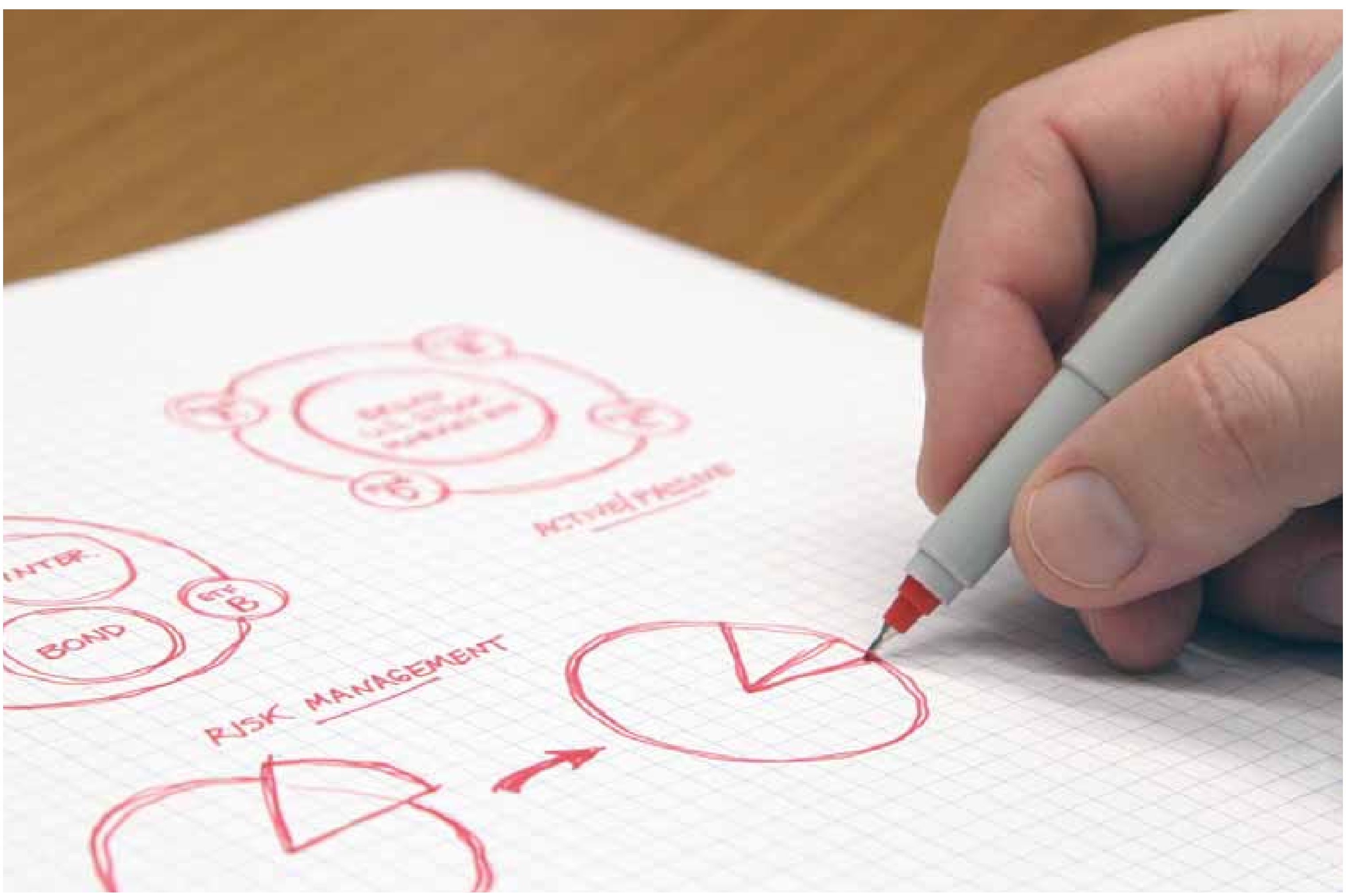
ETF Strategies

Vanguard®



Contents

Why ETFs?

Institutional investors were the first to recognize the merits of exchange-traded funds (ETFs), first introduced in 1993. But individual investors and financial advisors also recognized their appeal, helping to drive the explosive growth of ETFs in recent years, both in the number of offerings and in the amount of assets under management.

