2012: The year in review
Cape Neddick Lighthouse was built in 1879 to help mariners stay on course. Perched on rocky Nubble Island off Maine’s coastline, the lighthouse has a commanding view of the northern Atlantic.
Chairman’s message

The year 2012 was a time of seeming disconnect between what the financial markets were doing and what investors were feeling. Stock market returns were strong, and the returns posted by the bond market were certainly respectable. (See Figure 1.) Yet economic growth in the United States and abroad was sluggish, the jobless rate remained high, the European debt crisis dragged on, and 2012 closed with the U.S. government providing no lasting or satisfactory solution to the country’s staggering national debt. So investors wondered: Are things good? Or are they bad? That sentiment wreaked havoc with investor confidence and left many feeling rudderless and uncertain.

Figure 1. Market barometer

<table>
<thead>
<tr>
<th></th>
<th>One year</th>
<th>Three years</th>
<th>Five years</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Stocks</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Russell 1000 Index (Large-caps)</td>
<td>16.42%</td>
<td>11.12%</td>
<td>1.92%</td>
</tr>
<tr>
<td>Russell 2000 Index (Small-caps)</td>
<td>16.35</td>
<td>12.25</td>
<td>3.56</td>
</tr>
<tr>
<td>Russell 3000 Index (Broad U.S. market)</td>
<td>16.42</td>
<td>11.20</td>
<td>2.04</td>
</tr>
<tr>
<td>MSCI All Country World Index ex USA (International)</td>
<td>16.83</td>
<td>3.87</td>
<td>–2.89</td>
</tr>
<tr>
<td><strong>Bonds</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Barclays U.S. Aggregate Bond Index (Broad taxable market)</td>
<td>4.21%</td>
<td>6.19%</td>
<td>5.95%</td>
</tr>
<tr>
<td>Barclays Municipal Bond Index (Broad tax-exempt market)</td>
<td>6.78</td>
<td>6.57</td>
<td>5.91</td>
</tr>
<tr>
<td>Citigroup 3-Month U.S. Treasury Bill Index</td>
<td>0.07</td>
<td>0.08</td>
<td>0.44</td>
</tr>
<tr>
<td><strong>CPI</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer Price Index</td>
<td>1.74%</td>
<td>2.06%</td>
<td>1.80%</td>
</tr>
</tbody>
</table>

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.
Record-breaking year at Vanguard

To me, 2012 was a year of validation of Vanguard’s way of doing business: a singular focus on our clients, a commitment to low costs, and adherence to our disciplined, long-term approach to investing.

Vanguard’s value proposition is resonating in the marketplace, as clients entrusted $141 billion in net new cash to us in 2012—a figure that broke both company and industry records. It also contributed to Vanguard reaching $2 trillion in U.S. mutual fund assets on January 2, 2013. And it helped us to create $192 billion in wealth for our clients in 2012.

We’ve seen investors the world over gain an even deeper appreciation of low-cost investing. Witness the ongoing shift away from high-cost funds into lower-cost active funds, index funds, and exchange-traded funds (ETFs).

Other investment firms are becoming more sensitive to this shift. A few years ago, when Vanguard announced our intention to open an office in the United Kingdom, one of our competitors began reducing its fees. At the time, Morningstar dubbed it the “Vanguard effect.” Now I believe we’re seeing the Vanguard effect in the United States as well, as competitors are tactically pricing certain products to compete directly with us. (The question is whether they’ll be able to sustain that strategy or adopt it across their investment offerings. Unless it’s baked into a firm’s DNA, as it is with Vanguard through our client-ownership structure*, it’s no easy feat.)

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* Vanguard fund shareholders own the funds, which own Vanguard.

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Figure 2. Average expense ratios: Vanguard versus the industry

<table>
<thead>
<tr>
<th>Year</th>
<th>Vanguard</th>
<th>Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>0.02%</td>
<td>1.11%</td>
</tr>
<tr>
<td>1981</td>
<td>0.03%</td>
<td>1.11%</td>
</tr>
<tr>
<td>1987</td>
<td>0.04%</td>
<td>1.11%</td>
</tr>
<tr>
<td>1993</td>
<td>0.05%</td>
<td>1.11%</td>
</tr>
<tr>
<td>1999</td>
<td>0.06%</td>
<td>1.11%</td>
</tr>
<tr>
<td>2005</td>
<td>0.07%</td>
<td>1.11%</td>
</tr>
<tr>
<td>2012</td>
<td>0.08%</td>
<td>1.11%</td>
</tr>
</tbody>
</table>

Expense ratios as of December 31, 2012. Vanguard expense ratios range from 0.02–1.71%. Average expense ratios are represented as a percentage of net assets.

* Sources: Vanguard and Lipper Inc.

Figure 3. The value to clients of our low costs

Estimates in millions of dollars

<table>
<thead>
<tr>
<th>Year</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>5,000</td>
</tr>
<tr>
<td>2003</td>
<td>10,000</td>
</tr>
<tr>
<td>2004</td>
<td>15,000</td>
</tr>
<tr>
<td>2005</td>
<td>20,000</td>
</tr>
<tr>
<td>2006</td>
<td>25,000</td>
</tr>
<tr>
<td>2007</td>
<td>30,000</td>
</tr>
<tr>
<td>2008</td>
<td>35,000</td>
</tr>
<tr>
<td>2009</td>
<td>40,000</td>
</tr>
<tr>
<td>2010</td>
<td>45,000</td>
</tr>
<tr>
<td>2011</td>
<td>50,000</td>
</tr>
<tr>
<td>2012</td>
<td>55,000</td>
</tr>
</tbody>
</table>

Source: Vanguard.

