



[« Previous page](#)

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Indexing insight from Vanguard's chief investment officer



Gus Sauter

Type the words "index fund" into any Web search engine and Vanguard is likely to appear in the results. Indeed, Vanguard has become nearly synonymous with indexing since 1976, when we introduced [Vanguard® 500 Index Fund](#), the first index mutual fund for individual investors. At the time, the fund featured an expense ratio of 0.43% and shares were offered with a sales load as high as 5.5%. Investor response was understandably tepid to this novel investment offering.

The ensuing quarter century has, of course, resulted in significant changes to the fund and the passive management approach. Today, the fund once derided as "guaranteed mediocrity" is one of the industry's largest, with \$106 billion in assets, according to Lipper Inc. (as of August 31, 2005). The sales load is long gone, and the fund's [Admiral™ Shares](#) feature an expense ratio of 0.09% as of June 30, 2005. Vanguard's commitment to the indexing strategy, however, hasn't changed, which is the reason Vanguard has emerged as a mutual fund indexing leader, managing \$370 billion in assets invested in more than 50 index funds as of August 31, 2005.

Vanguard is leading the index field in other ways, too, be it sharing our thoughts on optimal benchmark construction with the indexing community to continually refining our index trading strategies for the benefit of our shareholders. George U. "Gus" Sauter, who serves as Vanguard's chief investment officer, has been guiding Vanguard's index ship since 1987. Vanguard.com® recently interviewed Mr. Sauter about topical issues in the indexing arena.

Indexing appears to be enjoying a bit of a renaissance. Why?

Mr. Sauter: I agree. Indexing is back in the news largely because of increased price competition and the growth of index products like [exchange-traded funds](#) (ETFs). But beyond the headlines, the real story is that investors and financial professionals are gravitating to indexing. One out of every three dollars invested in an equity mutual fund in 2004 was directed to an index fund—about \$85 billion. (Source: Strategic Insight.) Index funds have become an increasingly important component to millions of investors' portfolios, representing some 15% of all equity mutual fund assets. (Source: Morgan Stanley Research.)

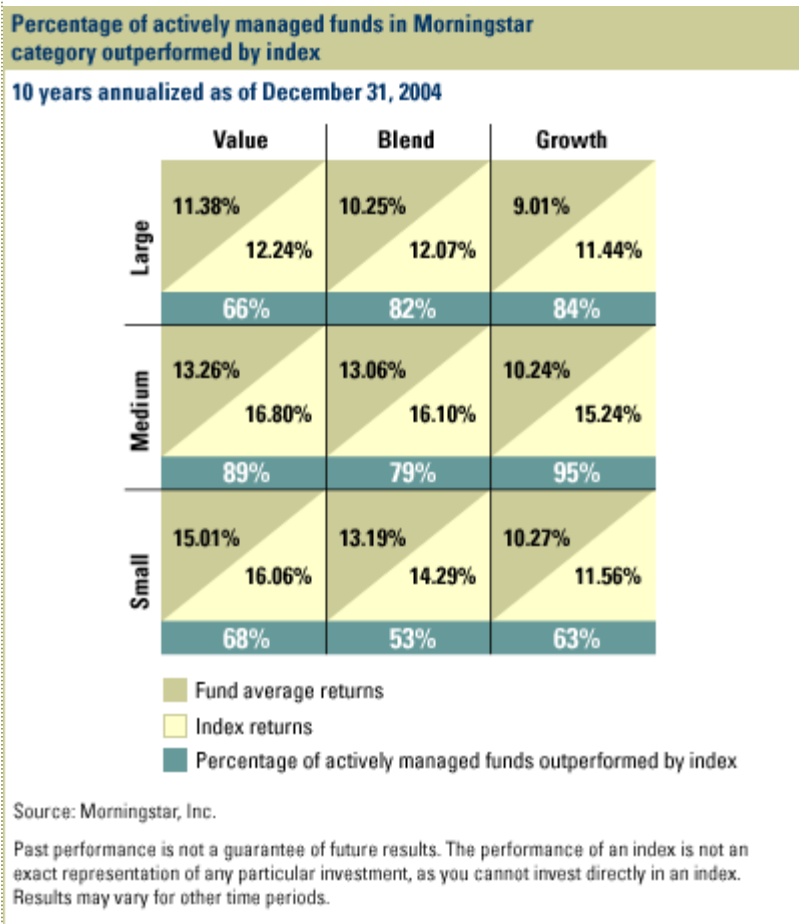
Why such strong cash flows?

