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June 21, 2011

Filed Electronically

Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Study Regarding Financial Literacy Among Investors;
<u>Release No. 34-64306; File No. 4-626</u>

Dear Ms. Murphy:

Vanguard strongly supports efforts to improve investor literacy, and we appreciate the opportunity to provide our comments to the Securities and Exchange Commission (the "Commission") on its initiative to study the effectiveness of existing private and public efforts to educate investors. As one of the largest firms in the mutual fund industry, Vanguard[1] has been a leading proponent of investor education, seeking to provide our clients with candid, concise, and easy-to-understand printed materials and online content to help them make better investment decisions. In short, we believe that knowledge is one of the keys to long-term investment success. In this letter, Vanguard will comment on improving disclosure and increasing transparency with respect to expenses. In addition, we will provide an overview of Vanguard's investor education efforts – both to retail clients and defined contribution plan participants.

The United States has become a nation of investors over the past three decades. Today, a total of 44% of U.S. households own mutual funds ("funds"), compared with less than 6% in 1980.[2] An estimated 90 million individuals own funds, covering a broad spectrum of age, education, and income characteristics.[3] Individuals predominantly buy and sell funds via one or more of the following sources: financial advisors/planners and brokers; employer-sponsored retirement plans; fund supermarkets; and directly from the fund company. While the buying experience is different in these four instances, there is commonality in the materials presented to investors – namely, the prospectus and shareholder reports.

<u>Methods to improve the content and format of disclosures to investors with respect to investment products:</u>
<u>Summary Shareholder Reports</u>

In 2009, with the adoption of amendments to Form N-1A and the introduction of the "Summary Prospectus," the Commission took an important step in enhancing disclosures and aiding investor understanding of funds. The summary prospectus provides key information in plain English in a standardized format and was

[1] Vanguard offers more than 170 U.S. mutual funds with aggregate assets of approximately $1.7 trillion.
[2] Investment Company Institute, *2011 Mutual Fund Fact Book*, at 79.
[3] Id. at ii.

welcomed by investors who found statutory fund prospectuses too long and detailed to be useful.[4] As the Commission noted in its release: "This improved disclosure framework is intended to provide investors with information that is easier to use and more readily accessible, while retaining the comprehensive quality of the information that is available today."[5]

We believe the Commission has a similar opportunity to apply this improved disclosure framework to shareholder reports, which would greatly benefit from a streamlined presentation of user-friendly information and data.

Industry research demonstrates that investors rely on a handful of key facts in making decisions, and that they prefer straightforward language and graphical presentations.[6] The typical fund shareholder report, however, is a daunting document, filled with pages of portfolio holdings and a myriad of number-heavy, technical accounting disclosures that are of little practical value to the average investor. As such, we believe that investors would benefit in receiving a **Summary Shareholder Report** that would contain a cogent and candid analysis of the fund's investment performance, along with streamlined reporting of return data, expenses, and relevant financial highlights.

Vanguard proposes that a Summary Shareholder Report contain the following elements:

Management's Discussion of Fund Performance – A discussion of the fund's performance over the last fiscal period, including relevant market conditions and the investment strategies and techniques used by the fund's investment advisor, all as currently required.

Performance summary – A graphical presentation of annual returns for each of the prior ten years, along with the average annual returns for the trailing one-, five-, ten-year periods, and since the fund's inception date. Fund performance would be compared to a broad market benchmark (as currently required), and additional comparisons should be made to a stated benchmark index and/or peer group of funds, if appropriate.

Fund profile – This section would include the tabular or graphical representation of fund holdings that is currently required, as well as a snapshot of share class characteristics (e.g., ticker symbol, 30-day SEC yield, expense ratio, net assets, etc.); a summary of other portfolio characteristics appropriate to the type of fund (e.g., number of holdings, yield, turnover rate, etc.); a listing of the ten largest equity holdings and their aggregate share of the portfolio's value; industry or geographical weightings; a graphical presentation of investment focus (e.g., style box); and a listing of volatility measures.

