Generating retirement income: Total return or income?

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Agenda

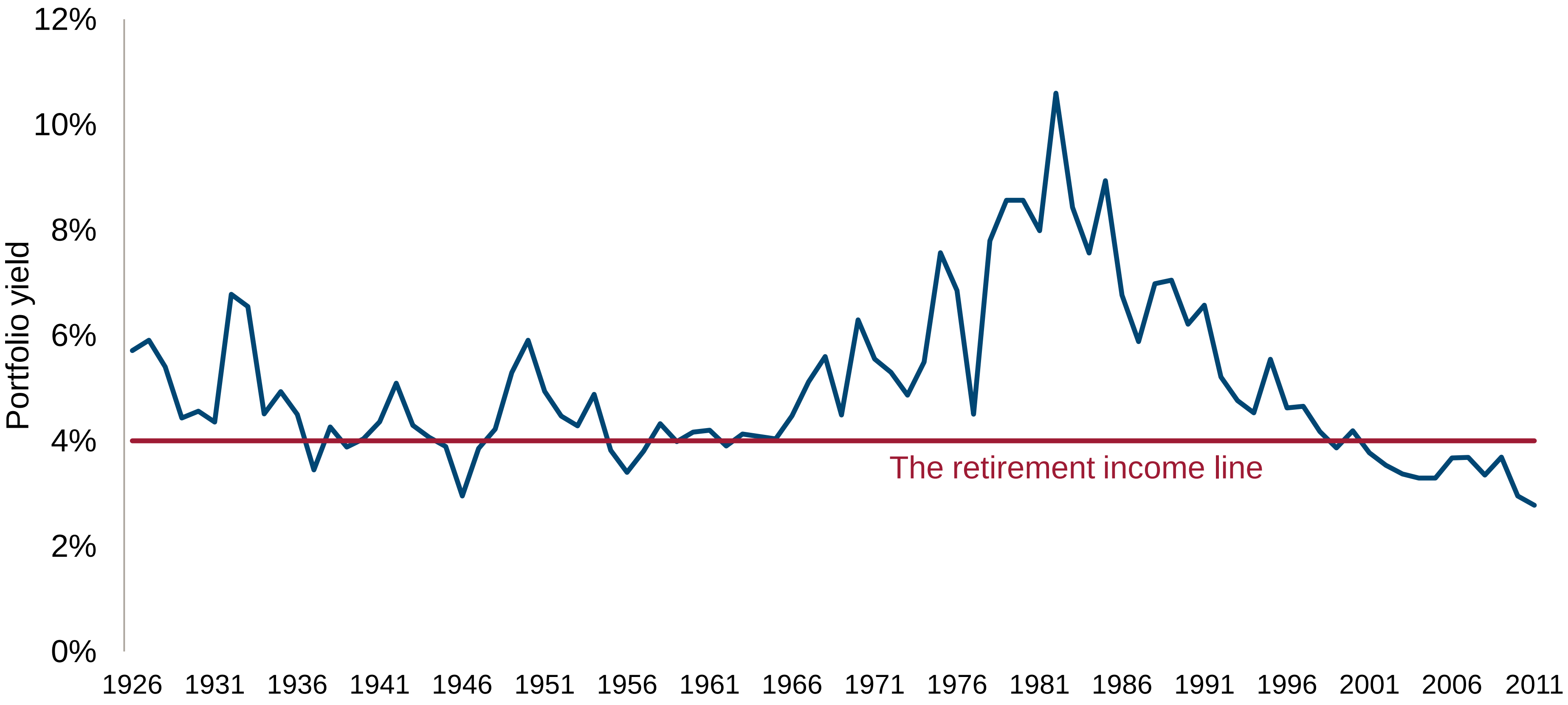
- Current yields
- Consequences
- Investor reactions