The chart shows the total additional fund operating costs that Vanguard shareholders would have paid each year if we had charged the fund industry’s average expense ratio (1.11% in 2012).

9.2 basis points on $1.85 trillion in mutual fund assets under management could translate into approximately $17 billion in savings.

Calculation: 9.2 basis points comes from subtracting the industry average expense ratio of 1.11% from the Vanguard average expense ratio of 0.19%. This number is then multiplied by Vanguard’s assets under management of $1.85 trillion to get the result of $17 billion.

This hypothetical illustration does not represent any particular investment and only holds true if the returns are identical. There is no assurance that individual investors will experience similar savings.
Creating value by lowering costs, enhancing quality

During the past year, we continued to raise the bar on creating value for clients. It’s always our goal to reduce expenses while improving the way we serve our clients, and in 2012, we again met that objective. Some highlights:

• **Lowering the cost of investing.** We made significant efforts to reduce investment costs for investors—for both the near and long term. For example, we adopted new benchmark indexes for 22 Vanguard index funds and ETFs—a move that will lock in long-term savings for investors. Overall, our mutual funds’ average expense ratio for 2012 decreased 1 basis point to 19 basis points. If Vanguard had charged the industry average expense ratio of 1.11% on our shareholders’ average assets of $1.85 trillion during the year, their returns would have been $17.04 billion less. (See Figures 2 and 3.)

• **Producing strong investment returns.** Portfolio managers steered Vanguard funds to admirable returns in 2012, building on a tradition of prudence, skill, and experience. Over longer time frames, our relative fund performance is even stronger. (See Figure 4.)

• **Advocating for investors.** As the legislative and regulatory landscape in Washington became more complex, lawmakers and officials increasingly sought Vanguard’s perspectives on topics ranging from money market fund reform to questions of taxes, transparency, and disclosures. We’ll continue to take a stand for investors on these important issues.

• **Enhancing the client experience.** We improved the way we interact with our clients across all of our businesses. For example, for retirement plan sponsors, we enhanced our recordkeeping reporting and launched the next evolution of the participant website, which has influenced participants to both save more and take advantage of advice offers. For retail clients, we simplified their website interaction. And to better serve financial advisors, we significantly expanded the number of Vanguard representatives throughout the country.

• **Taking our story to investors worldwide.** We opened an office in Hong Kong, launched a number of ETFs in Europe and Australia, and added five new ETFs to our Canadian lineup.

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**Figure 4. Percentage of Vanguard funds whose returns beat their peer-group averages**

Note: All performance periods ended December 31, 2012.

<table>
<thead>
<tr>
<th>Period</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year</td>
<td>73%</td>
</tr>
<tr>
<td>3 years</td>
<td>79%</td>
</tr>
<tr>
<td>5 years</td>
<td>87%</td>
</tr>
<tr>
<td>10 years</td>
<td>90%</td>
</tr>
</tbody>
</table>

Source: Vanguard. Comparative performance data provided by Lipper Inc.

For the one-year period, 10 of 10 Vanguard money market funds, 54 of 90 bond funds, 16 of 28 balanced funds, and 175 of 219 stock funds, or 255 of 347 Vanguard funds outperformed their Lipper averages.

For the three-year period, 10 of 10 Vanguard money market funds, 44 of 77 bond funds, 25 of 27 balanced funds, and 144 of 169 stock funds, or 223 of 283 Vanguard funds outperformed their Lipper averages.

For the five-year period, 10 of 10 Vanguard money market funds, 52 of 65 bond funds, 23 of 24 balanced funds, and 141 of 160 stock funds, or 226 of 259 Vanguard funds outperformed their Lipper averages.

For the ten-year period, 10 of 10 Vanguard money market funds, 44 of 52 bond funds, 13 of 13 balanced funds, and 81 of 89 stock funds, or 148 of 164 Vanguard funds outperformed their Lipper averages.

Results will vary for other time periods. Only funds with a minimum one-, three-, five-, or ten-year history, respectively, were included in the comparison.

*Note that the competitive performance data shown represent past performance, which is not a guarantee of future results, and that all investments are subject to risks. For the most recent performance, visit our website at vanguard.com/performance.*
A beacon for investors

While 2012 was a year of contradictions and confusion for investors, in many ways we’re living the old adage, “The more things change, the more they stay the same.” Indeed, this past year in some ways was just like any other post-financial-crisis year, with no respite from worry and a sense of powerlessness to turn things around. I’m optimistic that things will get better eventually, but not in the short or perhaps even intermediate term.

I see Vanguard’s job, now and always, as helping to guide our investors through the uncertainty, to provide the long view, and to answer the question, “What does this mean to me?”

It isn’t easy to tune out the noise, and sometimes it feels counterproductive to keep to the disciplined course and fix one’s gaze on the horizon, but time has demonstrated that these are the best courses of action. In 2013, we’ll again be encouraging investors to focus on controlling those things they can control: Know their goals, invest with balance, minimize costs, and maintain discipline. It’s not glamorous, but it works.

