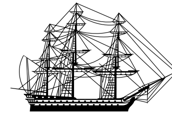


Investor brief

Indexing: The long-term view on investing

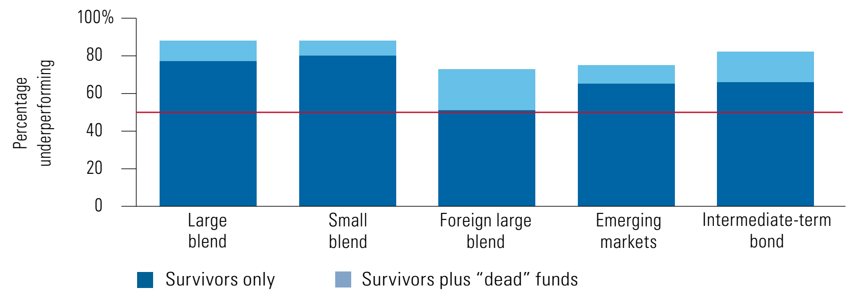
May 2015

- During the ten years through 2014, a majority of actively managed funds in several representative categories underperformed the average returns of their low-cost index fund peers.
- This is before we even considered "dead" funds, i.e., funds that were liquidated or merged out of existence. While not all dead funds were necessarily underperformers, a majority were.[1]
- When dead funds were included, the percentage that underperformed was even higher.
- Active funds can serve an important role in a portfolio, but Vanguard believes that low-cost index funds should be a part of a broadly diversified portfolio.

1 See the discussion of the impact of survivorship bias on performance results in *The case for index-fund investing* (Philips, Kinniry Jr., Walker, Schlanger, and Hirt, 2015).

Percentage of active funds underperforming the average return of low-cost index funds

Ten years ended December 31, 2014

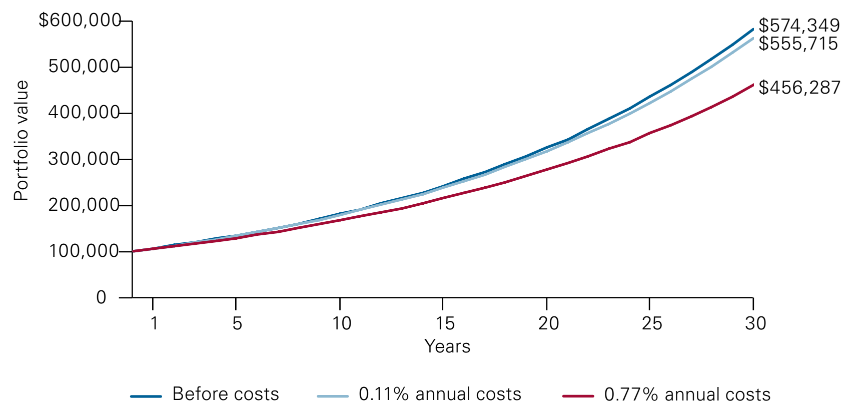


Notes: Index funds are represented by those funds with expense ratios of 20 basis points or less (1 basis point equals 1/100 of 1%) as of December 31, 2014. As shown in Figure 13 on page 16 of *The case for index-fund investing* (See footnote 1), an investor's experience in index funds is directly related to the expense ratio. As a result, we deemed a cutoff of 20 basis points as a reasonable limit for expenses. All performance numbers cover the ten years ended December 31, 2014, and include both surviving and "dead" (i.e., funds that were merged or liquidated) funds. For this analysis we were limited in our evaluations by the existence of both index and active funds in each market. As a result, we focused on large-cap blend stocks, small-cap blend stocks, foreign developed markets stocks, emerging markets stocks, and U.S. diversified bonds. Please note that other time periods applied to this study; for information on the results for the 1-, 3-, 5-, and 15-year periods ended December 31, 2014, see Figure 12 on page 15 of *The case for index-fund investing*.

Sources: Vanguard and Morningstar, Inc. Data as of December 31, 2014.

- One advantage of indexing can be lower costs. Active managers have a higher cost hurdle to overcome, year in and year out, to outperform comparable lower-cost index funds.
- The chart to the right shows the long-term impact of operating costs on a hypothetical portfolio based on an average expense ratio of 0.11% for large-cap U.S. equity index funds and 0.77% for actively managed large-cap U.S. equity funds.
- Index investments provide several additional benefits: greater control of risk exposure, diversification, and style consistency.
- Finding the right mix of active and low-cost index funds for your portfolio can make a big difference to reaching your long-term investment goals.
- Speak with your financial advisor about how indexing can be incorporated in your investment plan.

The impact of costs on portfolio balances



Notes: The portfolio balances shown are hypothetical and do not reflect any particular investment. The illustration assumes a starting balance of $100,000 and a yearly return of 6%, which is reinvested for 30 years. Before costs, the balance grows to $574,349. If a 0.77% annual charge is added—the average asset-weighted expense ratio for actively managed U.S. large-cap stock funds as of December 31, 2014, according to Morningstar—the end result drops to $456,287. But if the investor keeps annual costs to an average of 0.11%—the average asset-weighted expense ratio for U.S. large-cap stock index funds—he or she could have had over $99,000 more than the higher-cost portfolio at the end of the period. The final account balances do not reflect any taxes or penalties that might be due upon distribution.

Sources: Vanguard and Morningstar, Inc.

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For more information on Vanguard funds, contact your financial advisor to obtain a prospectus. Investment objectives, risks, charges, expenses, and other important information about a fund are contained in the prospectus; read and consider it carefully before investing.

All investing is subject to risk, including possible loss of principal. Investments in stocks issued by non-U.S. companies are subject to risks including country/regional risk and currency risk. These risks are especially high in emerging markets. Bond funds are subject to interest rate, credit, and inflation risk. Diversification does not ensure a profit or protect against a loss.

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