Total return is the better solution for income sustainability

How to make total return easy

Total return versus income investing

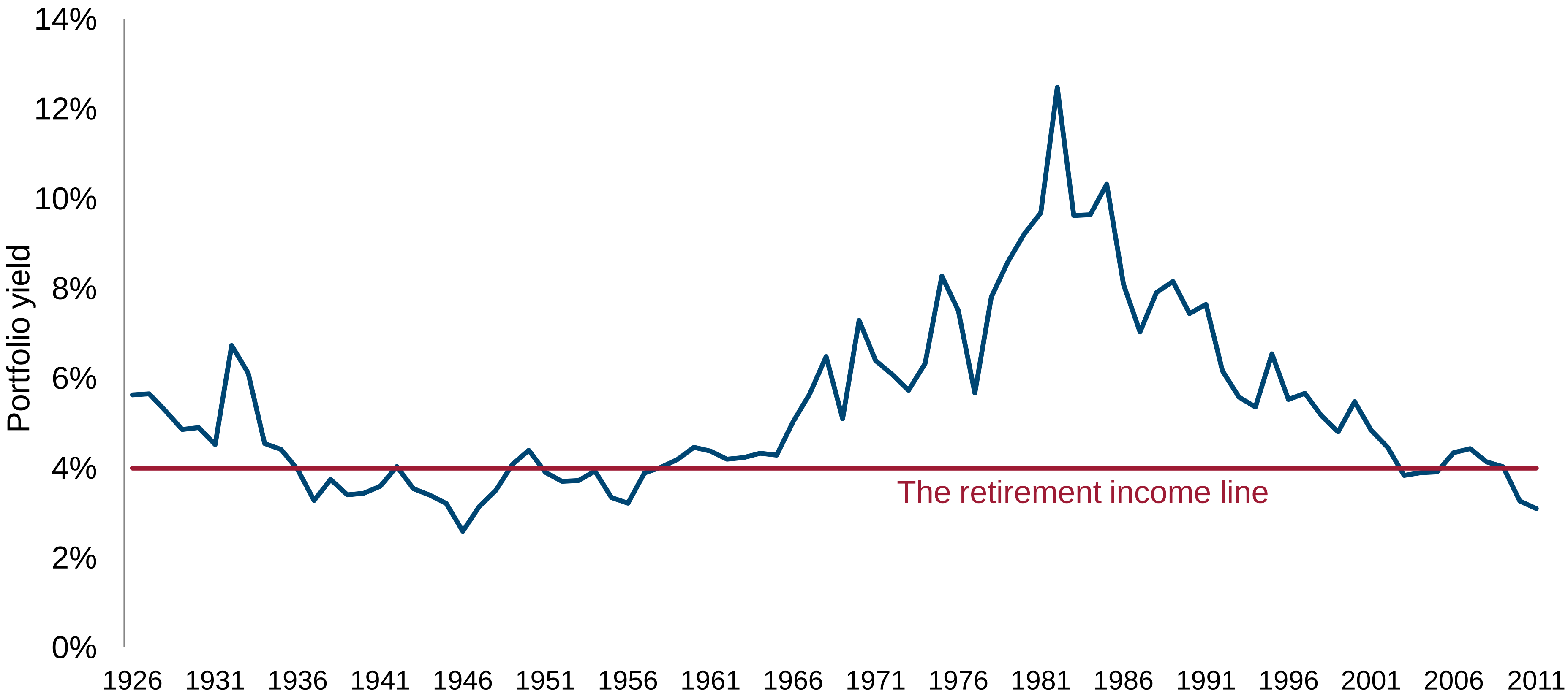
50% stock/50% bond portfolio yield



For U.S. stock market returns, we use the Standard & Poor's 90 from 1926 to March 3, 1957; the Standard & Poor's 500 Index from March 4, 1957, to 1974; the Wilshire 5000 Index from 1975 to April 22, 2005; and the MSCI US Broad Market Index thereafter.
For U.S. bond market returns, we use the Standard & Poor's High Grade Corporate Index from 1926 to 1968, the Citigroup High Grade Index from 1969 to 1972, the Lehman Brothers U.S. Long Credit AA Index from 1973 to 1975, the Barclays Capital U.S. Aggregate Bond Index from 1976 to 2009, and the Spliced Barclays Capital U.S. Aggregate Float Adjusted Index thereafter.
Note: *Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.*

Action now required to generate income

30% stock/70% bond as many investors in retirement become more conservative



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The consequences of focusing on yield

- Shift to dividend-focused equities
- Increase the credit risk of the portfolio
- Extend duration

Unexpected consequences may be:

- Less diversified portfolios
- Possibly more risk
- Decreased tax efficiency

In essence, investors are trading higher current income for a higher risk to future income

A strong attraction to dividend-centric investments

OE fund and ETF cumulative cash flows in $B, as of March 31, 2012

Ranked by 1-year cash flow	1 year	3 years	5 years	10 years
Total U.S. equity (nonsector)	**–79.7**	**–118.7**	**–200.4**	**85.3**
Equity income*	***33.5***	***45.7***	***50.5***	***72.9***
Large blend	3.9	0.1	51.2	117.2
Mid-cap value	0.2	3.8	–10.6	49.4
Small value	–3.1	3.9	1.3	15.9
Large value	–4.6	–16.7	–61.8	72.4
Mid-cap blend	–5.8	7.3	–1.5	46.4
Small growth	–6.7	–3.0	–10.6	–8.5
Small blend	–9.0	–0.3	–5.4	38.8
Mid-cap growth	–16.4	–16.6	–29.0	–31.9
Large growth	**–38.1**	**–97.1**	**–134.1**	**–214.3**

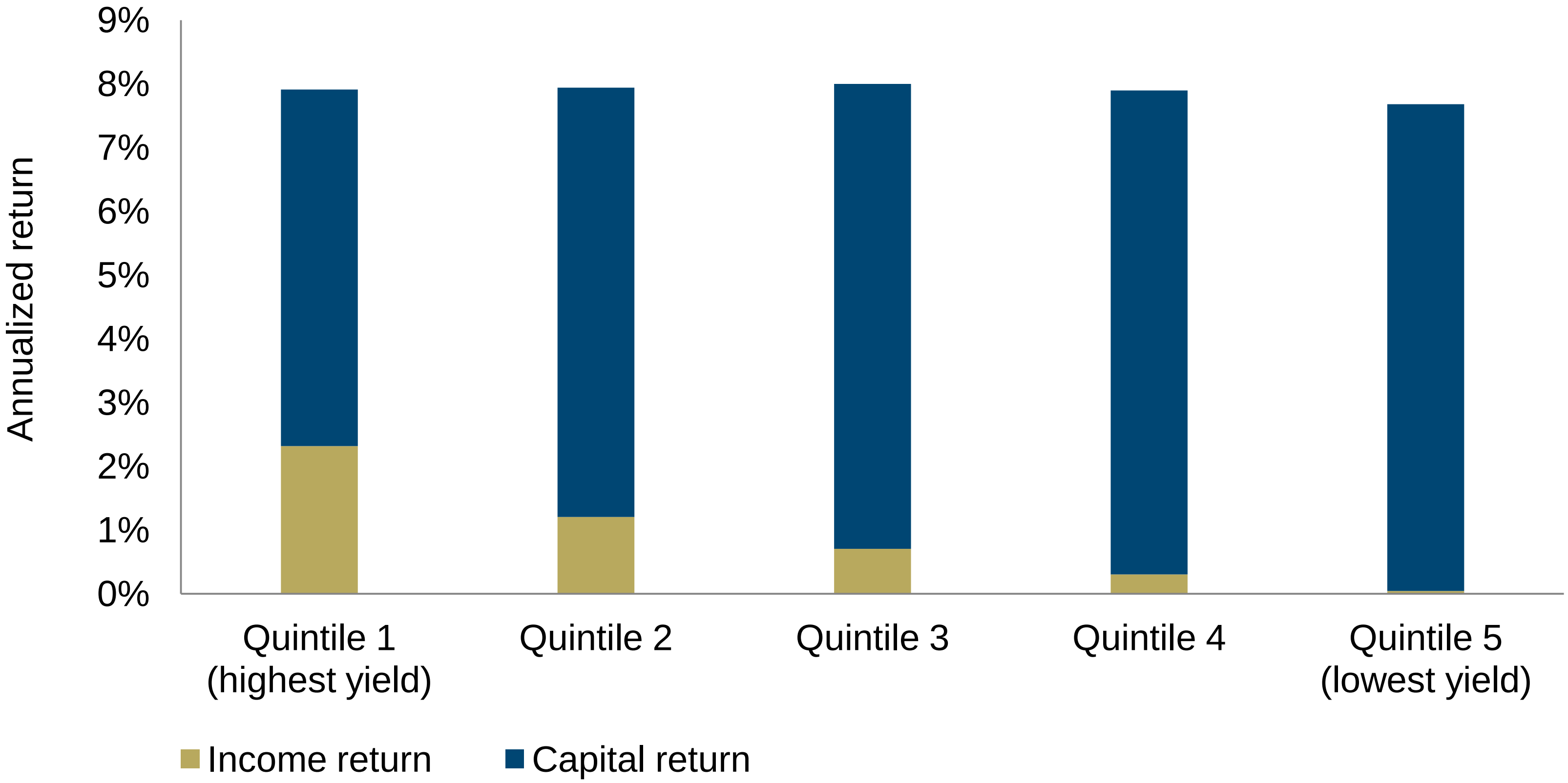
Sources: Vanguard and Morningstar, Inc.