Thank you for investing with Vanguard.

F. William McNabb III
Chairman and CEO
Aligning Vanguard funds with our clients’ needs
Vanguard is vigilant about monitoring our funds and making adjustments, when warranted, to help ensure they continue to deliver the value investors have come to expect from us. In 2012, we announced benchmark changes for nearly two dozen index funds, introduced lower minimums and eliminated fees for an array of funds, launched new funds and welcomed new fund advisors, closed one fund, said goodbye to our chief investment officer, and saw our bond chief inducted into the Fixed Income Hall of Fame.

To lock in high-quality benchmarks at a low cost for the long term, we announced plans in October to change the benchmarks of 22 index funds to ones from FTSE and the Center for Research in Security Prices. These well-constructed indexes offer comprehensive coverage of their respective markets and meet our “best-practice” standards for market benchmarks. As part of this transition, several of our largest and most widely held index funds are changing their benchmarks in 2013. In addition, the benchmarks for Vanguard Target Retirement Funds and other funds-of-funds will also change, but their asset allocations won’t shift as a result.

In addition, we reduced the minimum investment requirements for several fund share classes, broadened the availability of several funds to institutional investors, and eliminated contingent redemption fees on 19 equity index funds and 14 actively managed funds, leaving only six funds with purchase and/or redemption fees.

We launched two new funds in the United States:

- Vanguard Target Retirement 2060 Fund, offering broad diversification among the major asset classes and low costs for young investors just entering the workforce.
- Vanguard Short-Term Inflation-Protected Securities Index Fund, which we believe can serve a valuable role in a well-balanced portfolio as an inflation hedge and diversifier.

For updates on fund developments abroad, see the global investors section on page 18.

We regard the depth of experience and length of tenure of our external managers as a considerable advantage for our investors. Following a rigorous selection process, we added these fund advisors in 2012:

- Pzena Investment Management, LLC, joined the portfolio management team for Windsor™ Fund.
- ARGA Investment Management, LP, became a new advisor to the International Value Fund.

In an effort to curtail strong cash inflows and protect the interests of existing fund shareholders, we closed the High-Yield Corporate Fund to most new accounts in May.

Lastly, we must note key developments among our investment leaders. We bid a fond farewell to Gus Sauter, who retired as our chief investment officer at year-end, leaving behind a legacy of achievement and innovation. We extend our congratulations to longtime Vanguard veteran Tim Buckley, who succeeded Mr. Sauter as CIO. And honors went to Bob Auwaerter, principal and head of Vanguard Fixed Income Group, who was inducted into the Fixed Income Analysts Society’s Hall of Fame in April.

Investments in Target Retirement Funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in a Target Retirement Fund is not guaranteed at any time, including on or after the target date.
Serving our clients
While the equity markets were strong in 2012, U.S. economic growth continued to lag, and the finances of European governments and banks remained questionable. Following the U.S. elections in November, attention to the nation’s considerable budgetary challenges intensified. The focus on the “fiscal cliff” of expiring tax-law provisions and new budget cuts led to unsettling headlines and nervous markets.

Amid that uncertainty, Vanguard encouraged lawmakers to help restore stability to our markets and economy by:

- Creating a comprehensive framework for addressing deficit reduction.
- Adopting a simpler and more transparent tax code.
- Maintaining strong incentives for savings and investment.

Taking a stand on behalf of investors is a key part of our mission. But just as important are our efforts to lower investment costs, streamline administration, and apply the latest research findings to our programs and services.

With that level of client focus, it’s no surprise that we had one of our best years ever for institutional net cash flow. Within the defined contribution (DC) marketplace, a strong interest in lower fees led to surging demand for index mandates and, in particular, indexed target-date funds (TDFs). A similar interest in low-cost investing was apparent among the defined benefit (DB) and nonprofit clients we serve as well.

In the following sections, we highlight some key ways we are building strong relationships with clients across all our businesses. (See Figure 5.) Our focus, as always, is not on recent market results, but on serving our clients over the long run.

Figure 5. Vanguard’s diversified asset base worldwide

- 43% Individual investors
- 29% Financial advisors
- 21% Institutional investors and plan sponsors
- 7% International (non-U.S.) investors
DC plans emphasize the fundamentals

DC plans are now the primary vehicle through which most individuals save for retirement. As a result, plan sponsors are taking an even more active role in enhancing plan design, evaluating plan costs, and preparing participants for retirement. (See Figure 6.) Vanguard is a longtime advocate of that holistic approach to retirement readiness, and it’s why we hold numerous client events throughout the year—to share best practices from Vanguard’s leaders as well as other industry experts.

Vanguard’s dedication to serving plan sponsors and participants is one reason we remain at the forefront of the DC marketplace, with more than $525 billion in DC plan assets. In our full-service DC recordkeeping business alone, we serve 2,000 plan sponsors and more than 3.5 million participants.

In our work with clients throughout 2012, special focus areas included:

• Responding to the DC market environment.
• Refining the plan lineup.
• Making better use of plan options.

DC industry seeks greater transparency in plan costs

New requirements to increase transparency in fees and expenses for both retirement plan sponsors and participants began taking effect in 2012, a development Vanguard applauds.

