Vanguard®

Understanding indexing

Plain Talk® Library

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Introducing indexing

Investment funds can be managed in one of two ways—active or passive. Active managers aim to beat the return of a market index or benchmark, while index or passive managers aim to closely match market returns.

Since Vanguard first introduced index fund management in the United States in the 1970s, indexing has become a popular investment strategy.

In Australia, a total of $377 billion is now invested in index funds—that's 16 per cent of the total investment management market.[1]

This Plain Talk® guide explains how indexing works and how you can put it to work in your investment portfolio.

What is an index?

An index is a group of securities representing all or part of a broad investment market. Most investment markets have an index that measures their value over time. There is an index for almost every industry sector and asset class, including Australian and international shares, property and bonds. Indices are constructed by companies like Barclays, FTSE, Bloomberg and S&P/ASX.

What is indexing?

Indexing is a way of gaining exposure to an investment market by tracking the performance of an index. Index fund managers buy securities in the same weight that the index holds them. They aim to match an index's return by investing in all or a representative sample of the index. For this reason, indexing can also be called a passive approach to investing. This contrasts with active fund managers who try to beat the index by predicting which investments will perform well in the future.

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1 Source: *Rainmaker Roundup* as at 30 June 2017.

The benefits of indexing

It can be difficult to continually pick winners over the long term. So instead of trying to beat the market, indexing provides a low-cost way to track market returns.

Indexing offers investors two distinct advantages:

1. Investing in all or a representation of stocks in a market index can diversify your portfolio and reduce risk.
2. Buying and holding securities over the long term may reduce volatility, lower costs and taxes, and improve long-term returns.

Diversification

It can be argued, that if you only hold a single stock in your investment basket, you're leaving your portfolio exposed to the risk that particular company's share price will underperform.

So, the more stocks you add to your investment basket, the more you're mitigating your exposure to that risk.

Index funds invest in all or a representative basket of the securities in an index like the S&P/ASX 300. So when you invest in an index fund you are effectively buying the entire market, or a representative sample, and reducing your risk by leaving your portfolio less exposed to the ups and downs of single investments.

There are index funds covering most of the major asset classes, including shares, bonds and property. So by investing in a range of index funds, you can diversify your portfolio across different industries and securities, both in Australia and overseas.

As you can see from the chart on the next page, the returns from different types of investment can vary dramatically from year to year. This year's top asset class can quickly become next year's worst performer.

For example, in 2006 Australian listed property was the star performer, delivering a return to investors of 24.7 per cent over the year. The following year it finished at the bottom of the chart, with a return of 2.3 per cent, comfortably less than cash.

With a broad range of assets in your portfolio, returns from better performing assets can help compensate those not performing so well.

The power of diversification

Financial year total returns for the major asset classes for financial years ending between 1995 and 2015.

Source: Andex Charts Pty Ltd June 2017.
Notes: 1. MSCI World ex–Australia Net Total Return Index (Local Currency) – represents a continuously hedged portfolio without any impact from foreign exchange fluctuations. 2. Index prior to 30 June 2008 is the Citigroup World Government Bond Index AUD hedged, from 30 June 2008 the index is the Bloomberg Barclays Global Treasury Index $A hedged. 3. Prior to 1 May 2013, index is the UBS Global Real Estate Investors Index ex Australia with net dividends reinvested.
Past performance is not an indicator of future performance.

Low costs

Index funds usually have lower costs than actively managed funds.

1. **Lower transaction costs.** Index funds use a buy-and-hold approach, which means their fund managers generally trade securities less frequently than their active counterparts. This reduces brokerage, commission and other trading expenses.

2. **Lower management fees.** By tracking the performance of an index, index funds essentially rely on a repeatable investment process allowing for cost efficiencies, as they don't have to employ highly paid research teams to analyse and choose securities.

Potential tax efficiency

Every time you sell a stock, you're incurring a potential capital gain. Simply, capital gains is a tax incurred by the investor as a result of selling securities. As a rule, index fund managers have lower stock turnover, which helps minimise capital gains.

In contrast, actively managed funds typically trade more often than index funds so they tend to create more capital gains tax liabilities.

The higher your usual marginal tax rate, the more you stand to benefit from indexing's tax efficiency.