* Equity income is based on the prospectus objective and is a subset of the other categories.

Total return includes both income and capital returns

While the total returns are similar, the composition of the returns is not

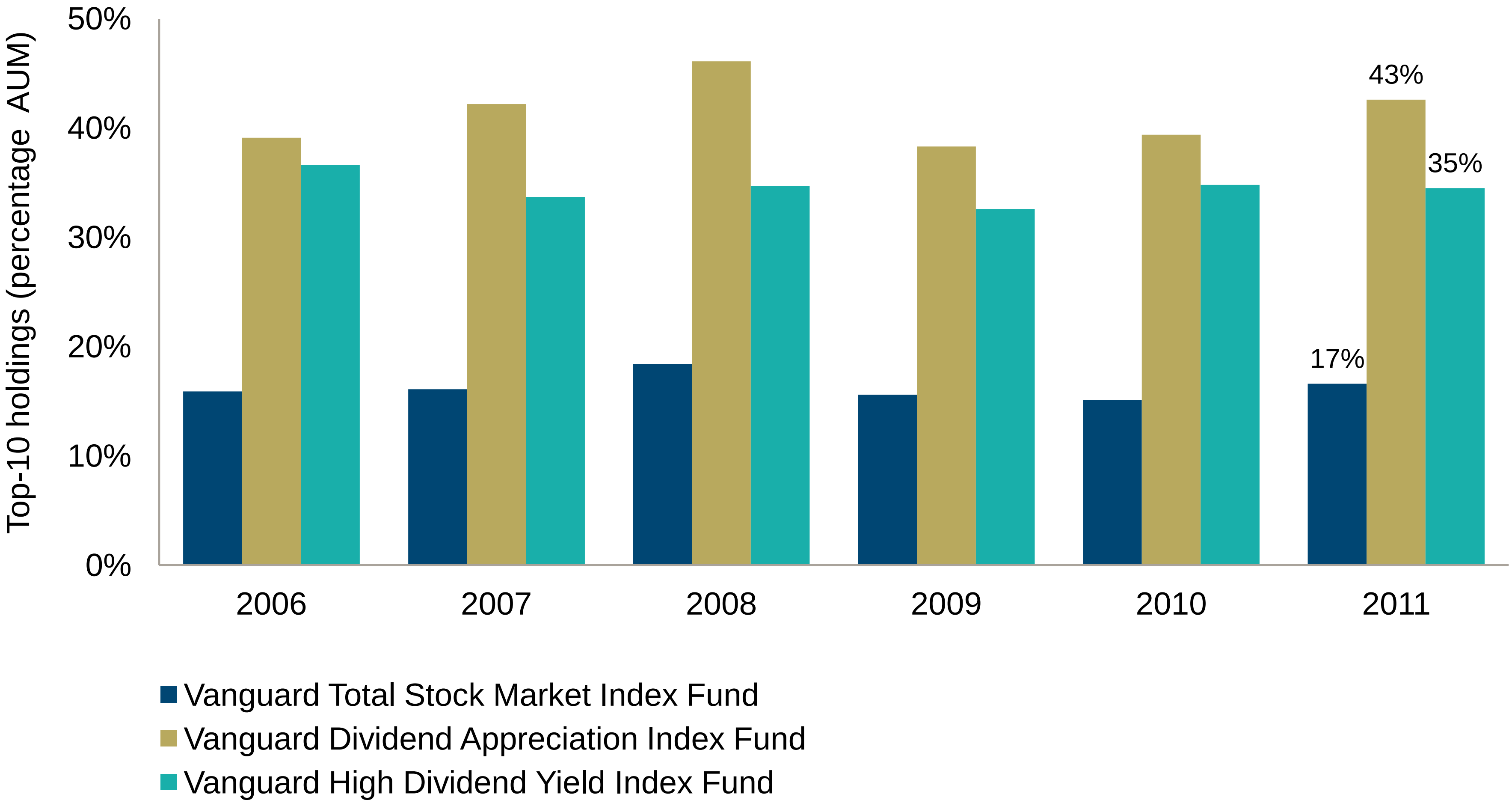
Average yields and returns for general equity funds,
20 years ended December 31, 2011



Sources: Vanguard and Morningstar, Inc.