Mr. Sauter: Following the boom-and-bust period that we've experienced over the past five years, I think that the enduring benefits of indexing are really resonating with individual investors, as well as financial planners and advisors: low costs, broad diversification within market sectors, performance predictability relative to benchmarks, and the potential for tax-efficiency. These benefits are constant in good markets and bad.

What about performance?

Mr. Sauter: The stock market's 31%-plus rebound following the recent bear market (as measured by the MSCI US Broad Market Index) certainly reignited interest in stock funds in general, but 2004's 7% gain was below the market's historical average.

If performance is a factor in indexing's resurgence, I would point to relative long-term performance. In presentations to clients and investment groups, I frequently present the accompanying graphic, which shows various S&P benchmarks outperforming their comparable actively managed funds in all nine Morningstar style boxes over the past ten years. It's a fairly compelling argument for the index approach.



You mentioned increased price competition. What does that mean for investors?

Mr. Sauter: It's good news, and we're encouraged that costs are becoming more of an issue within the mutual fund industry. We championed the importance of low costs—somewhat as a lone voice—for 30 years.

With regard to index funds, in particular, our offerings have always been among the lowest cost. We offer [more than 50 index funds](#), with costs as low as 0.025% for institutional clients and 0.07% for individual shareholders. In fact, nine of our index offerings available to individuals have expenses equal to or below the heralded 10-basis-point mark. And, importantly, our low-cost advantage extends beyond our index funds to our entire family of stock, bond, balanced, and

money market funds.

Investors interested in indexing face a choice between traditional funds or the exchange-traded variety. Which is better?

Mr. Sauter: First, let me set the record straight. ETFs *are* index funds, which I think gets lost in all of the hype. The difference between a traditional index mutual fund and an ETF is how you invest in it—directly from the mutual fund provider or on a stock exchange through a broker. So, it's really not a question about which index product is better, but which is better for a particular investor. For a proper evaluation, investors should weigh quantitative factors as well as qualitative factors before picking the index fund best for their distinct needs.

On the quantitative side, consider factors like expense ratios and brokerage commissions. On the qualitative front, you should think about the level of importance that you assign to trading flexibility versus investing for the long term. Conventional index mutual funds are purchased and redeemed only at net asset value at the end of the day; ETFs can be bought and sold throughout the day at current market price. ETFs can also be sold short and bought on margin.* Of course, you pay a price for such flexibility in the form of brokerage commissions and other transaction costs (i.e., [bid/ask spread](#)), which should never be left out of the equation.

If you're [dollar-cost averaging](#) on, say, a monthly basis, the traditional index shares are clearly the way to go. If you want intra-day pricing and plan to buy and sell over a short period of time—say, within a year—an ETF is the better bet.**

Vanguard is the only firm to offer both traditional and exchange-traded index products, so we're not going to over-sell the advantages of one over the other. We want to help investors make informed decisions about which approach is right for them. It is also not an either/or proposition. You can own both traditional and exchange-traded index funds, as I do.

Once you've decided that ETFs are right for you, how do you choose among the 200-plus now available?

Mr. Sauter: That process is backwards. You should first decide which investment satisfies your needs and then determine how to invest in it—ETF or conventional mutual fund. Once you've decided which market or market segment you want exposure to (e.g., large-cap U.S. stocks, Pacific-rim stocks, energy stocks, etc.), the evaluation process should be the same for both ETFs and traditional index products. Among the factors that I suggest examining: expense ratio, tax-efficiency, pre- and post-tax returns, the diversification and construction of the underlying benchmark, product structure, and the experience and expertise of the manager.

Can you elaborate on some of these factors, starting with expenses?

Mr. Sauter: Sure. ETFs are properly considered low-expense investment vehicles, but there is a wide disparity between products. We offer [VIPER® Shares](#) at expense ratios as low as 0.07%; some ETF expense ratios top 0.80%. The average VIPER expense ratio is 0.10%; the average industry ETF expense ratio is 0.46%. (Source: Bloomberg, as of July 2005.)

And tax-efficiency?