Financial highlights – The standard table including beginning and ending net asset values, net income, realized and unrealized gains and losses, distributions on a per share basis, net assets, total returns, net income expense ratio, and the portfolio turnover rate for the most recent fiscal period for each share class.

We would also suggest including clear instructions on how to review the full financial statements and portfolio holdings of the fund, similar to the following language (example assumes a December 31, 2011 annual report):

> The fund's full financial statements, including a complete list of portfolio holdings as of December 31, 2011, and the report of an independent registered public accounting firm are

[4] Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information* (August 2006), at 22-26.
[5] "Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies," Release No. IC-28584 (Jan. 13, 2009), at 7.
[6] See supra note 4.

available on our website at vanguard.com and in the fund's N-CSR filing with the Securities and Exchange Commission ("SEC"). The fund files full financial statements on Form N-CSR semiannually, as of the end of the second and fourth fiscal quarters. The fund also files a complete list of portfolio holdings for the second and fourth quarters with the SEC on Form N-Q. Shareholders can look up the fund's Forms N-CSR and N-Q on the SEC's website at www.sec.gov. These forms may also be reviewed and copied at the SEC's Public Reference Room.

Real-world evidence suggests that "shorter is better." In 2010, Vanguard began publishing an abridged list of holdings (top 50 securities held and issuers representing over 1% of net assets) in annual and semiannual reports for funds with a large number of holdings, making the full list available upon request. Out of millions of shareholder accounts, only 23 shareholders requested the full list of portfolio holdings for a particular fund over the course of a year.

Some critics may contend that fund investors deserve the same level of disclosure that fund managers receive from public companies. It is important to distinguish between the use and relevance of a corporate annual report and that of a mutual fund report. Unlike investment analysts, who rely on data and financial statements found in corporate annual reports to analyze a company, fund investors do not need to scrutinize financial statements in order to understand fund strategy and performance. To the contrary, number-laden, dense financial statements may serve to reduce readership and, therefore, their effectiveness in promoting investor comprehension.

We look forward to reviewing the Commission's findings on the effectiveness of the shareholder report. The 2008 focus groups conducted by the Commission on the summary prospectus yielded useful insights in developing the final disclosure document. As the Commission found with the summary prospectus, a useful, readable disclosure document, coupled with the ready availability of supplementary information and data online, can help investors make more informed decisions.

Methods to increase the transparency of expenses: *Modify fee table*

The 1988 adoption of the consolidated, standardized fee table in fund prospectuses represented a "great leap forward" in promoting a better understanding among investors of mutual fund expenses and fees. The table provides a clear, easy-to-understand depiction of both the costs to buy and sell fund shares, as well as the annual ownership costs. The presentation of the dollar amount of annual expenses paid on a hypothetical $10,000 investment over various time periods also provides investors a simple "dollars and cents" example of the impact of costs on investment returns.

Useful and usable cost disclosure is of paramount importance, given the relationship between costs and returns. According to Morningstar, "expense ratios are strong predictors of performance. In every asset class over every time period, the cheapest quintile produced higher total returns than the most expensive quintile."[7]

It is also clear that investors are increasingly examining costs when evaluating mutual funds. In a 1997 Investment Company Institute ("ICI") study, investors cited returns as the second most important factor influencing their mutual fund purchase decisions.[8] Cost ranked a distant sixth.[9] A more recent study by the same organization, however, indicates that costs are becoming more top of mind among investors. According to the

[7] Russel Kinnel, "How Expense Ratios and Star Ratings Predict Success," Morningstar Advisor (Aug. 10, 2010).
[8] Investment Company Institute, *Understanding Shareholders' Use of Information and Advisers* (Spring 1997), at 25.
[9] Id.

