Vanguard®

Our enduring approach to selecting active managers

We're actively different

Contents

Investors choose active management because they want to achieve superior long-term outperformance. And, that's not easy.

Through research we know there are three critical factors required for your clients to achieve outperformance.

Top talent, low cost and patience.

These attributes have played a consistent role in our long history of successful active management and are evident when we select managers for our active funds.

Picking world leaders in active portfolio management needs to be done by world leaders in manager selection and oversight.

We'd like to tell you more about our approach.

The advantage of active at Vanguard

When we first opened for business in 1975, Vanguard offered 11 actively managed funds. Even before we launched a single index strategy.

Today, the Vanguard Group manages more than AUD$7.5 trillion in assets[1].

A quarter of these assets are actively managed, which makes us one of the world's largest active managers.

We use our scale to bring world-leading talent to our investors at a low cost.

And, as we grow, we pass on the continuing benefits of our increasing scale via lowering the cost of our funds.

And, since we're not publicly traded or owned by a small circle of individuals focused on their own interests, we're in a position to align our interests with those of our investors.

The culture, philosophy and policies throughout our entire Vanguard organisation are purposely designed to do just that.

Vanguard puts investors first.

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Vanguard is one of the world's largest active managers

We are managing over AUD$2 trillion in active investments[2]

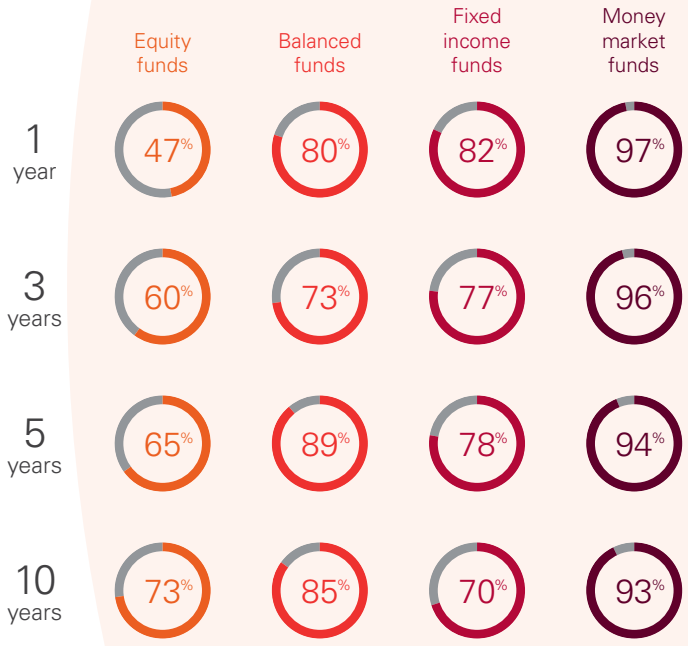
1 , 2 Source: Vanguard. As of 23 July 2019.

Top talent, low cost and patience pay off

We believe that low-cost active funds run by talented managers can achieve long-term outperformance for patient investors.

Applying this conviction, coupled with our rigorous manager search and oversight process, has produced impressive long-term results.

Percentage of Vanguard US-domiciled active funds outperforming their Lipper peer group averages



Source: Vanguard illustration, using data from Lipper, a Thomson Reuters company. Graphic shows the number of Vanguard U.S.-domiciled actively managed funds that outperformed their Lipper peer-group averages for periods ended 30 June 2019.

