

Managed Funds

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Introduction to managed funds

The first Australian managed fund was introduced in 1936. Since then managed funds have become a popular form of investment, with millions of Australian now investing more than \$1.2 trillion. So why are managed funds so popular, and more importantly, how do they work?

Managed funds provide a cost-effective way for investors, large and small, to access a diversified mix of investments in a professionally managed package. Because your money is pooled with other investors you can invest in assets which might be too difficult or expensive to invest in directly yourself.

This Plain Talk® guide introduces the concept of managed funds; describing the types of funds available, how they are managed and their benefits and costs. It aims to improve your knowledge and understanding of managed funds and help you make more informed investment choices.



What is a managed fund and how does it work?

A managed fund pools together people's money to invest in a range of investments.

Typically, a professional fund manager makes investments on behalf of investors in line with the fund's stated investment strategy and objectives. Instead of owning the investments yourself, like when you buy shares directly, the managed fund owns the underlying investments on your behalf.

Most managed funds are divided into units – so when you invest in a managed fund you are usually purchasing units in that fund. The number of units you are allocated will depend on how much money you have invested and represents your share of the fund.

While the number of units you own doesn't change, their value will change in line with the market value of the underlying investments. This is measured by the unit price.

There are many different kinds of managed funds offering a range of investment objectives and strategies. Managed funds generally have a Product Disclosure Statement (PDS), which clearly states the investment objective, benefits and costs of the fund.

The PDS also details the types of investments the fund will hold, how the investments will be managed and the types of risk investors can expect.

Why invest in managed funds?

Professional management

Professional fund managers take care of managing your money on your behalf. This means you don't have to worry about trying to time markets and choosing which companies or securities to invest in.

Fund managers are experts in their field of investment, combining economic, market and corporate knowledge to analyse the sectors and companies they invest in. They also make sure your money is invested in accordance with the fund's objectives, investment strategy and risk parameters.

Diversification

As your money is pooled with other investors, you can access a much wider range of investments than you can by investing directly yourself. As managed fund investors enjoy a greater level of diversification than direct investors, they are less exposed to the performance fluctuations of individual shares or securities. An Australian equity fund, for example, might hold 100 or more shares in its portfolio. It would be very costly and time-consuming to build this level of diversification as an individual investor.

Access global investment opportunities

As an individual investor it is difficult to build up a portfolio of international investments directly. Investing internationally can increase your diversification further and give access to industries and companies not available in Australia. After all, Australia represents less than three per cent of the total world sharemarket.

Long-term growth potential

Managed funds provide the opportunity to grow your money over the long term. Compounding returns over time can make a big difference to the growth of your investment.

While more volatile over the shorter term, growth assets, like shares and property, can help protect the purchasing power of your money and offer greater growth potential over the longer term. Don't forget

Smart investing tip 1 – invest often

Timing the markets for the best time to invest is easier said than done, which is why many investors use a dollar cost averaging strategy. With this strategy, you invest a set amount into a managed fund on a regular basis, regardless of the unit price, to average out market fluctuations over time. One of the easiest ways to implement this strategy is to start a regular investment plan with a managed fund.

that past performance is no guarantee of future performance, and that returns can go up as well as down.

Regular income

Managed funds can provide a regular source of income. Some funds offer monthly, quarterly or six-monthly income distributions to investors. Investors can choose to take distributions in cash payments or reinvest them back into the fund. Reinvesting your income distributions can compound your returns giving you potential for higher growth.

You don't need much money to get started

You can access a managed fund with a few thousand dollars, or less. There are managed funds available for personal investors, higher net worth individuals, self managed super funds, companies and major institutions.

Flexibility

Most fund managers offer a switching service so you can change funds quickly and easily if your investment needs or circumstances change. You should check the PDS for information about switching, including any costs involved.

It's simple

Investing in managed funds is easy. Once you've decided which fund suits your investment style, objectives and risk profile, the fund manager does the rest.

Types of managed funds

Managed funds offer a wide choice of investment options. For example, you can choose from single sector funds like Australian share and international share funds, or diversified or multi-sector funds that include a mix of sectors like shares, fixed interest and property. The mix of assets in a diversified fund reflects the risk profile of the fund – usually described as conservative, balanced or growth.