ETFs are typically index-oriented or passive investments that trade like individual stocks. As such, they have the following features:

Diversification within a market segment

An ETF might contain hundreds or thousands of securities—more than many actively managed mutual funds and far more than a portfolio of individual securities.

Potential for tax-efficiency

Because of their structure, index funds and ETFs usually provide a tax advantage relative to their active peer groups over longer holding periods.

Low costs

ETFs generally have lower expense ratios (annual operating costs as a percentage of average net assets) than actively managed funds and, in some cases, index funds as well. Lower costs mean more of a fund's returns go to the investor.

Transparency

They hold the same securities or a representative sample as their benchmark indexes, so they're transparent and easy to understand.

Low manager risk

Index funds and ETFs virtually eliminate the exposure to manager risk. They may underperform their benchmarks because of real-world operating costs and tracking error, but usually by very narrow margins. Active fund performance, on the other hand, is more unpredictable.

Trading flexibility

Unlike mutual funds, ETFs can be traded throughout the day. Anything that can be done with a stock—such as margin buying and short selling—can also be done with an ETF.[1]

Accessibility through financial advisors

Index funds are not always widely available for investors who work with a financial advisor. But ETFs are available to anyone who has a brokerage account.

These features make ETFs ideal for implementing various portfolio strategies, whether over the long term or the short term. This brochure outlines some strategic and tactical uses for ETFs. We also cover a few caveats about the investment risks.

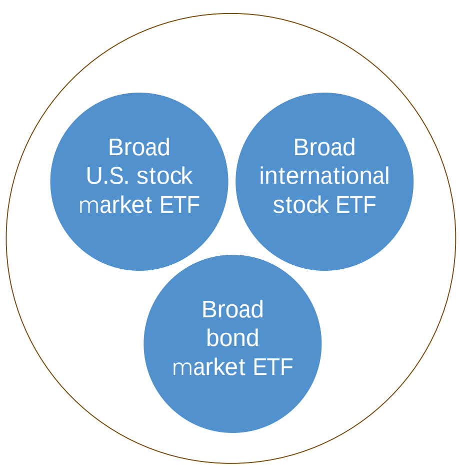
1 Margin buying (borrowing to buy securities) and short selling (selling borrowed securities) carry their own risks. Adverse price movements can exacerbate losses.

1

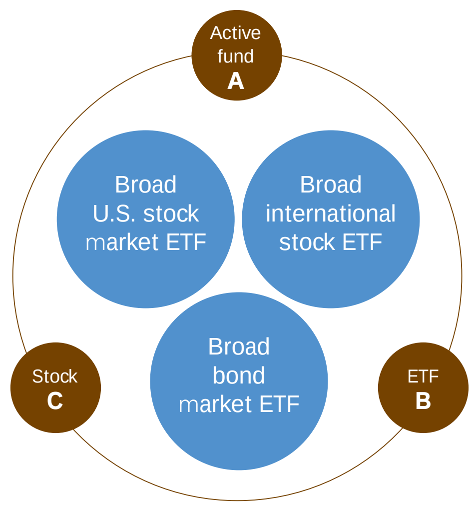
Asset allocation

Studies show that asset allocation—the division of assets across broad asset classes—is the primary determinant of a portfolio's risk and return, assuming a diversified portfolio engaged in limited market-timing. Active management—whether at the individual level or through an actively managed fund—is a wild card that can introduce unintended risk into a portfolio.

For those who prefer to eliminate that factor, a portfolio composed entirely of broadly diversified ETFs can help ensure that performance depends primarily on your asset allocation decisions. In fact, three broad-market ETFs can provide convenient, cost-effective diversification across asset classes.



In addition, those three ETFs can serve as the primary diversifiers of a new client's portfolio, where significant embedded capital gains may make wholesale portfolio changes impractical.



Points to ponder

- Diversification does not guarantee a profit or protect against a loss during a market decline.
- An all-index portfolio removes the possibility of excess return that can result from active management or individual security selection.
- All ETFs are subject to market risk, which may result in the loss of principal. International ETFs involve additional risks, including currency fluctuations and the potential for adverse developments in specific countries or regions. Bond ETFs are subject to interest rate, credit, and inflation risk.

