Vanguard's strength and diversity help to assure clients

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During a time of tremendous upheaval in the financial industry and unprecedented volatility in the equity and credit markets, it's natural—and certainly prudent—to consider the health of your business partners. Since September, several big-name institutions have gone bankrupt or have been acquired; others have been forced to seek federal government protection.

So against the backdrop of all this turmoil, we'd like to outline the sources of Vanguard's considerable strength. Our confidence in our stability, and in our continued success, is rooted in several key factors, some of which are unique to Vanguard and some of which are inherent in the investment products we offer. Our funds and our businesses are well diversified, and we have in place a rigorous program of controls and oversight.

Finally, for those who entrust their assets to us on behalf of their employees, their own clients, or their firm or organization, strict regulatory protections provide yet another layer of assurance.

Vanguard's corporate strengths

First and foremost, Vanguard is financially strong. We provide investment management, administrative, and other services to the Vanguard funds. This business requires relatively modest amounts of capital. We have no exposure to the kinds of investment-banking businesses and proprietary trading losses that have shaken Wall Street. We don't borrow money to leverage, or magnify, investment returns in our stock, bond, or money market funds. At a corporate level, our debt is extraordinarily low, yet our financial strength gives us access to borrowing should we need it or choose to exercise it.

Our structure ensures that our focus remains solely and squarely on our shareholders. Helping our investors achieve their goals is our sole reason for existence. Because Vanguard is owned by its funds, which in turn are owned by their investors, there are no other parties to answer to and, therefore, no conflicting loyalties. We make every decision—such as keeping investing costs as low as possible—with only your needs in mind. This focus is helpful all the time, but especially in challenging markets because it allows us to remain true to our long-term view. This objective defines our value proposition: combining highly disciplined investment management and attentive service at a very low cost.

Vanguard's disciplined approach

Vanguard's singular commitment to clients helps shape our approach to investment management. Our watchwords are discipline, prudence, and low costs. Low costs mean that, compared with higher-cost peers, our funds don't have to take undue risk to produce competitive returns. This is an especially powerful advantage within the fixed income markets. As the credit crisis has unfolded, the credit analysts, portfolio managers, and risk managers in Vanguard Fixed Income Group have protected our money market fund shareholders from the meltdowns in structured investment vehicles, collateralized debt obligations, and dealer-issued debt such as Lehman Brothers commercial paper. Our own team of credit analysts, working closely with our portfolio managers long before the current crisis came to a head, identified a number of securities, issuers, and investment vehicles deemed too risky for our portfolios.

Here too, our diversified approach is evident. Vanguard portfolio managers serve as investment advisors for some of our equity funds and many of our fixed income funds, and we work with dozens of external investment managers (yet another key source of diversification within our investments and our business) who provide investment management within the tightly drawn objective that we have established for each fund.

In addition to the portfolio managers and credit experts who continuously monitor the risks in the markets and in our funds, oversight for our investments and our business comes from:

- Board of directors. Our board members serve on the board of The Vanguard Group and generally serve as members of the board of trustees of each Vanguard fund. Eight of the ten directors are independent and have no other affiliation with Vanguard or the funds—aside from personal investments they make in our funds. The main role of the board is to ensure that the funds and the company are managed in the best interest of Vanguard shareholders. Learn more about our board of directors.
- Senior management. Our team of managing directors, led by President and Chief Executive Officer Bill McNabb, is responsible for our investment products and for our overall business. The team plays a key role in the diversification of our funds and businesses and it sets, and enforces, our high standards for portfolio management, great service, and efficiency. Gus Sauter, Vanguard's chief investment officer, is responsible for the management of nearly $1 trillion in assets (as of October 2008) and he oversees our risk-management operation.
- Portfolio Review department. This group oversees our funds and manages our relationships with outside advisors. The professionals in this group help to identify and select investment advisors for consideration by Vanguard's board of directors. They closely monitor investment performance, and they continuously evaluate the investment firms themselves to look for consistency in such things as investment approach, philosophy, and even personnel. Our rigorous selection process and our regular contact with these firms are two of the key reasons we have tremendous confidence in the abilities of our investment managers.

The diversified nature of our business

Vanguard's business is well diversified across stock, bond, and money market mutual fund management. Our client base is also diversified. About 50% of our assets come from institutional investors and the other half from individual investors. Within our institutional business, we're diversified across institutional asset management, retirement plan, and our rapidly growing financial advisor businesses. As of September 30, 2008, 51% of our assets were considered “direct” (primarily individuals), about 21% came through intermediaries such as financial advisors, and about 28% were in institutional. Our international business provides yet another source of revenue and investors.

Through the first nine months of 2008, our net cash flow totaled more than $65 billion. Of that total, about 45% was invested in equities, about 45% in bonds, and roughly 10% in money market investments.

This broad diversification—among the types of investment products we offer (mutual funds, exchange-traded funds, collective trusts), the businesses in which we operate, and the clients we serve—moderates the impact of cyclical changes in any one segment of Vanguard's business.

Of course, Vanguard shareholders also benefit from the built-in diversification of our investment products, whether they're mutual funds, exchange-traded funds, or trusts. Diversification does not ensure a profit or protect against a loss in a declining market. But even though a broad-based decline can affect all asset classes, the benefits of diversification do not evaporate during times of market stress.

It's important to note that although our assets under management have dropped as a result of the markets' decline, Vanguard funds continue to attract assets. Because of the diversity of our business, we've continued to see positive cash flow over the past couple of months, particularly from institutions and financial advisors. It's extremely encouraging that a large number of existing shareholders continue to see the value of our investments and our approach and that new shareholders are finding their way to us during this turbulent period. In fact, the combination of new cash flow into our funds and the tremendous loyalty that our clients have shown us has contributed to our financial strength.

Regulatory protections

Vanguard shareholders can also benefit from the protections built into the Investment Company Act of 1940, which established the framework for mutual fund regulation.

Each fund is a separate entity. Losses in one fund will not affect another. A fund's assets are the securities it holds. The value of these assets rises and falls, based on activity in the financial markets. As a mutual fund shareholder, you share in these gains and losses, proportionate with your investment in the fund. As a practical matter, a mutual fund cannot go bankrupt, except in the highly unlikely event that its assets fall to such a low level that it can no longer meet its operating expenses.

Can a fund's investment manager go bankrupt? It's possible, but again, the industry's regulatory structure ensures that fund assets would not be at risk. The fund manager and the fund are separate legal entities. If a fund manager went bankrupt, creditors would have no access to the fund's assets. In fact, these assets are safeguarded at independent custodian banks. If a fund manager disappeared, fund assets would be unaffected, although costs could change. The board would be responsible for choosing another advisory company to manage the portfolio.

Long-term perspective is key

When will the financial markets settle down? No one can say for sure. But our financial markets are resilient. Crises have been encountered in the past, and the stock and bond markets have continued to produce wealth for long-term investors.

Though we can't predict when a turnaround may come, we can with great confidence say that we will never waver in our commitment to provide excellent service and superior performance at the lowest reasonable cost. This is part of our pledge to you and it is a commitment that endures in all market environments.

We are in an excellent position to help our partners reach their long-term financial goals. We thank you for entrusting your assets to us.

Notes:

- **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.**
- All investments, including a portfolio's current and future holdings, are subject to risk. Investments in bond funds are subject to interest rate, credit, and inflation risk.

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