Investments are divided into growth or income assets. Shares and property are growth assets that primarily provide returns in the form of capital growth. Over the longer term these assets can provide a good hedge against inflation.

Bonds and cash are income assets that primarily provide returns in the form of income. Income assets tend to provide more stable, albeit lower returns.

The right type of investment for you will depend on your investment objectives, timeframe and tolerance for risk. The following are the most common types of managed funds.*

Single sector managed funds

Cash

- for short-term investors;
- usually includes higher interest paying securities than bank accounts or term deposits; and
- lowest risk of all asset classes.

Fixed interest

- for short to medium-term investors (around three to five years);
- low to medium risk;

* This is general financial product advice only. We have not taken your circumstances into account when preparing this publication so the above information may not suit your needs. You should consider your circumstances and consult your financial adviser before making any investment decision.

- can provide a steady and reliable income stream and potential for capital growth;
- usually offer a higher interest rate, or yield, than cash; and
- access Commonwealth Government, state governments, semi-government authorities and company debt from Australia or overseas.

Property securities

- for medium to long-term investors (five years plus);
- lower risk growth asset than shares;
- returns include income and capital growth;
- diversification benefits with access to properties in retail, office, industrial, tourism and infrastructure sectors; and
- you can invest in both Australian and international property security funds.

Australian shares

- for long-term investors (seven years plus)
- potential for higher returns with higher risk;
- potential for income through payment of dividends and tax benefits in the form of dividend imputation; and
- access a diversified range of companies listed on the Australian Stock Exchange

International shares

- for long-term investors (seven years plus);
- potential for higher returns with higher risk;
- access industries and investment opportunities not available in Australia; and
- diversification benefits when investing in a range of countries, industries and companies.

Diversified or multi-sector managed funds

- available in a mix of investment profiles from conservative to more aggressive;
- investment timeframe depends on type of fund chosen;
- invests in more than one asset sector;
- diversified approach can lower risk; and
- professional fund manager decides the asset allocation (i.e. how much to invest in each asset sector) of the fund according to the fund's investment objectives and prevailing market conditions.

Choosing a managed fund

When choosing a managed fund there a number of factors to take into account. These include your attitude to risk and return, your investment objectives, your time horizon and personal circumstances. Costs, tax and investment styles are also important considerations.

Risk and return

Risk and return are inextricably linked. Usually the higher the risk, the higher the expected return.

How are returns generated?

The overall performance of a managed fund simply reflects how the underlying assets are performing. The market prices of these assets can go up and down daily.

Returns generally come in the form of income and growth. Income can include earnings from share dividends, rent from property and interest from fixed interest and cash type investments. It can also come from capital gains when profits are realised upon the sale of an underlying asset in the fund. Fund income distributions are generally made at regular intervals. Investors can choose to take their income payments in cash or reinvest them back into the fund.

Growth comes from any increase in the value of the portfolio's assets and is reflected in the fund's unit price. It is only realised when you sell your units in the fund.

As performance can be volatile in the short term it is best to take a longer-term perspective (five years plus) when assessing managed fund performance. It is also important to remember that past fund performance is no guarantee of future performance.

About risk

No risk can be a risk in itself

Rising prices due to inflation can erode the real value, or purchasing

Smart investing tip 2 – invest long term

People often get caught up with short-term stock selection, which can deliver inconsistent results. While one investment might deliver great returns one year, it is difficult to pick winners every year. When it comes to investing, it generally pays to invest for the long term.

Smart investing tip 3 – diversify

One of the most important investment decisions you can make is how you divide your money between each asset class, referred to as asset allocation. Diversifying across a range of asset sectors, industries and securities reduces market risk and can improve your performance potential. In multi-sector managed funds the fund manager does this for you.

power of your investments. In some cases, the real value of your money may actually fall over time.

Market risk

This is the risk that share, property, fixed interest or cash markets will decline in value. The sharemarket is influenced by a number of factors, including the underlying strength of the economy, political factors, industry trends and investor sentiment. On the other hand, fixed interest and cash markets are influenced by expectations for interest rates and inflation.

Currency risk

International investments are subject to fluctuations in the value of the Australian dollar against other currencies. Currency movements can seriously impact the return on your investments, when you convert your returns into local dollars.