2

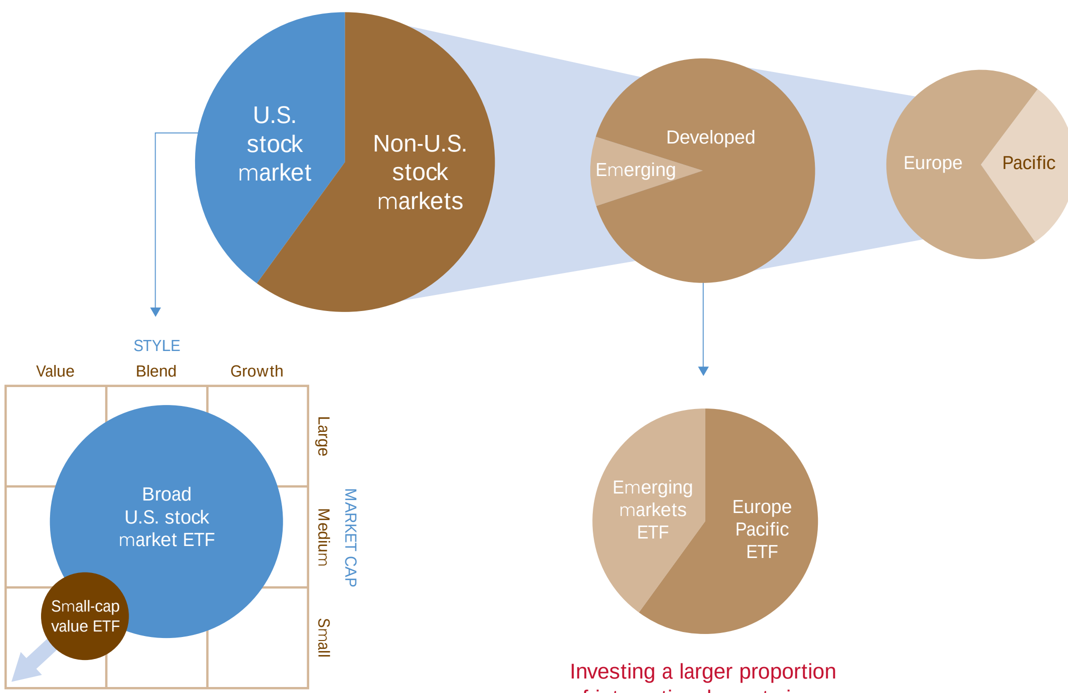
Sub-asset allocation

Portfolio weightings within an asset class should largely reflect those of the broad market unless objectives, risks, costs, liquidity, or other issues warrant otherwise.

Some investors may prefer to actively change the characteristics of a market-weighted portfolio, and specialized ETFs can provide the desired market tilt. Investors who believe value and small-cap stocks can enhance returns over the long run (as some studies suggest) may want to buy ETFs to overweight those market segments in the U.S. equity portion of their portfolio. On the international side, investors who believe that emerging markets will ultimately provide higher returns than developed markets and are willing to bear higher volatility might invest a larger proportion of their international assets in an emerging-markets ETF.

Points to ponder

- Concentration in any security, industry sector, market segment, or asset class can lead to greater risk relative to a diversified portfolio.
- Prices of mid- and small-cap ETFs often fluctuate more than those of large-cap or broad-market ETFs.
- ETFs that invest in emerging markets are generally more risky than those that invest in developed countries.



Overweighting a market segment in the U.S. equity portion of a portfolio

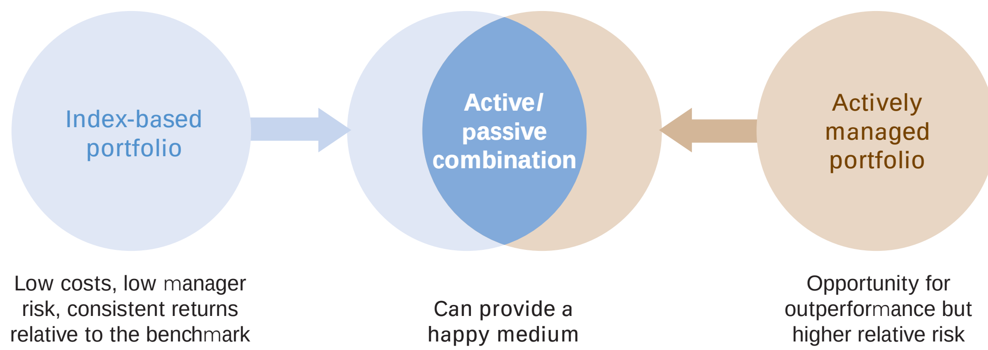
Investing a larger proportion of international assets in an emerging markets ETF

3

Active/passive combinations

Combining a broad-market ETF with actively managed funds may have a certain appeal for some investors. A portfolio composed entirely of broad-market ETFs typically means low costs, low manager risk, and consistent performance relative to benchmarks. But it also means giving up any opportunity for outperforming the market.