In support of our clients, Vanguard provided a variety of information for sponsors seeking clarity and insight about the new rules. One major resource for plan sponsors on the many aspects of fee disclosure was Vanguard’s online Defined Contribution Resource Center. It features a special fee disclosure page with links to relevant articles, Strategic Retirement Consulting commentary papers, Department of Labor rulings and information, and more. To help with participant fee disclosure, Vanguard developed a template notice that plan sponsors could use to meet the annual notice disclosure requirement.

In addition, for recordkeeping clients, we significantly enhanced our All-In Fee Report with an easy-to-read summary and additional information—a continuation of our long-term effort to clearly delineate the value plan sponsors can expect as Vanguard clients.

In a related effort for clients, we provided greater flexibility in share classes and instituted an open architecture approach to the fund lineup.

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Figure 6. Elements of a comprehensive retirement plan

<table>
<thead>
<tr>
<th>Streamlined lineups</th>
<th>Professionally managed allocations</th>
<th>Automated features</th>
<th>Engaged and educated participants</th>
<th>Focus on fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Consolidation</td>
<td>• Target-date funds</td>
<td>• Autoenrollment</td>
<td>• Preparation for retirement</td>
<td>• Plan sponsor and participant fee disclosures</td>
</tr>
<tr>
<td>• Tiering</td>
<td>• Managed account program</td>
<td>• Autoescalation</td>
<td>• Financial wellness</td>
<td>• Multiple fee structures</td>
</tr>
<tr>
<td>• Index core</td>
<td></td>
<td>• Default funds</td>
<td>• Web and mobility</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Retirement income</td>
<td></td>
</tr>
</tbody>
</table>
Plans continue to go automatic

If left to their own devices, participants can sometimes go astray with their investment decisions. Heeding the findings from behavioral research, plan sponsors in 2012 continued to expand their use of automatic plan features, including autoenrollment and autoescalation. (See Figure 7.)

Figure 7. Automatic enrollment adoption

Vanguard defined contribution plans that permit employee-elective deferrals

The historical notion of asset allocation and investment selection being left to individual participants is gradually evolving, and just beginning is an era in which more and more participants are leaving the investment decision-making to the professionals. At the heart of this transformation are target-date funds (TDFs). Driving this development is the growing designation of TDFs and balanced funds as default options under automatic enrollment, as well as the increased use of investment advice within DC plans.

Professionally managed allocations like TDFs, along with balanced funds and managed accounts, are designed to provide participants with a streamlined decision-making process, whereby a fund manager or third-party advisor is responsible for all portfolio allocation and rebalancing decisions.

Today, more than one-fourth of all participants in Vanguard-recordkept plans have their entire balances invested in a single TDF—up dramatically from essentially zero in 2003. When participants invested in a single balanced fund or a managed account service are included, more than one-third of participants have a professionally managed allocation as of year-end 2012. (See Figure 8.) Because of the growing use of target-date options, we anticipate that 55% of all participants and 80% of all new plan entrants will be invested in a professionally managed option by 2017.

Figure 8. Use of professionally managed allocation is rising

A similar focus on automating investment decisions is happening in plans’ investment lineups, prompting a historic transformation in how investment decisions are made in 401(k) plans.
Indexing grows, takes center stage in lineups

As a result of the trend toward automating the investment experience for participants, indexed plan assets have surged at Vanguard, especially in the form of Vanguard Target Retirement Funds. (See Figure 9.)

In light of expanded investment options and regulatory changes, many retirement plan sponsors took a closer look at how they were presenting investment options in their plan. To help in that effort, Vanguard identified five best practices in 2012 that we believe can help sponsors assess and construct their investment lineups and effectively communicate their plan lineups to participants:

• Focus on the investment fundamentals of asset allocation, diversification, and low costs.
• Offer professionally managed allocations, including TDFs and managed accounts.
• Offer a core set of broad-market index funds.
• Make the plan lineup easy for participants to understand and use.
• Ensure active, ongoing oversight.

Plan sponsors consider retirement-income options

Plan sponsors play a critical role in helping their participants accumulate savings for retirement, but many are also asking how they can help participants manage their income after they leave the workforce. It’s an especially critical question at a time when increasing numbers of baby boomers are expected to retire in the coming decades, and they face a variety of financial pressures.

The changing retirement landscape—a convergence of trends

78 million
baby boomers have begun to retire

| Americans are living much longer in retirement. | Lump-sum distributions are more prevalent from both defined benefit (DB) and defined contribution (DC) plans. | More are assuming the burden of providing for their health care. |

Figure 9. Rise in indexed assets in DC plans

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>24%</td>
<td>24%</td>
<td>24%</td>
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<td>4%</td>
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<tr>
<td>18%</td>
<td>17%</td>
<td>16%</td>
<td>15%</td>
<td>23%</td>
<td>18%</td>
<td>16%</td>
<td>17%</td>
<td>15%</td>
</tr>
</tbody>
</table>

Money market/stable value
Company stock
Index target-date
Index target risk
Active equity/bond/balanced
Index equity/bond/balanced

Source: Vanguard, 2013.
Plan sponsors are encouraging participants to think about this next phase of their financial lives well before they reach retirement age, and they are increasingly educating pre-retirees about income options. That way, participants are better prepared for critical decisions, including when to take Social Security, how much they can prudently spend from their savings, and how much they value lifetime income guarantees.