For example, when the \$A appreciates dramatically against the \$US and the profits are repatriated to Australia, they then convert into fewer \$As than they would have if the \$A had been weaker. The converse also applies. Some funds use hedging to reduce the impact of currency fluctuations.

Economic and political risk

Economic and political factors play an important role in the performance of investment markets. Economic factors include economic growth, inflation, employment, interest rates and business sentiment. Changes in government, political uncertainty and international conflicts can also impact markets.

Credit risk

Funds that invest in fixed interest and debt securities are subject to credit risk. This is the possibility that an issuer will fail to repay interest and principal in a timely manner (also known as default risk). By holding a diversified portfolio of high quality securities this risk can be reduced.

Manager risk

Manager risk is where a managed fund underperforms its benchmark or market index due to poor investment selection. Active fund managers will try to pick stocks they believe will outperform the market based on

their philosophy and research. Sometimes this works in their favour and sometimes it doesn't. Some active funds rely on individual fund managers for their performance and can be subject to key person risk if that manager decides to leave.

How much risk can you tolerate?

Your attitude to risk is one of the most important factors when considering a managed fund. While growth assets, like shares and property securities, tend to have more volatile returns over the shorter-term – meaning they are likely to produce negative returns more often than income type investments – they have the potential to produce higher returns over longer-term timeframes.

The Australian Securities and Investments Commission suggests investors can expect a negative return once in every four years for shares, six years for property and eight years for fixed interest.

Generally, the longer your investment timeframe and risk tolerance level the higher the level of growth assets you can include in your portfolio. As the graph opposite shows, over time, the ups and downs of investment markets tend to even out and the gap between the highest and lowest returns closes. This is why it is important to consider your investment timeframe when choosing a managed fund.

Controlling risk

Spreading your money across a range of investments is one of the best ways to reduce your exposure to market risk. This way you are not relying on the returns of a single investment. Investment markets move up and down at different times. With a diversified portfolio of investments, returns from better performing investments can help offset those that underperform. You can achieve diversification through a managed fund in a number of ways:

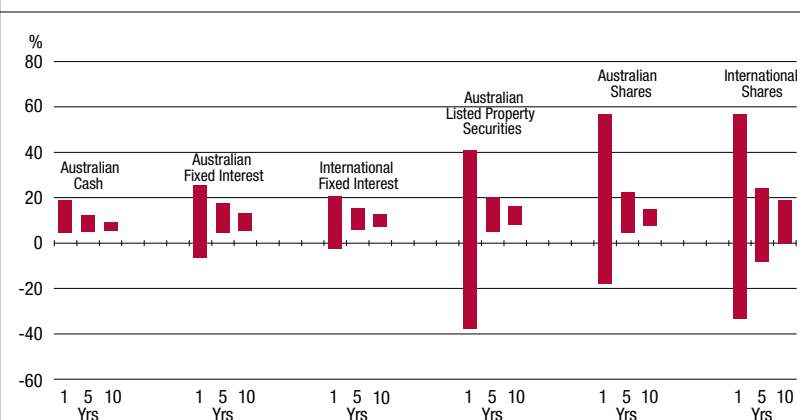
- invest in a fund that has exposure to different asset sectors, such as shares, fixed interest and property;
- invest in a fund that holds a spread of investments within an asset sector, such as different countries, industries and companies; and

Smart investing tip 4 – costs matter

Costs can take a large chunk out of your investment return. So, it's important to compare fund fees before you invest. Look at things like contribution fees, adviser commissions and management fees as these can all add up over time. Not all managed funds charge these fees, so make sure you examine the fine print and know exactly what you are paying for and how much.

Risk of major asset sectors

Range of returns over 1, 5 and 10 year periods (1 January 1988 - 30 June 2008)



The graph does not reflect an investment in any of the Vanguard Funds. Past performance is not an indication of future performance.

Source: Vanguard using the following index data: Vanguard Cash Plus Index, UBS Australian Composite Bond Index, Citigroup World Government Bond Index Hedged in \$A, S&P/ASX300 A-REIT Index, S&P/ASX300 Accumulation Index, MSCI World ex Australia Total Return Index in \$A (net divs)

- invest in a number of managed funds managed by different fund managers. For example, blending active funds with index funds – this is covered in the ‘types of fund managers’ section.

The lowdown on fees

Like any other investment, there are fees involved when investing in a managed fund. The types of fees charged will vary from fund to fund and depend on the type of investment chosen. All managed fund fees must be disclosed in the fund’s PDS.