Active funds provide that opportunity, but they also entail greater relative risk and unpredictability. Some clients may prefer a combination of ETFs and low-cost active funds that can potentially achieve a happy medium between these two approaches.



Points to ponder

- There is no guarantee that a combined active/passive approach will be less risky than an all-active or all-index approach or will achieve comparable returns.
- Whether they choose active or passive funds, investors should consider funds that have low expense ratios to increase the probability of long-term success. Costs directly detract from returns.

4

Asset location

In addition to asset allocation, most investors should consider asset location in portfolio construction discussions. Asset location is simply the way in which assets are divided among taxable and tax-advantaged accounts to maximize a portfolio's after-tax returns.

For tax-advantaged accounts, the pre-tax total return is generally the return the investor gets (ignoring for the moment taxes on withdrawals from tax-deferred accounts). For taxable accounts, taxes will have to be paid on most dividend and capital gains distributions, even if all the distributions are reinvested in the fund. So a fund's total return can overstate the return the investor actually gets after taxes are deducted.

Asset location tackles the issue of appropriately allocating assets among taxable and tax-advantaged accounts to maximize after-tax returns at the overall portfolio level. The extra return an investor gets after taking taxes into account might be incremental, but it can make a difference when compounded over time.

General guidelines

Because the qualified dividends generally paid on shares of certain equities and long-term capital gains are currently taxed at a maximum rate of 15%, stocks are generally better suited for taxable accounts. However, the typical actively managed stock fund and certain equity index funds and ETFs that concentrate in narrow market sectors are usually more suitable for tax-advantaged accounts, because their higher portfolio turnover leaves shareholders more vulnerable to capital gains distributions.

Points to ponder

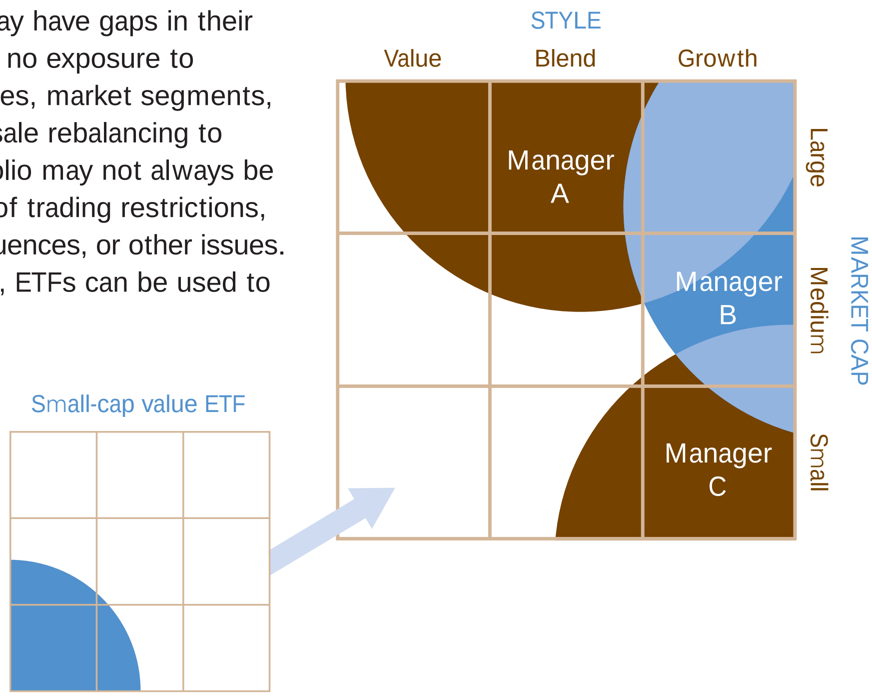
- Tax codes can change. For example, the maximum 15% tax rate on long-term capital gains and qualified dividend income will expire after 2010, unless legislatively extended.
- It's difficult to predict investors' tax brackets many years ahead.
- Pre- and after-tax returns of asset classes could deviate substantially from historical averages.