To help participants in retirement and nearing retirement develop an income strategy that suits their personal needs and preferences, Vanguard has created a comprehensive program that includes targeted advice and education within the employer’s plan, and product solutions for rollovers outside the plan. One of its critical components is Vanguard’s Ask a CFP® Professional service, which provides retirees and pre-retirees, free of charge, advice around drawdown options, among a range of other financial issues.

For participants who roll over their plan accounts to a Vanguard IRA®, our income solutions include:

- Systematic withdrawals, which can be established using the education tools on vanguard.com or by contacting a Vanguard IRA rollover specialist by phone.
- Managed Payout Funds, which combine investment management and a systematic withdrawal income strategy all in one package.
- Vanguard Annuity Access™ built on the Income Solutions® platform, which is designed for participants looking to generate a stream of guaranteed income for life.
- Vanguard Variable Annuities with Guaranteed Lifetime Withdrawal Benefits (GLWB), recent innovations for participants looking for guaranteed income while retaining access to their savings.

Some participants, however, simply want to take installments from their current employer’s DC plan. For them, the plan account may represent all or most of their retirement investments. To serve this population, Vanguard is turning its attention to within-the-plan solutions and making it easy for participants to create a steady stream of income from their retirement plan investments.

Figure 10. New website tool for participants
The My MoneyWhys® education and news center houses many resources on personal finance topics.
Participants seek help with their financial lives

Today’s employees need a systematic approach to accumulating assets for retirement and tools that help them see how they are progressing toward their goals. In early December, we updated the participant homepage with two new features designed to increase the “retirement readiness” orientation of the site.

• A “Save more” calculator that encourages individuals to boost savings.
• The Financial Engines “stoplight,” which provides a red/yellow/green estimate of retirement readiness, while giving individuals the opportunity to sign up for a managed account service.

To help participants better manage their broader financial lives, Vanguard introduced the new My MoneyWhys® education and news center on our website. (See Figure 10, page 13.) This one-stop, easy-to-use, personalized experience aggregates Vanguard’s award-winning education tools and resources across a wide variety of personal finance topics—including retirement. Of course, the education and news center houses information about the employer plan, such as plan news and details about plan services. Participants also have easy access to any available plan communications.

In addition, anticipating that more and more employees will be using tablets and cell phones online, Vanguard has added transaction capabilities for mobile applications—another example of Vanguard’s technology leadership.
Research helps improve plans and portfolios

Institutional investors and retirement plan sponsors delved into Vanguard’s research and commentary throughout 2012 to better meet the challenges they faced, including:

- Meeting investment goals while prudently managing risk.
- Fulfilling their fiduciary responsibilities.
- Optimizing their retirement plans.
- Increasing their participants’ retirement readiness.

Research is not only the foundation for Vanguard’s investment methodology, but it also serves as the springboard for new products and services in today’s ever-changing environment.

In 2012, we were pleased to present *How America Saves 2012: A report on Vanguard 2011 defined contribution plan data*—the 11th edition of this report. Other notable publications included:

- A three-part diversity series that reflects the growing interest in the study of workforce diversity in DC retirement plans—and in particular, the role of race and ethnicity in savings and investment choices.
- *Global fixed income: Considerations for U.S. investors,* which discusses how an allocation to hedged international bonds may be useful in reducing overall portfolio volatility for some investors.
- *Creating an effective RFP process,* a guide for systematizing the process of evaluating potential investment providers.
- *Pension derisking: Diversify or hedge?* that explores why diversification with alternatives may not reduce risk at all because of the unique way DB plans define risk.
- Regulatory limits poster and compliance calendar, featuring convenient reminders of regulatory limits as well as recurring compliance and notice requirements.
Nonprofits review strategies amid volatility

Facing a low-yield environment, nonprofit organizations continue to look for ways to improve their returns while managing risk. Critical parts of this effort are to incorporate low-cost active and index funds to increase their chances of success and to manage spending dynamically. To help with decision-making, many nonprofits and other organizations are turning to advisors like Vanguard Institutional Advisory Services® for our time-tested investment methodology and experience working with investment committees.

With Vanguard’s strong commitment to the more than 1,400 nonprofit organizations we serve and their consultants, assets under management in 2012 increased by 13.7%, and Vanguard continued to be recognized as a leading investment manager to endowments and foundations (Pension & Investments, May 2012).

Vanguard Institutional Advisory Services, which offers a comprehensive approach to portfolio management, turned 15 in 2012, garnering a record number of new clients and marking an 18% rise in assets under management.

Defined benefit plans focus on mitigating risk

In 2012, DB plan sponsors faced a low interest rate environment, lower funded status, and volatile plan costs. Many were considering a liability-driven investment (LDI) strategy to mitigate this risk and provide more predictable costs. Others sought to eliminate risk by terminating the plan, offering lump-sum distributions, or taking other actions. But because interest rates were so low, many sponsors ended up postponing derisking strategies.

