 months.

So indexing can also help to reduce the costs of investing through savings in capital gains tax payable.

Using indexing

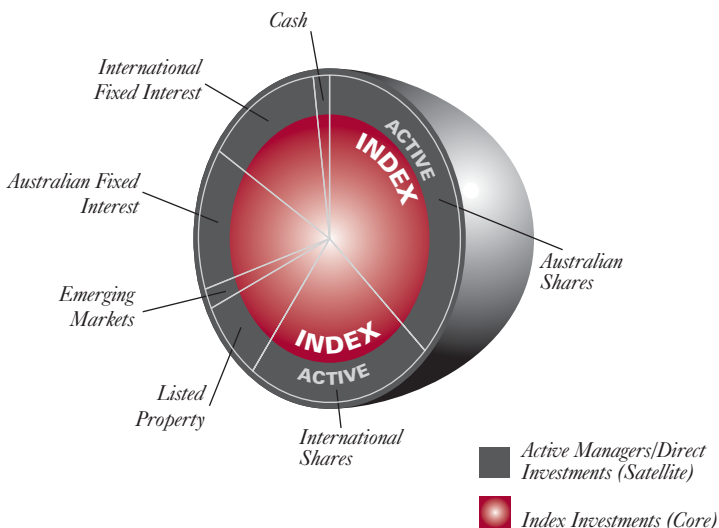
Indexing the core of your portfolio

There are a number of ways to use indexing as part of an investment program.

Even though indexing is an excellent foundation for an investment portfolio, many investors will continue to be attracted to the distinctive investment philosophies offered by actively managed funds. They may also wish to own shares directly or participate in alternative forms of investment.

Index management is commonly used as the core holding of an investment program. Building on that core of broadly diversified index funds, an investor can select actively managed funds, or purchase direct holdings in other assets such as shares or property.

Core satellite approach



Note: Asset allocations in this diagram are intended to be an example only and not a recommendation.

Institutional investors and superannuation funds have been using indexing as a core, long-term investment strategy for a number of years. Some investors choose to have 100% of their assets indexed. Many of Vanguard's institutional clients index 30 – 70% of their assets.

What to avoid if you are not using an index fund

If you decide to employ active managers to look after your portfolio, here are some important issues to consider:

Be sceptical of past performance

It's not easy to differentiate good management from good luck;

Minimise your costs

Look for all the hidden costs of investing. A two or three percent cost may not seem much in a bull market when returns are high, but in a flat market they can really eat into your returns;

Compare after tax returns

It's the net performance that really counts; and

Think in portfolio terms

Choose your asset allocation carefully, because up to 90% of the variation in returns between different portfolios can be attributed to your choice of investment assets.

Indexes used by Vanguard

Vanguard carefully selects indexes as appropriate benchmarks for each of its funds. The benchmarks we use are broadly diversified and well constructed indexes, allowing for efficient portfolio management.

Australian shares

One of the best-known share indexes in Australia is the Australian Stock Exchange (ASX) All Ordinaries Accumulation Index (the 'All Ords'). The ASX also has a number of other indexes including the S&P/ASX100, S&P/ASX200 and the S&P/ASX300 Index.

The S&P/ASX300 Index is a capitalisation-weighted index of 300 Australian equity securities and covers approximately 91% of the Australian share market's total capitalisation. This benchmark is used for most of Vanguard's Australian equity index funds.

International shares

Internationally, the standard benchmark is the Morgan Stanley Capital International (MSCI) World ex-Australia Index. This MSCI Index comprises shares in over 1,400 companies, listed on the exchanges of 22 of the world's major developed economies.

Emerging markets shares

The modified MSCI Emerging Markets Free Index is a capitalisation weighted index of over 650 companies in 23 countries. It represents the share market performance of the world's major developing economies.

Australian property securities

The S&P/ASX300 Property Index is a sector index of the S&P/ASX300 Index mentioned earlier. This provides diversified exposure to the securities of 30 or so property trusts listed on the Australian share market.

Australian fixed interest

The UBS Warburg Australian Composite Bond Index consists of approximately 190 fixed interest securities issued by Commonwealth and state governments' guaranteed treasury corporations, quasi-government authorities and prime corporate issues. This provides a good representation of the movements in value and interest rates of this important asset sector. These securities are often referred to as 'bonds'.

International fixed interest

The Salomon Smith Barney World Government Bond Index consists of about 630 securities issued by 19 governments in various countries. This provides diversified exposure to the interest rate segments of most of the developed economies of the world.

Cash

The Vanguard Cash Plus Index is a custom index which has been developed by Vanguard to measure short-term fixed interest investments. This index has been constructed and is administered in the same manner as a market index.

The components of an index change from time to time. For instance, new additions and index deletions cause some portfolio turnover. Index managers pay a great deal of attention and use a range of techniques to control and minimise the transaction costs associated with these changes.

Conclusion

Indexing is a proven strategy offering investors access to high-quality, low cost investment opportunities. It provides an extremely efficient way of participating in broadly diversified portfolios delivering competitive, long term performance.

While indexing is still in its early growth phase in Australia, we believe that it will evolve into a major part of the investment landscape – as it has overseas.

Research indicates that indexing is one of the fastest growing segments of the managed funds industry. At June 2002, indexing accounted for 12.5% of the managed funds industry or \$92 billion.*

Vanguard are experts in indexing, having established the world's first public offer fund in the US, in 1976. With the benefit of over 25 years experience, The Vanguard Group now manages over \$320 billion in index funds.

* Rainmaker June 2002

The founder of the Australian Investors' Association, Investment Adviser Austin Donnelly, wrote in Donnelly's Investing Digest the following regarding index funds:

“Their ultimate entry into the retail market in Australia should be welcomed by the investing public. ... In recent years some of these funds, particularly index funds managed by Vanguard Investment Group in the United States, have produced considerably better results than most of their competitors.”

Take charge with Vanguard

Vanguard Investments Australia Ltd is a wholly owned subsidiary of The Vanguard Group, Inc., based in the US. It combines the skills of its team of Australian investment professionals, with the strength and expertise of its international parent.

The Vanguard Group manages approximately \$1 trillion for individual and institutional investors.

Vanguard in Australia has established a strong reputation as the index specialist, managing over \$17 billion in index funds, primarily for large institutional investors.

Vanguard Investor Funds

If you are looking to access low cost investments, we have a range of asset sector and diversified index funds. You can invest in our funds by contacting us directly or through your financial adviser.

Asset sector index funds

- International Shares
- Hedged International Shares
- Australian Shares
- Property Securities
- Diversified Bond
- Cash Plus

Diversified index funds

- High Growth
- Growth
- Balanced
- Conservative

Vanguard Personal Superannuation Plan

Our low cost Personal Superannuation Plan offers a range of asset sector and diversified investment options to choose from.

Why Plain Talk?

At Vanguard, we believe that one of the keys to investment success is being an informed, knowledgeable investor.

Our growing Plain Talk Library covers a number of aspects regarding investing for success. Our aim, through this library, is to offer candid, concise and easy to understand information on a variety of topics.

Currently our Plain Talk Library includes:

- Understanding Indexing
- Asset allocation
- Understanding bonds
- International shares
- Realistic expectations for share market returns
- Understanding managed fund costs
- Maximising your Super
- Managing your investment portfolio

Like more information or to give us your feedback?

We would be happy to provide you with more information about our Investor Funds or Personal Superannuation Plan. We also value your feedback.

Please contact Vanguard Client Services on **1300 655 101** or access our website through www.vanguard.com.au or contact your financial adviser.

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