Investments more suited for:	
Taxable accounts	• Most broad-market stock index funds and ETFs • Tax-managed funds or other tax-efficient active funds • Municipal bonds • Annuities • Individual stocks, if held long term
Tax-advantaged accounts	• Most actively managed funds • Taxable bonds • REITs • Certain commodities, such as gold and silver ETFs • Individual stocks, if held short term • Some narrowly focused equity index funds and ETFs

1

Portfolio completion

Some investors may have gaps in their portfolios—little or no exposure to certain asset classes, market segments, or sectors. Wholesale rebalancing to diversify the portfolio may not always be possible because of trading restrictions, severe tax consequences, or other issues. In those situations, ETFs can be used to fill in those gaps.



Point to ponder

- Greater diversification entails the possibility of underperformance relative to a concentrated portfolio, but it also means less risk.

2

Cash equitization

ETFs are also a good option for investors who have a large temporary cash position such as a bonus or other windfall, or when transitioning between asset managers.

Such a cash position may tilt an investor's portfolio away from its targeted allocation to equities. Over extended periods, that position can mean potential performance shortfalls relative to benchmarks or financial goals.

Investing a temporary cash position in ETFs reduces the likelihood of such performance shortfalls.

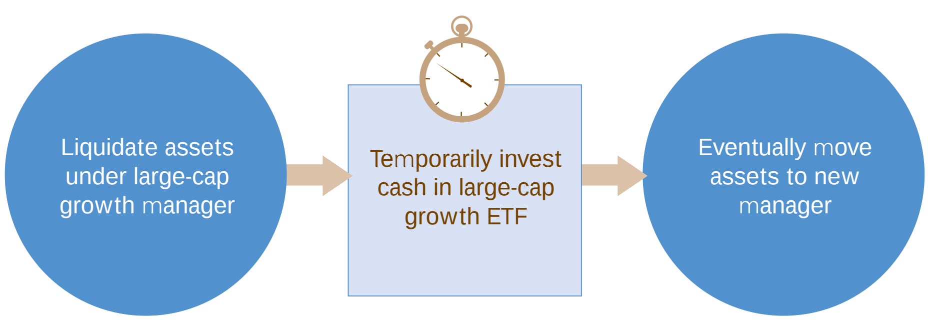
Historically, the stock market has had an upward-performance bias, meaning that there have been more periods with a positive return than with a negative return. The longer the time period, the stronger that performance bias, both in the frequency of the periods and in the magnitude of the returns. As the table below illustrates, being out of the market for a month would have cost an investor more than half a percentage point in return, on average.

Standard & Poor's 500 Index, 1995–2009

	Daily	Weekly	Monthly
Occurrence of positive return	54%	56%	64%
Average return	0.04%	0.18%	0.75%

Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Source: Vanguard.



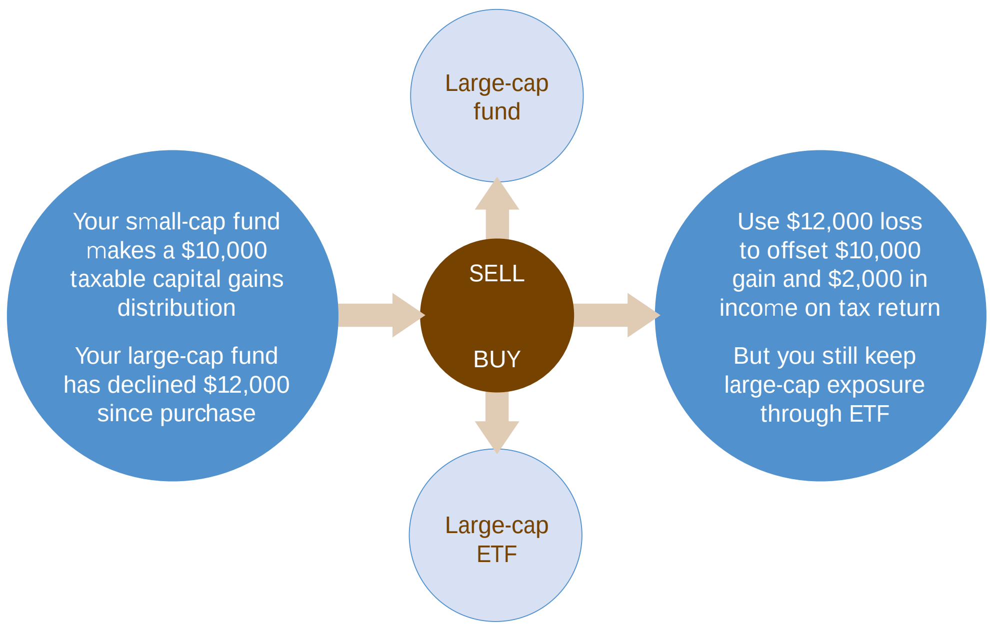
Points to ponder

- Equities could underperform cash during the transition period.
- Trading costs and possible tax consequences may offset some of the advantages.
- Cash equitization is more effective within tax-advantaged accounts.