With no expected return advantage, this strategy does increase concentration risk

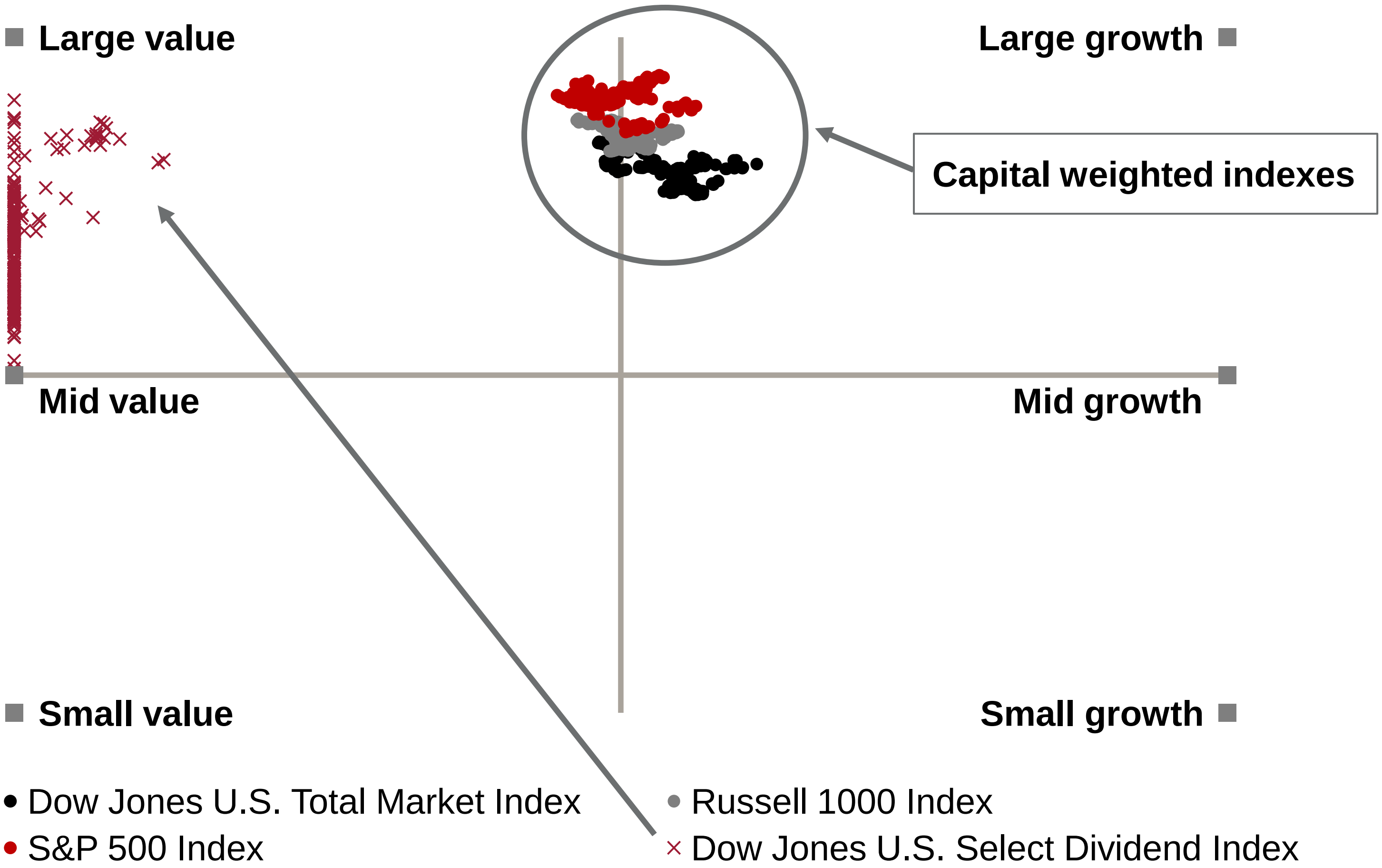
More highly concentrated in top-10 holdings



Source: Vanguard.

Dividend strategies also tend to be value-centric

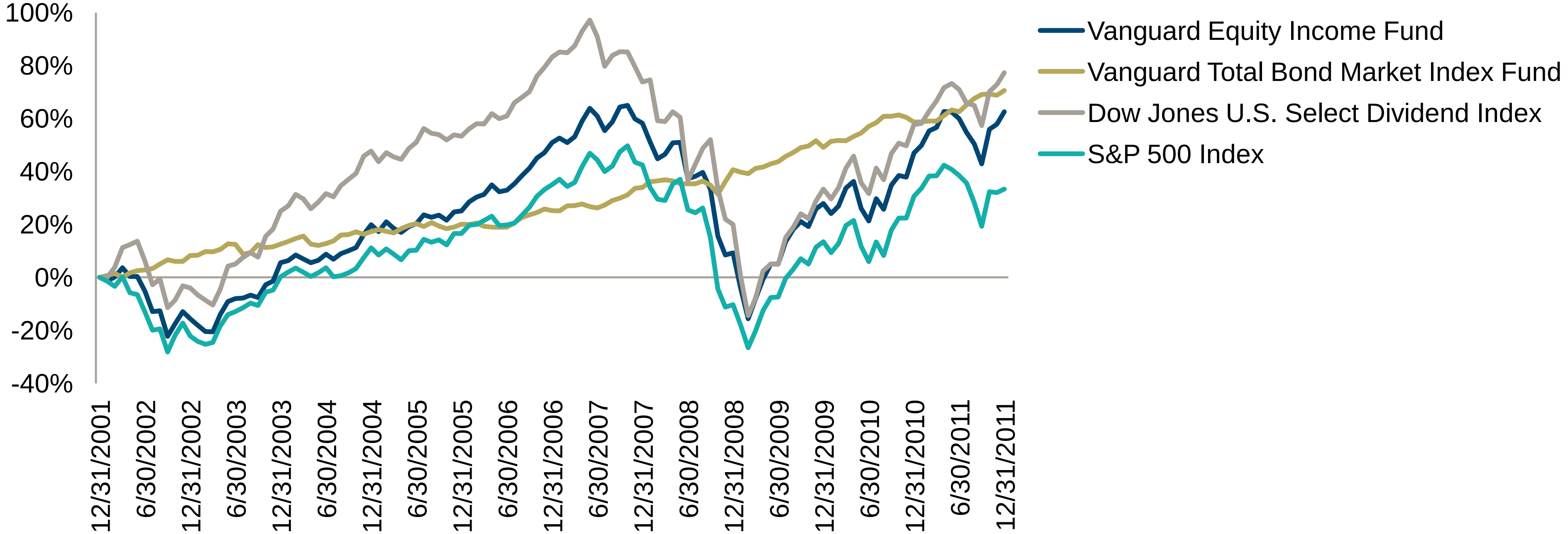
Performance has been driven by size and style biases