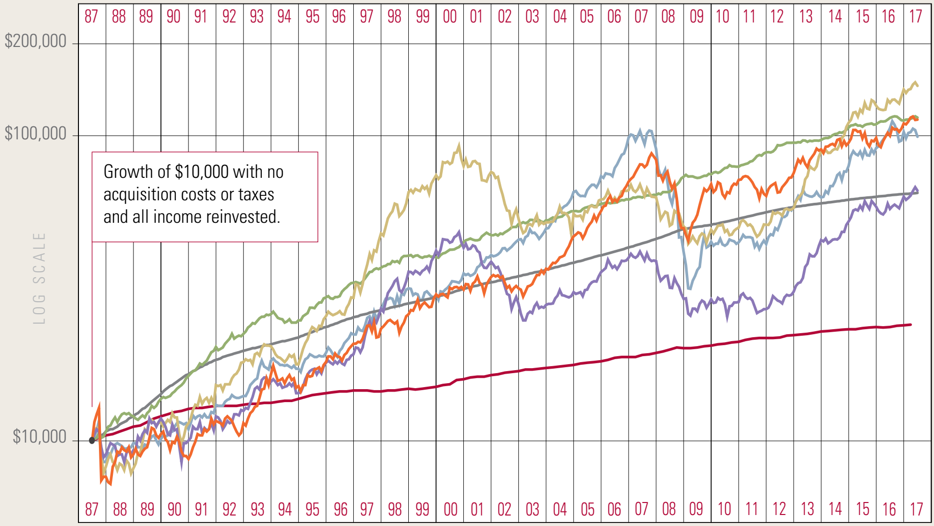
Long-term performance

Indexing's buy-and-hold approach is a low-cost way to tap into the long-term returns generated by investment markets.

As you can see in Vanguard's 2017 Index Chart to the right, history tells us that despite bumps along the way, investors who have the patience and discipline to stay the course are well rewarded over the long term—particularly if they reinvest their returns along the way to take advantage of compound interest, where they earn interest on their interest payments as well as on the principal amount they originally invested.

The value of long-term investing

Financial year total returns for the major asset classes for financial years ending between 1987 and 2017.



Percentage returns (% p.a.) as at 30 June 2017[1]

	1 Year	5 Years	10 Years	20 Years	30 Years
Australian Shares[2]	13.1	11.6	3.5	8.1	8.4
International Shares[3]	14.7	18.2	5.1	5.3	6.5
US Shares[4]	13.8	21.3	8.2	7.0	9.4
Australian Bonds[5]	0.2	4.3	6.2	6.2	8.5
Listed Property[6]	–6.3	14.1	0.1	7.1	8.0
Cash[7]	1.8	2.5	3.9	4.7	6.4
CPI (to March 2017)[8]	2.1	2.0	2.5	2.5	3.0

Sources: Australian Bureau of Statistics, ASX Limited, Bloomberg Finance L.P., Commonwealth Bank of Australia, Melbourne Institute of Applied Economic & Social Research, MSCI Inc., Reserve Bank of Australia, Standard & Poor's, Thompson Reuters. Notes: 1. One-year returns are total returns from 1 July 2016 to 30 June 2017. 5, 10, 20 and 30 year returns are average annual compound returns to 30 June 2017. 2. S&P/ASX All Ordinaries Accumulation Index. 3. MSCI World ex-Australia Net Total Return Index. 4. S&P500 Total Return Index. 5. Prior to December 1989 the index is the Commonwealth Bank All Series Greater Than 10 years Bond Accumulation Index. From September 1989 the index is the Bloomberg AusBond Composite 0+ Yr Index. 6. S&P/ASX 200 A-REIT Accumulation Index. 7. Data prior to March 1987 supplied by Reserve Bank of Australia. From March 1987 the index is the Bloomberg AusBond Bank Bill Index. 8. ABS Consumer Price Index (to March 2017). Disclaimer: The information contained herein is intended for informational purposes only. It is not intended as investment advice, and must not be relied upon as such. No responsibility is accepted for inaccuracies. Past performance does not guarantee future returns.

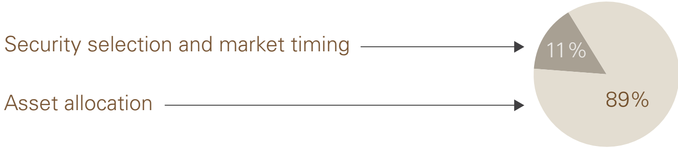
Asset allocation

Before you decide on your investment strategy, you need to work out how you allocate your money to different asset classes. It's one of the most important decisions you'll make in the whole investment process.

Vanguard research shows that effective asset allocation is the key to long-term investment performance. The chart below is from a study Vanguard conducted which looks at the returns of more than 550 fund managers over approximately 25 years. It found that asset allocation was responsible for 89 per cent of a diversified portfolio's return. This leaves only 11 per cent for factors such as market timing or securities selection.

Investment outcomes determined by asset allocation

Percentage of a portfolio's movement over time explained by:



Note: Calculations are based on the monthly returns for 580 Australian funds from January 1990 through to September 2015. For details of the methodology, see the Vanguard *The global case for strategic asset allocation and an examination of home bias (Scott et al., 2016).*
Source: Vanguard calculations using data from Morningstar.