3

Tax optimization

Besides asset location, there are other ways to maximize a portfolio's after-tax return. For example, an investor sells an investment at a loss to offset capital gains from another investment and up to $3,000 in income on that year's tax return. At the same time as the sale, the investor buys an ETF with a high correlation to the original investment. The investor simultaneously achieves three goals—harvesting losses to lower tax liabilities, remaining fully invested within the chosen investment strategy, and potentially improving the overall portfolio's future tax-efficiency by using an ETF.



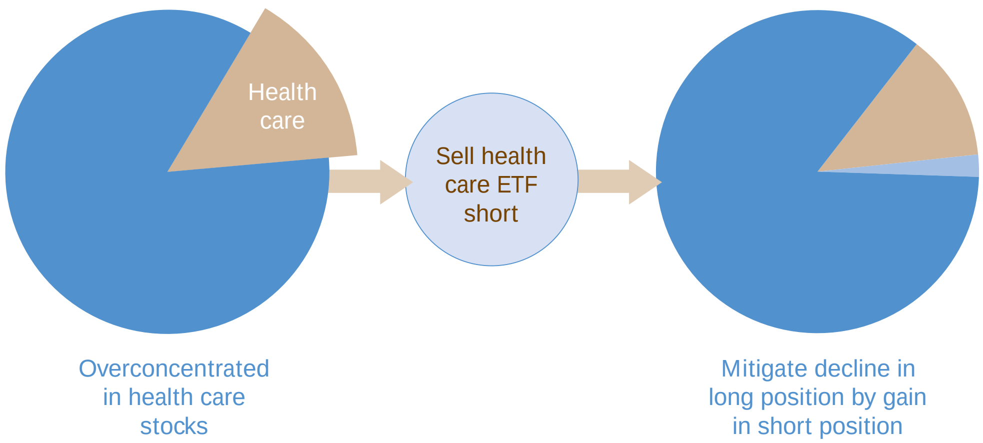
Points to ponder

- The 30-day wash sale rule defers a capital loss if you buy a substantially identical investment 30 days before or after the sale, potentially negating tax-loss harvesting. There are no firm guidelines on what is "substantially identical," so consult your tax advisor.
- Your replacement investment could underperform the original investment.
- Transaction costs may be greater than the tax benefit.

4

Risk management

Investors who have a concentrated position in a particular market sector or industry put themselves at risk if there's a severe downturn in that industry.[2] However, rebalancing may not be an option because of trading restrictions, tax consequences, or other reasons. One could try to moderate a possible downturn by short selling an ETF that's highly correlated to that industry.[3] If the long position declines, the short position might offset some of that loss.



Points to ponder

- Hedging techniques such as short selling can exacerbate your losses, especially if the long investment falls and the short position rises.
- For hedging to work, there must be high correlation between the two investments. However, high correlation in the past does not necessarily mean high correlation in the future.
- This technique is not recommended for hedging a single stock, because a single company does not necessarily have a high correlation with its industry.
- There are tax-related risks, such as "constructive sale" treatment for short against-the-box transactions. Consult your tax advisor.

2 Sector ETFs 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 ETFs that sample their target indexes to comply with tax diversification rules may experience a greater degree of tracking error than other ETF products.

3 Shorting entails selling "borrowed" securities in anticipation that the investor can later return those securities with shares bought at a lower price. The investor makes a profit from shorting if the share price drops or incurs a loss if the price rises. The loss on a short sale is potentially unlimited because there is no upward limit on the price a borrowed security could attain.