Vanguard continued to help plan sponsors understand how to implement an effective LDI strategy in a low interest rate environment where long bonds still make sense. Recent innovations that help plans manage risk include technology that models derisking glide paths and daily monitoring of funded status. Vanguard also helped plans implement sophisticated strategies such as immunization and matching assets with different demographic cohorts of liability (actives, vested terminees, and retirees). For Vanguard’s recordkeeping clients who offered a lump-sum window to their DB plan participants, we provided consultation and administrative assistance to support these complex projects.

In the wake of all the changes surrounding DB plans, participants face complex choices as well. Through Vanguard Pension Reinvestment Services, Certified Financial Planner™ professionals walk participants through the pros and cons of their various distribution options such as lump sums or annuities and help them understand tax implications and investment alternatives for their distributions.
Financial advisors strive to deepen relationships

The business structure for advisors is continuing to evolve from a commission- and transaction-based system to a fee-based, asset management framework. As part of that transition, advisors looked for new ways to add value. And Vanguard responded by developing new Advisor’s Alpha resources to help them provide discipline and experience to investors who need it, thereby enhancing practices, improving client retention, and increasing share of wallet.

In 2012, we continued to build upon our new service model that moved sales crew into the territories where they work. As a result, our regional sales executives are better equipped to assess the advisors’ needs and respond accordingly.

When advisors and their clients need support, we want to be ready with research, business strategies, and other tools. We addressed those needs in 2012 by:

• Conducting proprietary events across the country. We sponsored ten symposiums designed to provide advisors with direct access to Vanguard thought leaders and the latest industry and research topics.

• Continuing to reduce expense ratios as our ETFs achieve economies of scale, and widespread usage among financial advisors. In 2012, we lowered expense ratios on 43 Vanguard ETFs.

• Helping advisors become experts on complex topics and explain them to clients. We rolled out new advisor briefs that distill Vanguard’s lengthier research papers into key, actionable takeaways and complemented them with one-page client summaries that simplify topics even further.

• Providing insights and information through multiple channels. Our social media efforts expanded throughout 2012, including refining apps for mobile devices, continuing our lively Twitter feed, uploading new YouTube videos, enhancing the advisor website, and creating an advisor blog in response to advisor feedback.

Once again, we earned advisors’ loyalty in 2012. Industry research from Cogent continued to rank Vanguard among the top firms for advisor loyalty. In addition, investors have increasingly focused on the costs of investing. As a result, investment companies are lowering expense ratios, oftentimes to either attract new investors or maintain their existing client base. Vanguard is proud of our role in helping advisors and investors globally benefit from cost-cutting at major investment firms, and it’s gratifying to see what the media hails as “the Vanguard effect” coming to fruition across domestic and international markets.

1 Source: Morningstar.

2 Cogent Research, 2012 Advisor Brandscape. Advisor BrandscapeTM data are collected via a web-based survey amongst a nationally representative sample of more than 1,600 registered financial advisors. Cogent Research provides custom research, syndicated research products, and evidence-based consulting to organizations in the financial services, life sciences, and consumer goods industries. This advisor survey was conducted independently by Cogent. Vanguard neither commissioned nor paid to be included. Cogent has conducted unrelated, custom market research for Vanguard in the past.
Global clients find new ways to invest

In several key markets, Vanguard added funds—many of them investing locally—that make it even easier for investors around the world to build low-cost, long-term, broadly diversified portfolios.

Vanguard Investments Canada launched five ETFs, bringing the total offered to 11, including the S&P 500 Index ETF (CAD-hedged), the FTSE Canadian High Dividend Yield Index ETF, and the Canadian Short-Term Corporate Bond Index ETF.* The introduction of our dividend reinvestment plan also allows Canadian investors to reinvest Vanguard ETF cash distributions without paying a commission.

We launched our first suite of ETFs in Europe: five Ireland-domiciled UCITS ETFs available on the London Stock Exchange, including the FTSE All-World ETF, the FTSE Emerging Markets ETF, and the U.K. Government Bond ETF.** These ETFs complement our index mutual funds and give investors another series of options for implementing cost-effective investment strategies.

Vanguard Investments Australia introduced two fixed income ETFs, the Australian Fixed Interest Index ETF and the Australian Government Bond Index ETF***, each a diversified portfolio investing in more than 300 bonds. We also launched a dedicated learning center, enabling Australian advisors to access a comprehensive suite of educational materials designed to help them meet their annual accreditation requirements.

Vanguard Investments Hong Kong received clearance from the Hong Kong Securities and Futures Commission to offer Hong Kong-domiciled ETFs, the first of which is expected to launch in the second quarter of 2013.

Individual investors see market conditions improve

Facing a more favorable investing environment than in previous years, individual investors who were wary of the markets in 2011 began to return in 2012. In doing so, they adhered to the principles of diversification and long-term investing, contributing to bond, balanced, and equity funds.

* Inception date: November 2, 2012.
** Inception date: May 22, 2012.
*** Inception dates: October 31, 2012, and April 30, 2012, respectively.
Against the backdrop of improved market conditions, we continued to build on our history of enhancing our service capabilities while also lowering costs for our shareholders. To help improve our clients’ chances of achieving long-term success, we adopted new benchmark indexes for several of our funds that will result in savings over the long run. And, we lowered 529 fees yet again to help our clients save for college.