2006 ICI survey, 74% of investors considered a fund's fees and expenses prior to purchasing shares, and expenses displaced performance as the most cited factor.[10]

Investor's growing preference for lower cost funds has been due in large part to a greater understanding of costs and their impact on long-term performance. Investor awareness of cost has been aided by: improved cost disclosure in fund prospectuses; the wide availability of cost information and calculators online; and the greater attention paid to costs by the media and fund providers.

As investors learn more about investment costs, they become smarter consumers of investment products. A 2010 Vanguard study on fund purchasing activity revealed that lower-cost products have attracted the predominant portion of investor dollars over the past decade. Vanguard found that in each of five categories, investors favored funds with lower expenses, directing between 55% and 93% of cumulative net cash flow to the lowest-expense quartile of funds from 2000-2009.[11]

Vanguard believes that the current regime of mutual fund fee disclosure is, for the most part, very effective and accessible, and enables investors to make informed decisions related to the cost of investing. We would suggest, however, two minor modifications to the prospectus fee table to further aid investor understanding and provide a clearer picture of the fund's operating expenses.

1. The first modification would be for the Commission to allow for supplemental explanatory footnotes to the fee table in the summary section of the prospectus. We believe additional disclosure would promote transparency and clarity with respect to investment costs. For example, Vanguard charges redemption fees on certain funds for shares purchased and sold within a specified period of time. While we are required to show the amount of the redemption fee in the standard table, we are unable to explain in a footnote that this fee will only be paid if an investor buys and sells shares within a specified time period, for example, 60 days. Without this explanatory footnote, an investor is under the mistaken impression that any and all redemptions are subject to this fee. Only if the investor requests and reads the statutory prospectus will he or she find the more detailed explanation of the redemption fee.

2. The second modification is a suggestion to the Commission to more rigorously define the term "acquired funds" with respect to 2006 changes to Form N-1A, which required funds to disclose the indirect expenses of investing in other funds. The acquired fund fees and expenses ("AFFE") disclosure rule requires a separate line item in the prospectus fee table for the expenses of the acquired funds.

   Vanguard is concerned that the AFFE requirement results in overstated expense ratios that distort an investor's true economic experience of investing in a fund. Specifically, certain Vanguard funds invest in business development companies ("BDCs"), which constitute a sub-classification of registered investment companies. However, like an automaker, retailer, or any other operating company (but unlike a fund), a BDC incurs operating expenses such as employee salaries, depreciation of equipment, utility costs, etc. These expenses are not paid directly by a fund that owns shares in a BDC, just as the expenses associated with the production of autos (e.g., labor, steel, etc.) are not paid directly by a fund that owns shares in an automaker. Nonetheless, these expenses are required to be included in the fund's expense ratio.

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[10] See supra note 4, at 10.

[11] Francis M. Kinniry Jr., Donald G. Bennyhoff, and Yan Zilbering, "Costs Matter: Are Fund Investors Voting With Their Feet?" (May 2010), at 4-8.

The expense ratios of BDCs can be extremely high. The BDCs held by Vanguard funds have expense ratios ranging from 0.53% to 41.0%. As such, the inclusion of BDC expenses in the fund's total expense ratio can be quite distortive and not reflective of its weighting in a fund. For example, the current operating expenses of a representative Vanguard small-cap index fund are 0.08%. The fund holds, on average, less than 1% of its total net assets in BDCs and the associated expenses of these aggregate holdings is 0.11%. As a result, under the AFFE requirement, the stated expense ratio of the fund is 0.19%, *which is more than double its true operating costs.*

We propose two simple solutions: 1) Issue a supplemental FAQ to the SEC's original FAQ on AFFE or an amendment to the instruction of Form N-1A that would eliminate BDCs from the list of investment companies; or 2) Exclude index funds and other funds whose investments in BDCs represent less than 1% or some other immaterial portion of the fund's portfolio.

Vanguard's investor education efforts

Vanguard has a long history of educating investors. In the 1980s, Vanguard began publishing a library of "Plain Talk" booklets developed to promote a better understanding of a wide variety of investment topics in an accessible, easy-to-read format. These booklets, along with a quarterly shareholder newsletter, served as the mainstays of our education efforts.