The managed funds industry is regulated by the Australian Securities and Investments Commission (ASIC). Under the Corporations Act, all managed funds must disclose their fees and charges in a standardised format. Where possible, fund managers must give investors examples of the fees charged in dollar terms. This helps investors compare the fees across different funds.

Types of fees

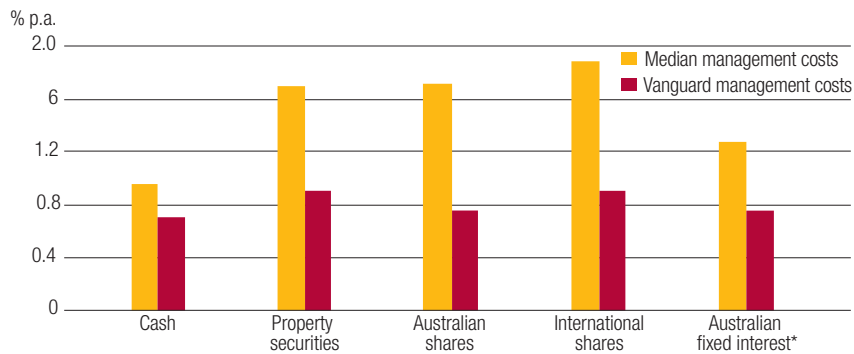
The types of fees you may pay when investing in managed funds are outlined below. Not all funds charge all of these fees, so check the PDS for information on fees before you invest. For example, Vanguard doesn’t charge entry or exit fees, contribution or switching fees (apart from the usual buy-sell spreads that apply to all transactions) and does not pay commissions to advisers.

Type of fee	What is it?
Entry or establishment fees	A fee for opening your account – can be up to five per cent of your initial investment.
Contribution fee	For initial and subsequent investments you make.
Withdrawal fee	A fee for withdrawals you make from the fund.
Exit or termination fees	A fee for closing your account. Sometimes this fee applies if you close your account within a specific timeframe.
Ongoing fees	Charged by all funds, this fee covers investment management, the administration costs of running a fund, such as accounting, legal and audit fees, fund documentation and investment costs. It excludes transaction costs covered in the buy/sell spread.
Switching fee	A fee for switching between funds or investment options
Adviser service fee or trailing commission	A fee charged by your adviser for advice about your investments in the fund. An adviser may also receive other amounts as commission.
Buy/sell spread	While not officially a fee, the buy/sell spread is the difference between the buy and sell unit prices of the fund. It reflects the transaction costs a fund incurs when buying and selling assets to invest application monies and to meet withdrawals. These can include brokerage, custody costs, government taxes and bank charges. The purpose of the buy/sell spread is to protect investors in the fund when other investors move money in and out of the fund.
Master trusts and platforms	You can buy managed funds directly from some fund managers, like Vanguard for example, but often investors access them through an adviser using a master trust or wrap account platform. These administrative platforms incur extra fees, which must be disclosed in the disclosure documents for the master trust or platform.

Higher fees can eat into investment returns

Lower costs can translate into better performance for investors over the long term. One of the major advantages of using an index fund is the lower costs. In fact, Vanguard’s retail fund costs are around half the industry median.

Comparison of Retail Management Fees



Source : Morningstar subscription data as at 31.10.08

Note: High yield Australian Shares Fund has an MER of 0.9 per cent. Sourced from Morningstar subscription data. The chart shows the median MER of funds in Morningstars retail managed investment category for each type of fund.

* Red bar refers to Vanguard's diversified bond fund.

Fees can accumulate over time and impact your final investment results. The table below shows how managed cost differences between funds can affect your total return over time. This example assumes an average return for the periods stated for a \$20,000 investment. Fund A has a higher management cost than Fund B.

No of years invested as at 30 June 2008	S&P/ASX 300 Accum. Index return % p.a. to 30 June 2008	Fund A Investment value with managed costs of 1.95%	Fund B Investment value with managed costs of 0.75%	Difference
5	16.2%	\$38,501	\$40,885	\$2,384
10	11.2%	\$47,495	\$53,558	\$6,063
15	11.9%	\$80,378	\$96,250	\$15,872
20	10.7%	\$103,613	\$131,753	\$28,141

Source: Vanguard using market data on an initial investment of \$20,000 with the MER paid monthly.