We invested in a new secure website for retail investors and continued to enhance our mobile capabilities, making it easier than ever to interact with Vanguard. To help our clients meet their investing objectives, we conducted more than 100,000 advice engagements. We also deepened client relationships by providing guidance and reached out to investors through new channels, such as social media.

As a result, Vanguard’s word-of-mouth referrals have never been stronger. To complement this growth source, our Vanguarding® campaign has continued to attract new individual investors. And our Concierge Services group has made bringing assets to Vanguard simpler than ever before. As always, we look forward to helping individual investors achieve their financial goals in 2013.
Vanguard directors and officers

Directors of Vanguard provide oversight to ensure that the funds are managed solely in the interests of their shareholders, who are the ultimate owners of the enterprise. Ten of the 11 Vanguard board members are independent directors, each with distinguished backgrounds in business, academia, and public service. They work with the fund officers to oversee the policies and activities of the funds and to represent shareholder interests. The accompanying list provides a brief description of each director’s professional affiliations. The year in which the director joined our board is noted in parentheses.

F. William McNabb III (2008). Vanguard chairman of the board, president, and chief executive officer; director of Vanguard Marketing Corporation; and a former managing director of Vanguard.

Emerson U. Fullwood (2008). Retired executive chief staff and marketing officer for North America and corporate vice president of Xerox Corporation; executive-in-residence and 2010 Distinguished Minett Professor at the Rochester Institute of Technology; and director of SPX Corporation, the United Way of Rochester, Amerigroup Corporation, the University of Rochester Medical Center, Monroe Community College Foundation, and North Carolina A&T University.

Rajiv L. Gupta (2001). Retired chairman and chief executive officer and former president of Rohm and Haas Company; director of Tyco International, Ltd., and Hewlett-Packard Company; senior advisor at New Mountain Capital; trustee of The Conference Board; and member of the board of managers of Delphi Automotive LLP.

Amy Gutmann (2006). President of the University of Pennsylvania; Christopher H. Browne Distinguished Professor of Political Science in Penn’s School of Arts and Sciences, with secondary faculty appointments in the Annenberg School for Communication and the Graduate School of Education; chair of the Presidential Commission for the Study of Bioethical Issues; director of the Carnegie Corporation of New York; member of the National Commission on the Humanities and Social Sciences; and trustee of the National Constitution Center.

JoAnn Heffernan Heisen (1998). Retired corporate vice president and chief global diversity officer, and a former member of the executive committee of Johnson & Johnson; director of Skytop Lodge Corporation, the University Medical Center at Princeton, the Robert Wood Johnson Foundation, and the Center for Talent Innovation; and member of the advisory board of the Maxwell School of Citizenship and Public Affairs at Syracuse University.

F. Joseph Loughrey (2009). Retired president and chief operating officer and former vice chairman of the board of Cummins Inc.; director of Hillenbrand, Inc., SKF AB, the Lumina Foundation for Education, and Oxfam America; chair of the Advisory Council for the College of Arts & Letters; and member of the advisory board to the Kellogg Institute for International Studies at the University of Notre Dame.

Mark Loughridge (2012). Senior vice president and chief financial officer at IBM and fiduciary member of IBM’s Retirement Plan Committee; and former senior vice president and general manager of Global Financing, vice president and controller, and other IBM management roles.

Scott C. Malpass (2012). Chief investment officer and vice president at the University of Notre Dame; assistant professor of finance at the Mendoza College of Business at the University of Notre Dame; member of the Notre Dame 403(b) Investment Committee; board member of TIFF Advisory Services, Inc.; and member of the investment advisory committees of the Financial Industry Regulatory Authority (FINRA) and of Major League Baseball.

André F. Perold (2004). Former George Gund Professor of Finance and Banking at the Harvard Business School; chief investment officer and managing partner of HighVista Strategies LLC; director of Rand Merchant Bank; and overseer of the Museum of Fine Arts Boston.

Alfred M. Rankin, Jr. (1993). Chairman, president, and chief executive officer of NACCO Industries, Inc., and of Hyster-Yale Materials Handling, Inc.; director of the National Association of Manufacturers; chairman of University Hospitals of Cleveland; and advisory chairman of the board of The Cleveland Museum of Art.

Peter F. Volanakis (2008). Retired president and chief operating officer, and a former director of Corning, Inc.; former director of Dow Corning; director of SPX Corporation; overseer of the Amos Tuck School of Business Administration at Dartmouth College; and advisor to the Norris Cotton Cancer Center.

Senior management team

Mortimer J. Buckley, Kathleen C. Gubanich, Paul Heller, Martha G. King, John T. Marcante, Chris D. McIsaac, Michael S. Miller, James M. Norris, Glenn W. Reed, George U. Sauter, Heidi Stam.

John J. Brennan, chairman emeritus and senior advisor.
All investments, including a portfolio’s current and future holdings, are subject to risk. 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. Although the income from the U.S. Treasury obligations held in the fund is subject to federal income tax, some or all of that income may be exempt from state and local taxes. Investments in stocks or bonds issued by non-U.S. companies are subject to risks including country/regional risk and currency risk. Stocks of companies based in emerging markets are subject to national and regional political and economic risks and to the risk of currency fluctuations. These risks are especially high in emerging markets. Diversification does not ensure a profit or protect against a loss.