Notes: The style analysis displays the benchmark weights that result from a 36-month rolling tracking-error minimization for each index across the set of six Russell size and style indexes (Russell 1000 Value, Russell 1000 Growth, Russell Midcap Value, Russell Midcap Growth, Russell 2000 Value, and Russell 2000 Growth Indexes). The results are not materially impacted by the choice of index provider. The analysis covers the time period from 1992 to 2011.
Sources: Vanguard, based on return data from Morningstar, Inc., and Dow Jones.

Income-oriented equity funds do not diversify nearly as well as bond funds

Cumulative total return



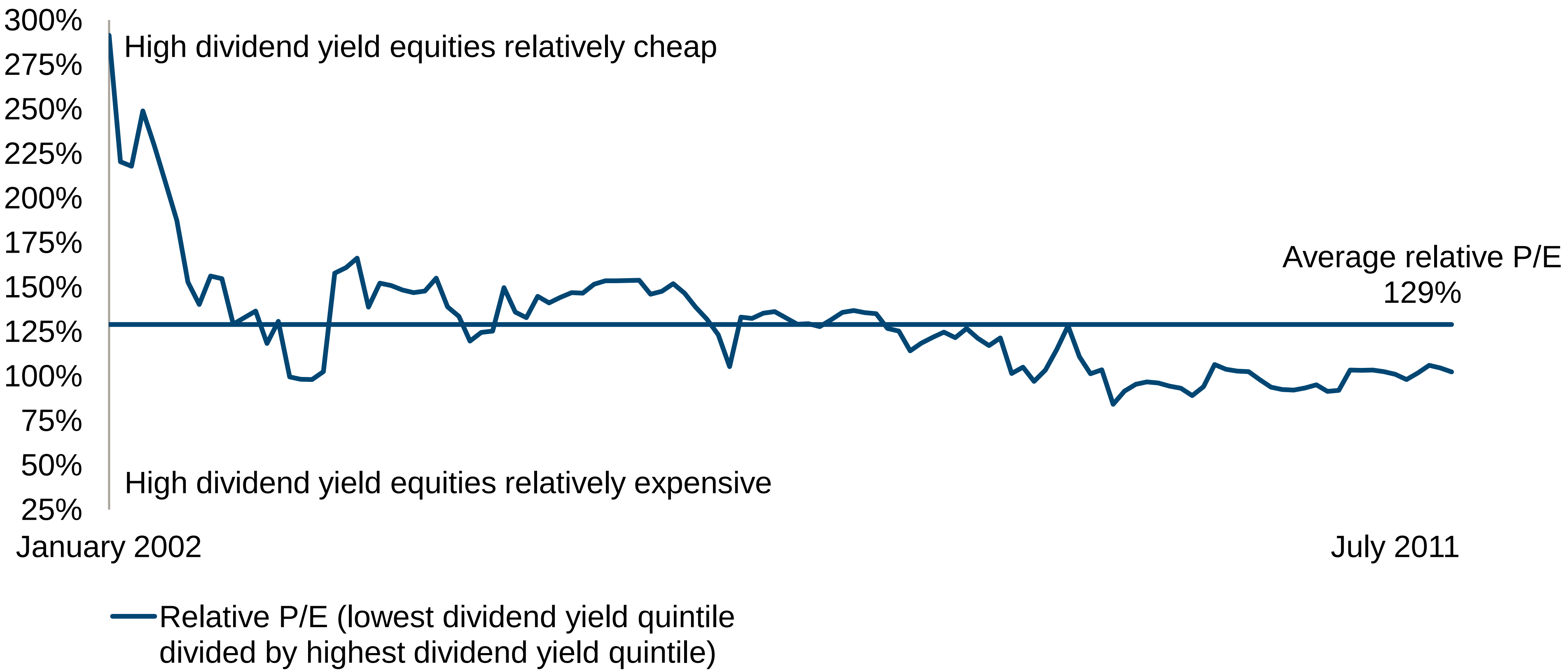
	Peak to trough: October 2007—February 2009		10 years ended December 2011, annualized	
	Percent	Vol	Percent	Vol
Total Bond	7.1	5.4	5.5	3.7
Equity Income	–48.7	18.1	5.0	14.6
DJ Select Divd	–53.8	24.2	5.9	16.3
S&P 500	–50.2	19.6	2.9	15.9

Sources: Vanguard, S&P, and Dow Jones. Note: *Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.*
Note: Standardized performance provided at the end of this presentation.