This is an example only, for illustrative purposes. It assumes both funds generate returns equal to the index returns before fees and taxes. It does not imply these returns are available on any particular investment. The fees do not relate to any particular funds.

Tax: the hidden cost*

Distributions paid to you from a managed fund throughout the year are assessed as part of your taxable income just like other income you receive, such as rent, wages and bank interest. Some asset sectors, like shares, provide tax concessions through dividend imputation. Because companies listed on the Australian Stock Exchange have already paid tax on the profits they distribute, investors receive a franking credit for the amount of tax the company has paid.

Investors can use franking credits as an offset against their income tax liability. For example, a person on the top marginal tax rate who receives a fully franked dividend would receive a tax credit of 15 per cent on their distribution. This represents the difference between the highest marginal tax rate of 45 per cent and the company tax rate of 30 per cent as at 1 July 2008. For investors on a marginal tax rate of 30 per cent, their distribution would be free of further tax.

Like direct share investors, unitholders in managed funds may also have to pay capital gains tax. Capital gains are generally only taxable once realised, that is, when the asset is sold for a profit. For investments held for more than a year, certain discounts may apply to the amount of the capital gain that is taxable, for example for an individual investor only half of the capital gain will be taxable, while for a super-annuation fund investor, only two thirds of the capital gain will be taxable. For short-term capital gains (on assets held for less than 12 months), the entire capital gain will be taxable. Similarly, if you redeem some or all of your units in a managed fund and you have made a profit – you may have to pay capital gains tax on that profit, and the discounts as described above may also apply.

Some investment styles are more tax-effective than others

How tax efficient are managed funds? The main factors impacting the tax efficiency of a managed fund are; the fund manager's investment process (turnover levels provide a good indication of tax effectiveness),

Smart investing tip 5 – less tax can mean higher returns
What's left in your pocket after tax is what really counts. Actively managed funds usually trade more often, which means they may generate more capital gains tax liabilities that can reduce returns. Index funds trade less, so they realise capital gains less often.

* Vanguard does not give or purport to give tax advice. You should seek professional advice relating to your own particular circumstances as taxation laws are very complex and subject to constant and rapid change.

the type of fund (imputation, small cap, sectorial bias etc) and the tax structure of the fund (super vs non-super).

As most fund managers publish their returns on a before-tax basis, turnover can often be overlooked when selecting fund managers. Turnover of a fund manager's assets reflects the level of trading activity within a fund and is usually much higher in active funds. Some fund managers can turnover their portfolios by 100 per cent or more in a year.

Fund managers that regularly turnover their investment portfolios will attract much higher realised capital gains than those that use a 'buy-and-hold' approach, like Vanguard. For example, Vanguard's Australian Share Index Fund has a turnover level of less than 5 per cent.

A fund manager's investment approach can make a big difference to the amount of tax you pay on your investment earnings and the amount of investment return you get to keep.

Investment styles

A management style is a framework that guides the way fund managers evaluate and select the investments they make. It is like a set of principles based on the fund manager's beliefs about investment markets.

When choosing a fund manager, it is important that you feel comfortable with their investment style. As different investment styles perform better at different times, some investors choose a number of different fund managers to manage their investments. This gives them a more diversified pool of assets.

Active and index fund managers

Index managers aim to match the performance of a market index by investing in all or a representative sample of the securities in the index.

A benchmark index measures the performance of a basket of securities. For example, the S&P/ASX 300 Index measures the performance of about 300 companies listed on the Australian Stock Exchange. Index funds invest in all or most of the securities in the index providing diversification, which means lower risk.

Active fund managers will usually try to outperform the market index by choosing a selection of stocks they believe will outperform the benchmark index. Active fund managers will hold a much smaller portfolio of stocks than index managers and they tend to charge higher fees as they have higher costs in the form of research analysts as well as transaction costs from trading securities much more often.

There are several different active investment styles but the three most common are 'growth', 'value' and 'style-neutral' (also known as core). For example, growth managers favour companies that have a solid earnings growth outlook. Value managers will look for market inefficiencies in the market and seek stocks they believe are undervalued in the market.