5

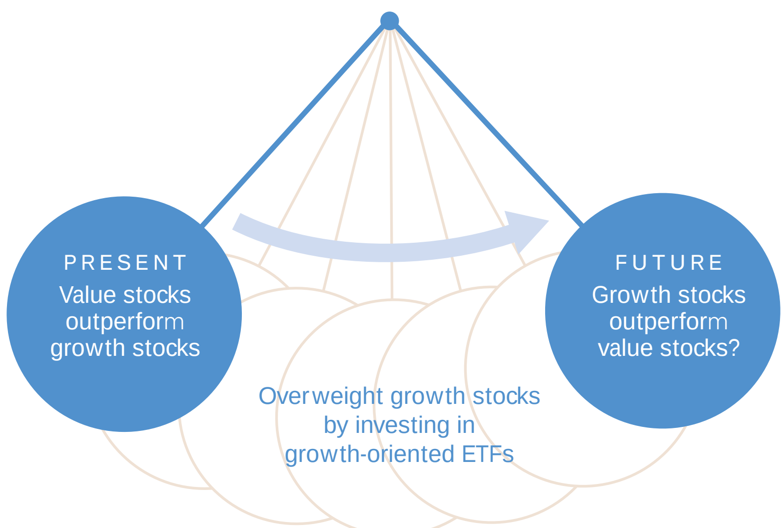
Market rotation

Most often a contrarian-approach, market rotation involves purposefully overweighting or underweighting certain market segments or industry sectors, but doing so on your assessment of current market or economic cycles rather than as a permanent tilt to one investment style or sector.

For example, an investor who believes that, after a protracted period of outperformance by value stocks, the pendulum will swing the other way, might invest in a growth-oriented ETF. Similarly, an investor who believes it's time for developed markets to start outpacing emerging markets, might wish to buy ETFs tracking developed markets.

Points to ponder

- You could end up doing worse than if you had done nothing.
- You would have to be right about the direction of the market/economic cycle, the sectors that might profit from it, and the timing of the investments, both buying and selling.
- If the investments were in taxable accounts, taxes could offset some of the gains.



Considerations across all strategic and tactical uses

Although we discussed some of the risks involved with each strategy, there are other considerations that cut across all strategies. Trading ETFs entails certain costs—brokerage commissions, bid-ask spreads, and some (though usually minor) deviation between an ETF's market price and its net asset value—that are normally not associated with mutual funds. A financial advisor should do a cost analysis to see if it's worthwhile to use ETFs.

Some of the factors to consider fall under what we call the "Six Ts":

1. Transaction amounts
2. Time period
3. Trading costs
4. Tax consequences
5. Temperament of client
6. Trade-off between risk and return

In other words, are the amounts invested large enough and the time horizon long enough to offset commissions, spreads, and possible tax consequences?

Some of the considerations are not limited to just the choice between ETFs and mutual funds, but pertain more directly to the investor's own profile and preferences. For example, what is the temperament and risk tolerance of the client? Will the client be more upset by a market downturn or by missing out on a market rally?

And because many of the strategies discussed entail taking more concentrated positions, financial advisors and clients will need to weigh the extra risk involved against the potential reward.

If they decide to go forward with ETFs after weighing these considerations, they gain access to a powerful and cost-effective tool for executing a wide variety of investment strategies.

Vanguard Financial
Advisor Services™

P.O. Box 2900
Valley Forge, PA 19482-2900

For more information about Vanguard ETF Shares, visit www.vanguard.com, call 800-997-2798, or contact your broker to obtain a prospectus. Investment objectives, risks, charges, expenses, and other important information are contained in the prospectus; read and consider it carefully before investing.

Vanguard ETFs are not redeemable with an Applicant 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 will incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.

Standard & Poor's 500 is a trademark of The McGraw-Hill Companies, Inc., and has been licensed for use by The Vanguard Group, Inc. Vanguard mutual funds are not sponsored, endorsed, sold, or promoted by Standard & Poor's, and Standard & Poor's makes no representation regarding the advisability of investing in the funds.

The information contained herein does not constitute tax advice and cannot be used by any person to avoid tax penalties that may be imposed under the Internal Revenue Code. Each person should consult an independent tax advisor about his/her individual situation before investing in any fund.

Investors cannot invest directly in an index.

Financial advisors: Visit advisors.vanguard.com or call 800-997-2798

Investment Products: Not FDIC Insured • No Bank Guarantee • May Lose Value

© 2010 The Vanguard Group, Inc.
All rights reserved.
U.S. Pat. No. 6,879,964 B2; 7,337,138.

FAETFBR 032010