With the advent of the internet, Vanguard launched an innovative education and information service. Vanguard.com offered content to help investors learn more about investing in mutual funds, portfolio construction, and retirement planning, in a manner that could be directed by the investor. Vanguard.com has since evolved as both a means to educate investors and serve their transactional needs.

Today, vanguard.com is our predominant channel of client interaction, receiving more than 400,000 visitors every day. Our focus remains on education, with additional engaging means of delivering content, including podcasts, videos, live webinars, and blogs. Vanguard also has taken its education efforts to social media outlets, including Facebook, Twitter, and YouTube. We are also developing applications for use of electronic tablets and other devices as additional means to communicate with and educate consumers.

The adaption to new technology is critical as a growing population of mutual fund-owning households now have access to the internet. According to ICI data as of December 2010, nearly 9 in 10 households have access to e-mail and the internet, and some 82% of households use the internet for financial purposes, such as to obtain investment information or conduct transactions.[12] We believe that mobile devices will eventually gain a high level of use among investors.

While the media and methods for delivering our educational messages may have changed (and will continue to change) over the years, our message has remained basically the same. In short, Vanguard has consistently focused on the following simple precepts for investment success:

1) Maintain a balanced and diversified portfolio.
2) Keep a long-term perspective.
3) Keep investment costs low.

Vanguard has developed a rigorous architecture that serves as a guide for developing our communications and education materials. We believe the effectiveness of our education efforts hinges on a few key communications principles:

1) Having a few clear, concise, and simple messages.

[12] See supra note 2, at 92-93

2) Repeating messages consistently and creatively.
3) Using "Plain Talk" language with candor and empathy.
4) Delivering timely, engaging content.

In addition to these efforts directed to Vanguard's direct retail client base, Vanguard serves some 3.5 million participants in more than 2,500 employer-sponsored retirement plans. We answered the Commission's following questions in the context of our participant education efforts.

(1) Have you attended, or does your organization operate, organize, sponsor, promote, or host, any investor education programs? Please describe the program, including its duration, target audience, and any measurable goals and objectives aimed at changing investor behavior. What specific topics are covered in its curriculum?

To enhance the learning experience for participants in defined contribution retirement plans, Vanguard has developed a series of education programs that address an array of financial and investment-related topics. We tailor each program to meet different participant needs through a multi-channel approach designed to reach investors through their preferred communications channel.

Our programs cover:

- The benefits of participating in a retirement plan.
- The importance of saving for retirement.
- How to understand asset allocation.
- How to approach investment decisions.

These programs are designed to motivate participants to take action by either enrolling in the plan or increasing deferrals into the plan, and to develop an appropriate asset allocation for their particular financial situation.

Vanguard also offers a series of workshops that provide participants the tools to manage their own financial well-being, covering topics from college saving to retirement planning. For participants approaching retirement, we offer a comprehensive, customized pre-retirement planning workshop. We also develop meetings and materials in response to market and legislative changes.

Vanguard uses a number of methods to measure and report on a program's effectiveness in helping achieve plan sponsor education goals. Comparing before-and-after plan data, we study program outcomes to determine if a program meets its objectives at both the individual and aggregate-plan levels. We also analyze and compare plan data to benchmark data derived from plan sponsors.

Some areas that we commonly study to evaluate program success include:

1) Success rate: Percentage of participants who took action.
2) Incremental-response increase: Whether the targeted group took more action than a control group.
3) Channel effectiveness: Whether one channel was more effective than another (e.g., comparing e-mail versus direct mail).
4) Enhanced behavior change: Whether one segment of the participant base changed behavior more than another.
5) Duration: How long it took for participants to act on the message.

(2) What do you consider the most important characteristics of an effective investor education program?

Helping guide participants toward a more comfortable retirement is a key mission at Vanguard. We aim to deliver smart, timely, relevant, accessible messages to people in "Plain Talk" and through channels they use.