This trend is occurring at a time when . . .

Relative valuations look very different from their historical relationships

Relative trailing 12-month price/earnings ratio



Sources: Vanguard and FactSet.
Notes: Relative P/E is calculated by dividing the P/E of the quintile by the P/E of the S&P 500 Index. Securities in each quintile are equal-weighted.

Investors not chasing yield for all equity investments

OE fund and ETF cumulative cash flows in $B, as of March 31, 2012

Category (excluding funds of funds)	**1 year**	**3 years**	**5 years**	**10 years**
U.S. equity (nonsector)	–79.7	–118.7	–200.4	85.3
Sector equity	**18.1**	**85.1**	**119.6**	**163.9**
International equity	–22.3	55.6	66.8	474.2
Emerging markets equity	**37.1**	**124.0**	**165.6**	**232.4**
Equity all (nonalternative)	**–46.9**	**209.1**	**151.6**	**955.8**
Alternative*	**31.1**	**134.3**	**206.2**	**265.0**

* Levered, inverse, commodity, currency, etc.
Sources: Vanguard and Morningstar, Inc.

Significant fixed income "yield seeking"

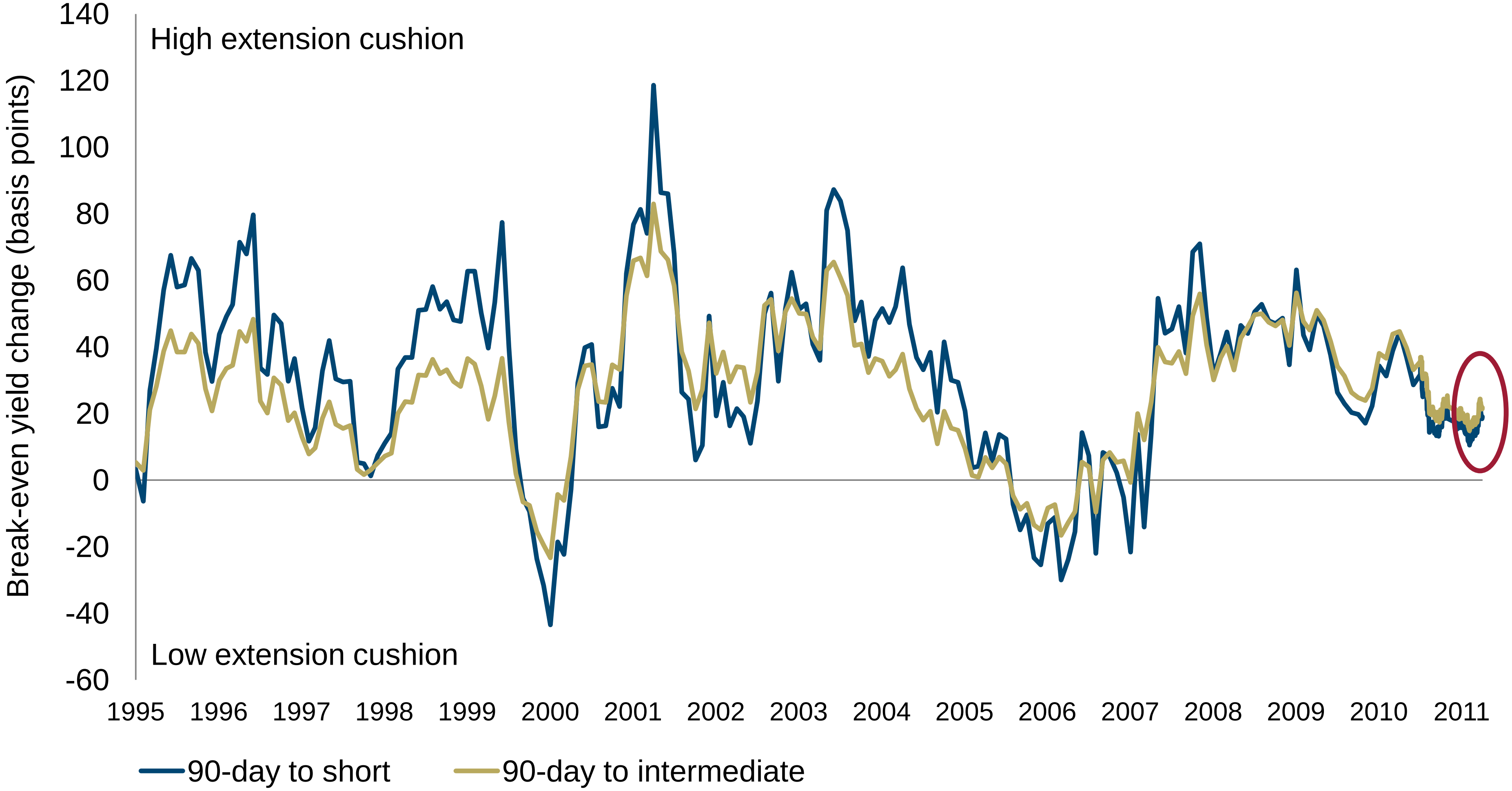
While an investor's portfolio yield may increase . . .
so will duration and credit risk

OE fund and ETF cumulative cash flows in $B (% of base AUM), as of March 31, 2012				
Ranked by 1-year cash flow	**1 year**	**3 years**	**5 years**	**10 years**
Total taxable bond	**219.7 (11%)**	**731.3 (62%)**	**887.5 (83%)**	**1,136.3 (184%)**
Intermediate-term bond	**89.3**	**270.6**	**348.8**	**483.8**
High-yield bond	32.0	71.3	77.9	80.3
World bond	20.7	43.1	44.9	49.3
Emerging markets bond	20.1	116.6	127.1	149.6
Government	7.9	12.7	38.4	15.0
Bank Loan	–1.6	31.4	17.9	33.2
Money market*	**–146.2 (–6%)**	**–1,220.7 (–33%)**	**–295.6 (–14%)**	**–503.3 (–23%)**

* Money markets are not part of the taxable bond universe.
Sources: Vanguard and Morningstar, Inc.