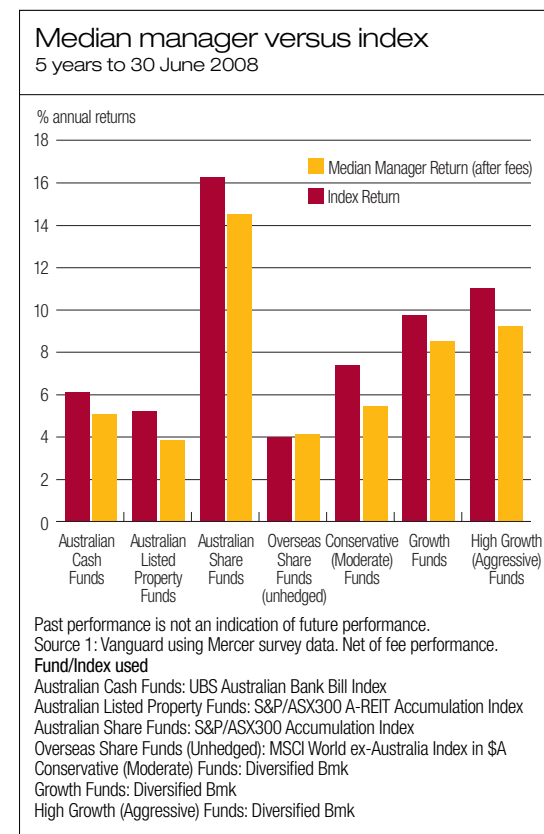
Long-term performance history

Indexing has a proven long-term performance history in all the major asset classes. Historically, few active managers have been able to sustain above benchmark returns after costs over the long term.

The graph below compares the median return for managers in the Mercer Retail Investment Surveys against the relevant index in each asset class over the last five years.

Low costs

Indexing's 'buy and hold' approach can significantly reduce the



cost of investing over time. This combined with low management costs means you can keep more of the returns you earn.

Tax-effective

Tax can potentially take the largest chunk out of your investment return so it pays to focus on your real return, after-tax. Because of its long-term nature, indexing benefits from capital gains discounts and the deferral of capital gains liabilities, which can improve after-tax returns.

Diversification

Index funds invest in all or most of the securities in an index, so they provide diversification. Diversifying across a range of asset sectors, industries and securities reduces market risk and can improve your performance potential.

Simplicity

It is very difficult to continually pick winners and outperform the market over the long term. Index funds take the guesswork out of investing by providing a low cost way to gain exposure to investment markets.

The indexing pioneers

Vanguard pioneered the concept of indexing, introducing the first retail fund in the US in 1976. Vanguard has since become one of the world's most experienced and successful indexing specialists. In fact, the Vanguard Group manages more than US\$1 trillion worldwide (as at November 2008).

In Australia, we've been helping professional and personal investors invest through our unique style of indexing for more than ten years.

Vanguard® index funds

Personal and professional investors can benefit from Vanguard's high quality, low-cost investment solutions.

Vanguard's indexing approach is a proven long-term strategy for wealth, super and self managed super fund investors alike. Our funds are available directly or on a wide range of platforms through financial advisers, and include:

- Vanguard's **Investor** Index Funds are suitable for individuals, joint investors, SMSF investors, businesses and trusts.
- Vanguard's Personal **Superannuation** Plan is a flexible super plan you can use throughout your working life.
- Vanguard's Personal **Pension** Plan offers a flexible account-based pension for retirees seeking a tax-effective income stream.

With Vanguard's low fees, around half the industry average of retail managed funds, you can be assured your investments are off to a head start. Scaled management costs apply to balances over \$50,000 so the more you invest the less you pay. And there are no upfront fees. Investors with larger sums to invest can access our range of index funds at wholesale rates.

Like some more Plain Talk®?

At Vanguard, we believe it is just as important to know about the potential risks of your investments as well as the rewards. That's why we publish our Plain Talk guides on a range of popular investment topics. After all, better informed investors make better investment decisions.

Our Plain Talk range includes:

- Understanding indexing;
- Realistic sharemarket expectations;
- Building your investment portfolio;
- Investing for income;
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- Managed funds.

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Note

All currency is in Australian dollars unless otherwise stated. Unless otherwise stated data sources are Vanguard, using market data. Performance data is as at 30 June 2008. To view current performance data, visit our website www.vanguard.com.au

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