Regardless of the delivery channel, the messages participants receive are intended to motivate them to take action, such as to enroll in the plan, to save more, or to adjust asset allocation.

(3) What programs do you view as most effective?

E-communication is rapidly becoming the preferred method of communication for retirement plan participants. Virtually all (99.6%) of Vanguard's defined contribution plan sponsors allow their participants to access plan information online. In 2010, 64% of Vanguard's 3.5 million defined contribution plan participants had registered to access their accounts online and 27% proactively elected to receive plan information via vanguard.com.

As the "go to" source for a growing number of Americans, the internet and corporate intranets play a key role in delivering plan communications, enabling participants to access information virtually anywhere, anytime. Online communication avenues also enable participants to customize the level of information that they receive. In other words, participants can research online in a more efficient and targeted way than can be achieved through paper alone. It also can be easier for participants to organize and store their plan information, search for specific content, and retrieve information.

(4) Has your organization or an independent third party evaluated any of your organization's programs? If yes, please describe the findings of the evaluation, including any statistical evidence of how your program effectively changed one or more investor behaviors among participants.

The key measurement of a campaign's effectiveness is its results in changing participant behavior. Vanguard uses market research and other independent evaluations to measure how our education efforts accomplish their goals. At a macro level, we participate in many studies and competitions that assess the quality of our communication programs, including those by the International Association of Business Communicators and the Mutual Fund Education Alliance.

On a plan level, we use third-party research surveys to gauge a communication program's success. In addition, we maintain plan analytics capabilities that produce a range of measurements of a campaign's effectiveness. Plan sponsors can compare their plan statistics, including participation and deferral rates, to those of other plan sponsors in their industries, geographic location, and size category. This benchmarking information helps them ensure that communications meet talent attraction and retention goals, as well as plan-specific goals.

(6) What types of investor behaviors or other topics do you think investor education programs should focus on? Why?

There are only a few big "levers" that investors control that can significantly influence their investment outcome. In simple terms, they are:

1. How you invest (asset allocation).
2. How much and how long you invest (savings sufficiency).
3. How much you pay to invest (cost).

(7) Which best describes you or your organization?

Private/business.

<u>Vanguard's student-oriented education programs</u>

To close, Vanguard would like to briefly provide some information about our efforts to educate school-age children. Research has demonstrated that more rigorous financial education in our schools is needed. For example, in a 35-question exam on personal finance issues that was taken by more than 46,000 American high school students in 2008, the average score was 56%.[13]

While there are efforts in place to improve financial literacy in school students, such as Jump$tart and the National Endowment for Financial Education, Vanguard has worked independently to advance financial education in our communities through employee participation with Junior Achievement since 1998. Junior Achievement is a national program that creates a link between business and education by connecting volunteers to classrooms to teach finance and workforce skills. Vanguard is considering two additional pilot programs:

1. Classroom Economy: A scalable, online program designed by Vanguard to train teachers both locally and nationally how to teach students financial and life lessons.
2. Mentorship: A program designed to engage local students on a one-on-one level to help them reach financial and life goals that they otherwise might not achieve.

In addition to workplace programs, Vanguard believes that addressing the literacy issue at the school level provides the opportunity to teach individuals skills that they may successfully apply throughout their investing lifetimes.

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We appreciate the opportunity to comment on the Commission's proposal. If you have any questions about Vanguard's comments or would like any additional information, please contact Natalie Bej at 610-503-5693.

Sincerely,

/s/ Heidi Stam
Managing Director
Vanguard

cc: Honorable Mary L. Schapiro, Chairman
Honorable Kathleen L. Casey, Commissioner
Honorable Elisse B. Walter, Commissioner
Honorable Luis A. Aguilar, Commissioner
Honorable Troy A. Paredes, Commissioner
Eileen P. Rominger, Director
Robert E. Plaze, Associate Director
Susan Nash, Associate Director

[13] President's Advisory Council on Financial Literacy, 2008 Annual Report to the President, at 6.