The implications of extending duration for yield

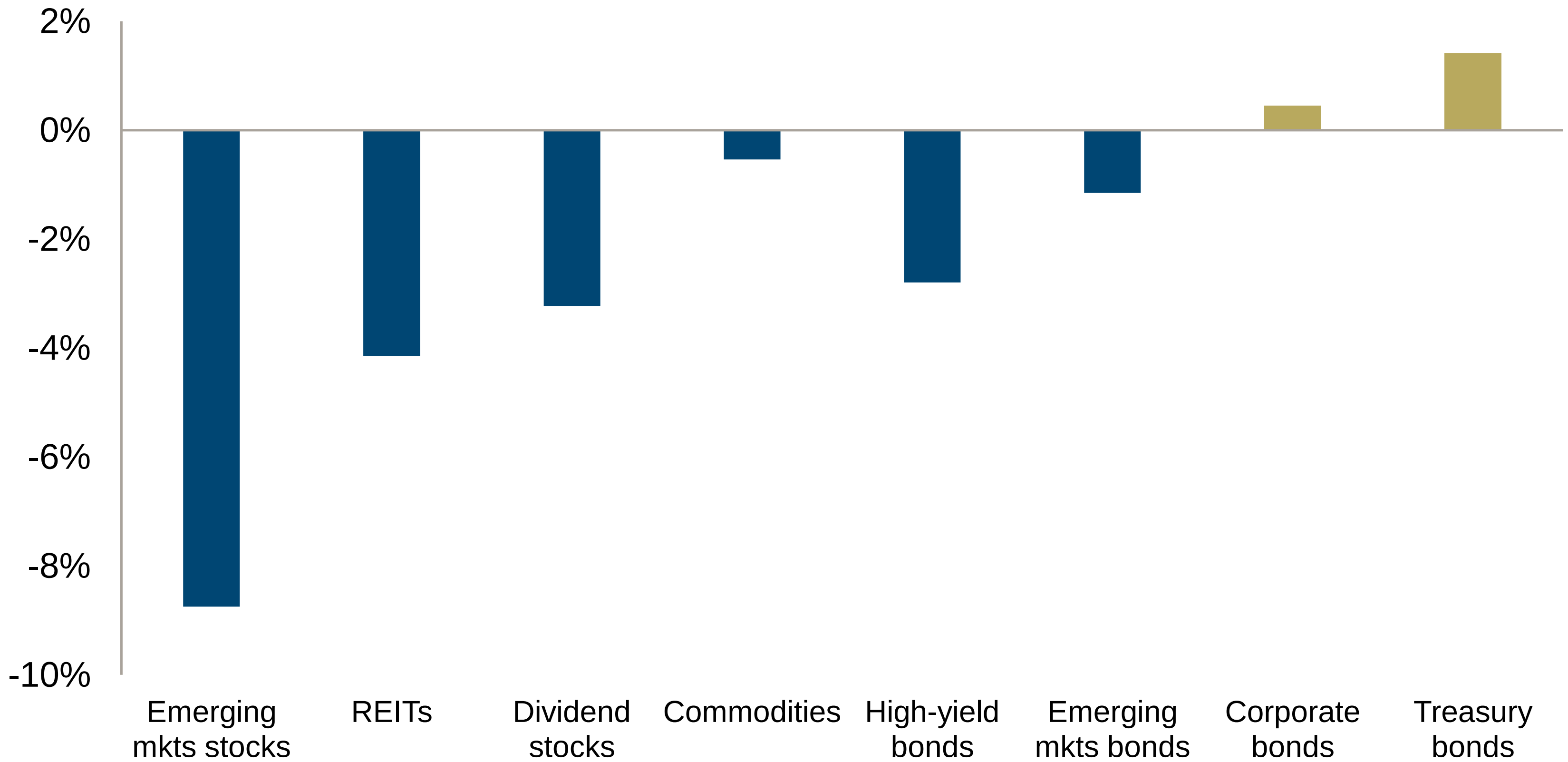
Change in yields to make total returns equal between 90-day bill and duration bonds



Source: Barclays Capital, as of March 31, 2012.