Mr. Sauter: ETFs are generally tax-efficient, largely because they are index funds. Over the past five years, most index funds have not distributed a capital gain and those that did typically had very small distributions. But capital gains distributions are only part of the tax-efficiency equation. Traditional index funds and ETFs also distribute taxable dividend income. The [tax law changes enacted in 2003](#) created favorable tax treatment for certain fund dividends, subject to holding-period requirements. For those in higher tax brackets, [qualified dividend income](#) (or QDI) is taxed at 15%, rather than higher ordinary income rates. The extent to which a fund pays income that does not qualify for the favorable tax treatment can have a meaningful impact on the after-tax return earned by an investor, especially a high-income investor. As a result, a tax-conscious investor should pay attention to the level of a fund's QDI.

I'd also caution investors not to equate higher tax-efficiency with higher after-tax returns. One investment can be more tax-efficient than a similar offering, yet offer lower after-tax returns. In other words, at the end of the day, it matters what you put in your pocket after costs and taxes.

Does the benchmark make a difference?

Mr. Sauter: You bet. Vanguard selects benchmarks that we believe have a high degree of style integrity and more accurately reflect the markets they are designed to track. In addition, our MSCI sector benchmarks tend to be more broadly diversified than comparable indexes. It is somewhat gratifying to see sweeping changes that have occurred to benchmark construction methodologies over the past several years, which have led to better indexes for the benefit of investors.

Can you explain the different structures of ETFs?

Mr. Sauter: Sure. There has been a tendency to treat ETFs as a homogenous category, thereby ignoring some fairly significant differences among the products available today. Several of the early ETFs were structured as unit investment trusts, which restricts portfolio management activity and only allows for the quarterly reinvestment of dividends, resulting in a drag on performance. The ETFs that followed were generally structured as mutual funds, which eliminated the dividend drag issue. Vanguard took a third approach with the innovation of VIPERs, which are the only ETFs structured as a separate share class of an existing mutual fund. The multiclass structure provides flexibility and generally enables us to leverage the benefits of our large, well-established index mutual funds. Indeed, we believe that the VIPER structure can lead to specific advantages for investors including tracking precision, low costs, the potential for tax-efficiency and stability—and, ultimately, an expected long-term performance edge relative to our peer groups.

When you first joined Vanguard to head up its indexing efforts, did you ever envision the growth in the index fund concept that we see today?

Mr. Sauter: No, not really to the extent we see today. But, today, I truly think indexing will continue to grow. For most investors, low-cost index funds should serve as the core of their portfolios. I don't think we've reached that point yet.

Thank you, Mr. Sauter.

* [Buying on margin](#) and [selling short](#) can be difficult to execute successfully and may expose investors to higher risks or tax costs than anticipated.

** Dollar-cost averaging does not guarantee that your investments will make a profit, nor does it protect you against losses when stock or bond prices are falling. You should also consider whether you would be willing to continue investing during a long downturn in the market since dollar-cost averaging involves continuous investment in securities regardless of fluctuating price levels.

Notes

- Unless otherwise noted, all asset and performance figures are as of December 31, 2004.
- All statistics, unless otherwise noted, are provided by Vanguard.
- The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index. Benchmark comparative indexes represent unmanaged or average returns on various financial assets, which can be compared with funds' total returns for the purpose of measuring relative performance.
- All VIPER products are subject to stock market risk, which may result in the loss of principal. Prices of mid- and small-cap VIPER products often fluctuate more than those of large-cap VIPER products. International VIPER products involve additional risks, including currency fluctuations and the potential for adverse developments in specific countries or regions. VIPER products that invest in emerging markets are generally more risky than those that invest in developed countries. Sector VIPER products are subject to sector risks and nondiversification risks, which may result in performance fluctuations that are more extreme than fluctuations in the overall stock market. In addition, sector VIPER products that sample their target indexes to comply with tax diversification rules may experience a greater degree of tracking error than other VIPER products.
- VIPER Shares are not redeemable with an applicant fund other than in creation unit aggregations. Instead, investors must buy or sell VIPER Shares in the secondary market with the assistance of a stockbroker. In doing so, the investor will incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.
- Diversification does not assure a profit or protect against a loss in a declining market.
- Past performance is not a guarantee of future returns.
- Mutual funds are subject to market risk.
- It is possible that an ETF will not meet its objective of being tax-efficient.

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