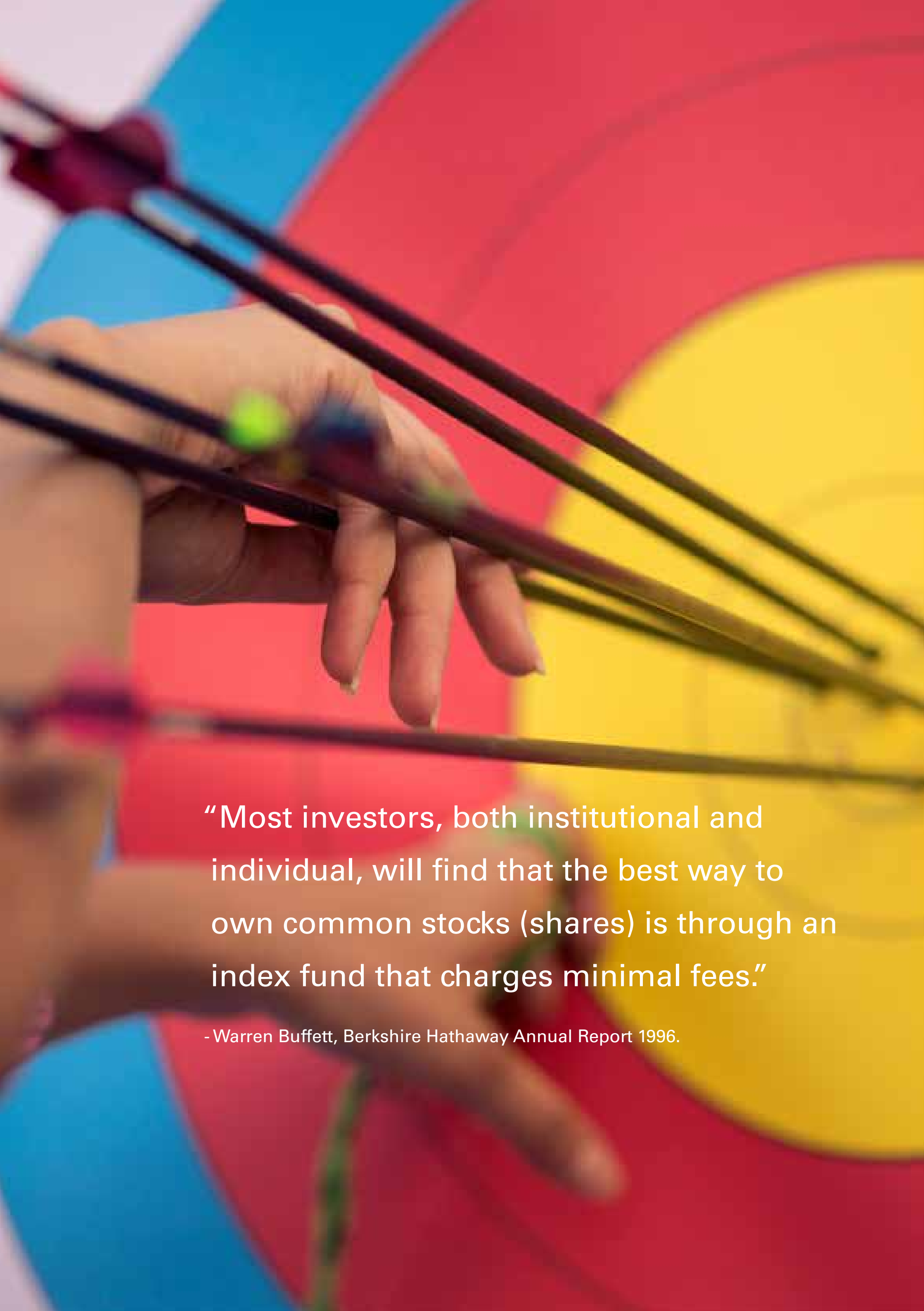
Using indexing to build your portfolio

Once you've decided on your mix of assets, you need to decide how to invest in them. This includes the option for 100 per cent of your portfolio invested in an index fund across asset classes or a core-satellite approach—a combination of both index and active funds.

Indexing's low costs make it one of the most efficient ways to invest your money across a range of assets.

A core-satellite approach

A core–satellite approach ensures you use a combination of both index funds and active funds to build your desired portfolio. As the name suggests—this approach assumes you use index funds as the main component of your portfolio (the core) in conjunction with a selection of actively managed funds (satellites). In essence, you can build on a core of diversified index funds across all the major asset classes by adding satellites in the form of actively managed funds or shares.



“Most investors, both institutional and individual, will find that the best way to own common stocks (shares) is through an index fund that charges minimal fees.”

- Warren Buffett, Berkshire Hathaway Annual Report 1996.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The Vanguard difference

When you invest with Vanguard, you have more than 40 years of investing experience behind you. So no matter which investment products suit your needs, you can feel confident that Vanguard investments are built on a rigorous investment philosophy that stands the test of time.

Since launching the first index mutual fund for individual investors in 1976, Vanguard has strived to be the world's highest-value provider of investment products and services. We have an unwavering focus on our clients with a commitment to champion what's best for investors by offering outstanding service, while keeping costs low.

Low-cost investing

We know we can't control the markets, but we can control the costs of investing. To that end, providing low-cost investments isn't a pricing strategy for us. It's how we do business.

We can keep our costs low because of our unique ownership structure in the United States, which allows us to return profits to investors through lower costs so investors can earn more over time.

Our range of managed funds and ETFs

Vanguard offers a complete range of funds across all asset classes.

To see our complete product offerings, visit vanguard.com.au.

For more information

Contact us or speak to your financial adviser.

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