The Managed Payout Funds are not guaranteed to achieve their investment objectives, are subject to loss, and some of their distributions may be treated in part as a return of capital. The dollar amount of a fund’s monthly cash distributions could go up or down substantially from one year to the next and over time. It is also possible for a fund to suffer substantial investment losses and simultaneously experience additional asset reductions as a result of its distributions to shareholders under its managed distribution policy. An investment in a fund could lose money over short, intermediate, or even long periods of time because each fund allocates its assets worldwide across different asset classes and investments with specific risk and return characteristics. Diversification does not necessarily ensure a profit or protect against a loss in a declining market. The funds are proportionately subject to the risks associated with their underlying funds, which may invest in stocks (including stocks issued by REITs), bonds, cash, inflation-linked investments, commodity-linked investments, long/short market neutral investments, and leveraged absolute return investments.

Please note that the Managed Payout Funds may not be appropriate for all investors. For example, depending on the time horizon, retirement income needs and tax bracket, an investment in a Managed Payout Fund might not be appropriate for younger investors not currently in retirement, in IRAs or other tax-advantaged accounts for those investors under 59½, or for participants in employer-sponsored plans. Investors who hold a Managed Payout Fund within a tax advantaged retirement account should consult their tax advisors to discuss tax consequences that could result if payments are distributed from their core account prior to age 59½ or if they plan to use the Managed Payout Funds, in whole or in part, to meet their required minimum distribution (RMD) obligations. Distributions from the Managed Payout Funds are unlikely to precisely match an investor’s IRA RMD obligations. In addition, use of the Managed Payout Funds may be restricted in employer-sponsored plans by the terms of the governing plan documents and/or at the discretion of the plan administrator. Review the information carefully with your financial advisor before deciding whether a Managed Payout Fund is right for you.

Before investing, consider the Managed Payout Funds’ investment objectives, strategies, risks, fees and expenses. Contact Vanguard for a prospectus containing this information. Read it carefully.

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The May 2012 Morningstar report evaluated performance, as well as the people, parent company, portfolio, and prices behind the funds offered. Past performance is no guarantee of future results.

Ask a CFP Professional is provided by Vanguard Advisers, Inc., a registered investment advisor.

The BRG and Cogent surveys were syndicated studies conducted independently by BRG and Cogent. Vanguard neither commissioned nor paid to be included in them. BRG has conducted unrelated custom market research for Vanguard in the past.
For more information, visit institutional.vanguard.com or call 800-523-1036 for Vanguard funds and 800-992-8327 for non-Vanguard funds offered through Vanguard Brokerage Services to obtain fund prospectuses. Visit our website, call 866-499-8473, or contact your broker to obtain a prospectus for Vanguard ETFs. Investment objectives, risks, charges, expenses, and other important information are contained in these documents; read and consider them carefully before investing.

Advice services offered through Vanguard Institutional Advisory Services are provided by either Vanguard Advisers, Inc., a registered investment advisor, or Vanguard Fiduciary Trust Company, a Pennsylvania registered bank.

An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at $1 per share, it is possible to lose money by investing in such a fund.

Variable annuities are long-term vehicles designed for retirement purposes and contain underlying investment portfolios that are subject to investment risk, including possible loss of principal.

Vanguard Annuity Access is offered in collaboration with Hueler Investment Services, Inc., through the Income Solutions platform. Income Solutions is a registered trademark of Hueler Investment Services, Inc., and used under license. United States Patent No. 7,653,560. Vanguard Annuity Access is provided by Vanguard Marketing Corporation, d/b/a VMC Insurance Services in California.

Guarantees are subject to the claims-paying ability of the issuing insurance company.

The underwriting risks, financial obligations, and support functions associated with the products are the responsibility of the issuing insurance company. The issuing insurance company is responsible for its own financial condition and contractual obligations.

The Vanguard Variable Annuity is a flexible-premium variable annuity issued by Monumental Life Insurance Company, Cedar Rapids, Iowa (NAIC No. 66281), and in New York State only, by Transamerica Financial Life Insurance Company, Harrison, New York (NAIC No. 70688). Form No. VVAP U 1101 (in Florida, Form No. VVAP U 1101 (FL), in Oregon, Form No. VVAP U 1101 (OR) (R), and in New York VVA NY 0208). GLWB Rider Form No. RGMB 43 0811 (in Florida, RGMB 43 0811 (SI)(FL), RGMB 43 0811 (JT)(FL), in Oregon RGMB 43 0811 (SI)(OR), RGMB 43 0811 (JT)(OR), and in New York RGMB 43 0811 (SI)(NY)(REV), RGMB 43 0811 (JT)(NY) (REV)), without agent representation. Policy and rider form numbers may vary by state and may not be available in all states. The Vanguard Group administers the Vanguard Variable Annuity for the issuer. Its variable annuity and investment costs rank among the lowest in the industry, according to Morningstar, Inc., December 2011. The Vanguard Group, Monumental Life Insurance Company, and Transamerica Financial Life Insurance Company do not provide tax advice. Investors are encouraged to consult a tax advisor for information on how annuity taxation applies to their individual situations.

Vanguard ETF Shares are not redeemable with the issuing Fund other than in Creation Unit aggregations. Instead, investors must buy or sell Vanguard ETF Shares in the secondary market with the assistance of a stockbroker. In doing so, the investor may incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.