Changing risk exposure can have significant implications

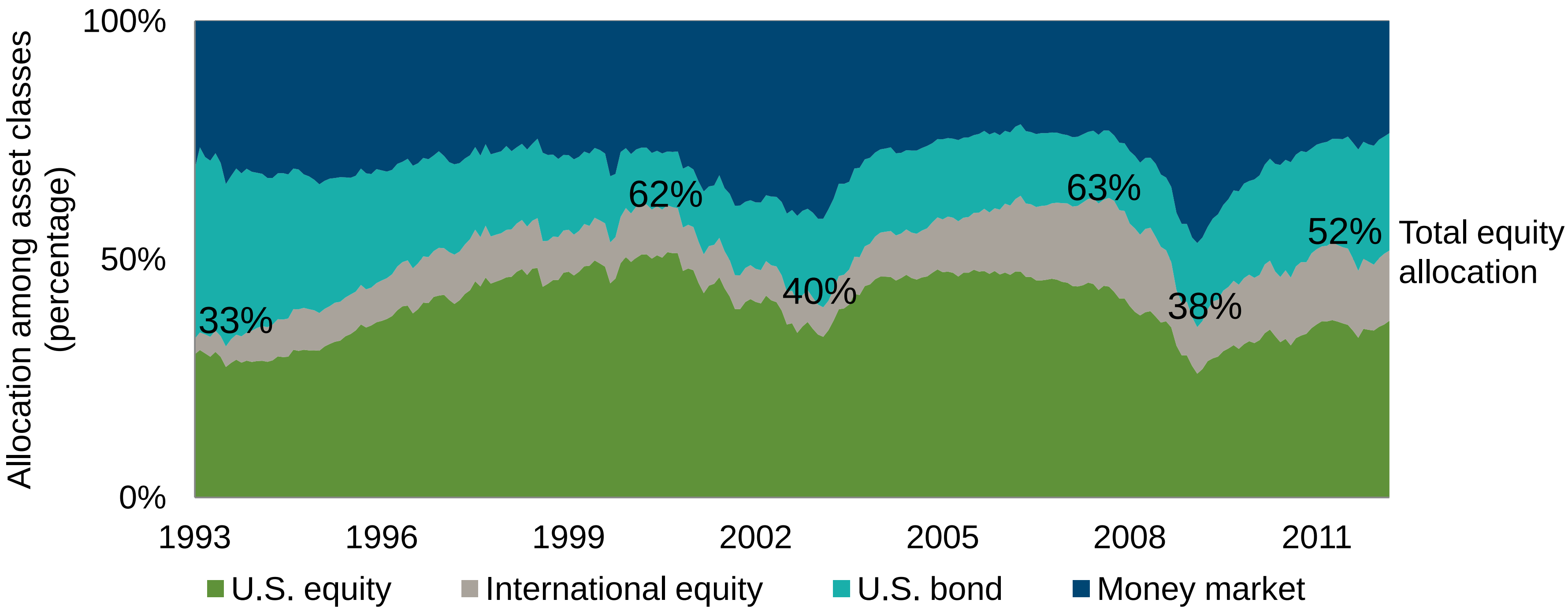
Median monthly asset class return during bottom-decile U.S. equity months (1988–2011)



Source: Vanguard.
Benchmarks: emerging markets stocks–MSCI Emerging Markets Index; REITs–FTSE NAREIT Index; dividend stocks–Dow Jones U.S. Select Dividend Index; commodities–Dow Jones UBS Commodity Index; high-yield bonds–Barclays Capital High Yield Index; emerging markets bonds–J.P. Morgan Emerging Markets Bond Index Global; investment-grade corporate bonds–Barclays Capital U.S. Corporate Index; Treasury bonds–Barclays Capital U.S. Treasury Index.
Notes: The Dow Jones U.S. Select Dividend Index starts in January 1992; the J.P. Morgan Emerging Markets Bond Index Global starts in January 1994.

Asset allocations remain largely the same and follow markets

Industry OE fund and ETF asset allocation breakdown by AUM



	Max.	Min.	Median	3/31/2012
U.S. equity	51.4%	25.9%	40.9%	37.1%
International equity	19.1	3.2	9.8	14.7
U.S. bond	38.8	11.3	17.3	24.6
Money market	46.7	21.8	28.8	23.5

As of January 31 for each year.
Sources: Vanguard Investment Strategy Group and Morningstar, Inc.

We believe total return
is a better solution
to sustainable income . . .

The advantages of a total return approach

Total return approach

Pros:

- Maintains asset allocation
- Provides broader diversification
- No factor, duration, or credit overweights
- Significantly increases tax efficiency
- Increases the longevity of the portfolio
- Lowers rebalancing events

Cons:

- More complicated to implement

Income-only approach

Pros:

- May be less complicated to implement

Cons:

- May shift asset allocation
- May shift sub-asset allocation
- Increases factor, duration, and credit risks
- Increases concentration risks
- Reduces tax efficiency
- Reduces longevity and future income generation
- Higher rebalancing events

How to make total return easy

Step 1: Establish a spending account

Nonportfolio cash flows

- Social Security
- Pension
- Trust

Required minimum distributions

. . . if applicable

Taxable portfolio cash flows

- Interest
- Dividends
- Capital gains

Spending account

Money market or checking account

Step 2: Replenish spending account by . . .

Selling assets within taxable accounts in the following order . . .

1. Assets at a loss
2. Assets at no gain or loss
3. Assets at a gain (minimize gains if possible)

Selling assets within tax-advantaged accounts in the following order*. . .

1. Tax-free accounts
2. Tax-deferred accounts

* Where to spend from next depends on tax-rate expectations relative to your current tax rate. This order assumes your future tax rate (or your heir's) will be the same or lower than your current tax rate. If you expect your *future* tax rate to be higher than your current tax rate, you should spend from your tax-deferred accounts, then your tax-free accounts. If unsure, consider spending equally from tax-free and tax-deferred accounts.

Step 3: Review your asset allocation

These activities all require actions!

- Rebalancing
- Asset location
- Loss harvesting

Successful tax-efficient drawdown can easily cover the fee-for-service advisory fee

Conclusion

- Headlines talk of investors de-risking . . . but their actions suggest otherwise
- Investors are taking on other risks (duration extension, credit, and reduced-equity diversification)
- Focus on dividend-oriented strategies is curious as valuations seem less appealing
- This focus on income is likely to result in less diversification, higher risk, decreased tax efficiency, and increased chance of falling short of long-term financial goals
- Vanguard recommends following a total return approach, where investors focus on both parts of their return, income as well as capital appreciation

Performance

Vanguard fund	1 Year	5 Years	10 Years
	Average annual total returns Periods ended March 31, 2012		
Total Bond Market Index Fund Investor Shares	7.56%	6.12%	5.51%
Equity Income Fund Investor Shares	12.46	2.85	5.45

The performance data shown represent past performance, which is not a guarantee of future results. Investment returns and principal value will fluctuate, so investors' shares, when sold, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data cited. For performance data current to the most recent month-end, visit our website at www.vanguard.com/performance.

Disclosures

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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 an investment at $1 per share, it is possible to lose money by investing in such a fund.

Investors cannot invest directly in an index.

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