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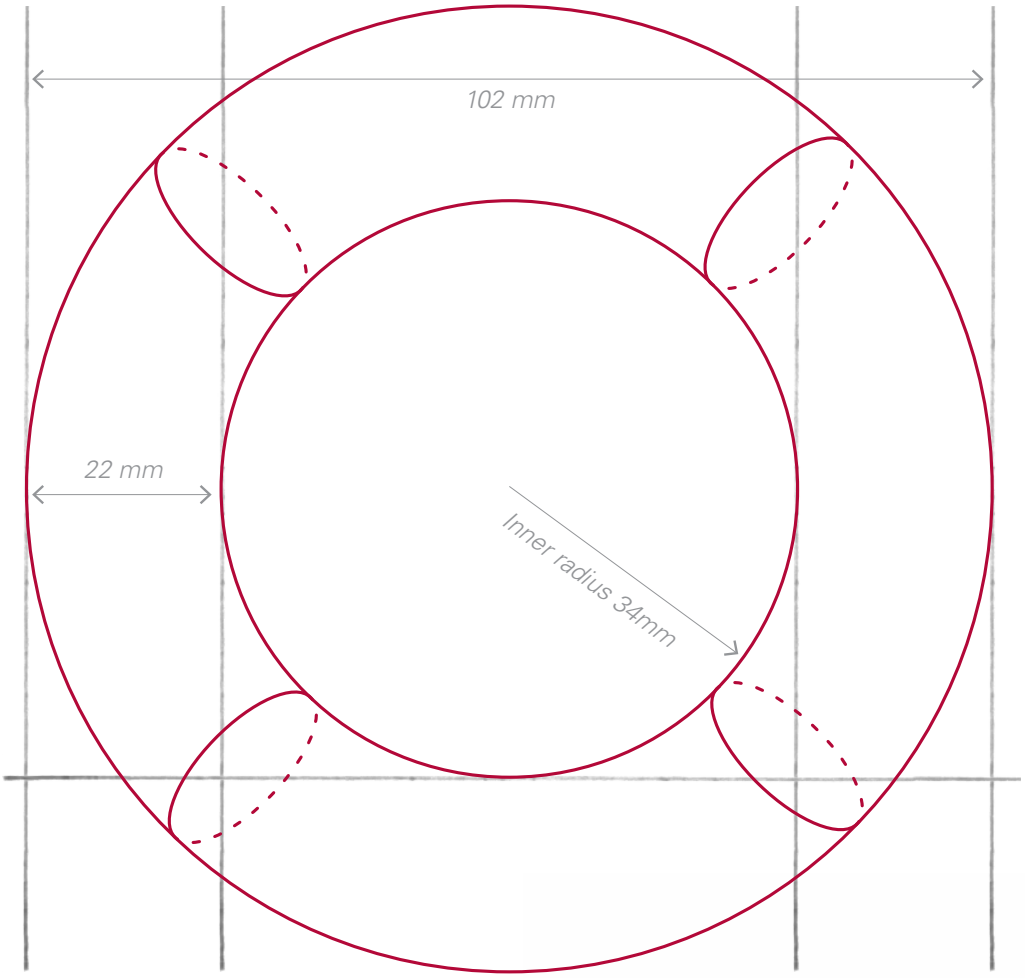
We're lowering the cost of investing

Vanguard Australia has delivered 29 fee reductions to our funds since 2012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An introduction to our approach

Investing skill and outcomes don't always correlate.

In some instances, strong performance can be a matter of luck, while poor performance can result from bad luck that masks underlying skill. So our manager selection and oversight approach focuses on the drivers that we believe help active managers succeed over the long term.

Hiring and firing managers based on short-term performance can lead to, in essence, buying high and selling low.

We aim to look past the noise of short-term performance and rigorously assess the stability of the manager's firm, the quality and depth of the investment team and the enduring nature of their philosophy and investment process – what we view as the true, sustainable drivers of long-term outperformance.

We marry these insights with a sophisticated analysis of a manager's performance patterns and portfolio to determine whether the manager remains true to their investing style and can add value over the long term.

This proactive approach lets us engage with them over years, not months, and over multiple interactions.

Our approach to oversight is similar, with a systematic process intended to ensure that the characteristics that attracted us to the manager in the first place remain intact over time.

Our evaluation of prospective managers begins years before we need them.

Such an approach allows for a day-to-day evaluation of current managers and a system for building a deep bench of potential managers.

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200+ meetings Vanguard conducts with prospective external managers each year

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20+ team members on Vanguard's oversight and manager search team

Our approach in detail – who is involved

At Vanguard we have a multi-layered oversight process that involves the most senior members of our organisation. Our Portfolio Review Department (PRD) has full-time responsibility for manager search and fund oversight.

The department's investment professionals attend more than 200 meetings with prospective managers annually and have regular conference calls and site visits with current managers.

Supported by PRD, our Global Investment Committee – a senior management panel led by the Vanguard Group's CEO – meets annually with each manager. Twice a year it strategically assesses the fund line-up.

Final hire and fire decisions are made by The Vanguard Group's board of Directors, of which the CEO is a member. The business experience and expertise of our non-investment executives ensure a consistent process and help us avoid rushed decisions that could result in mistakes.

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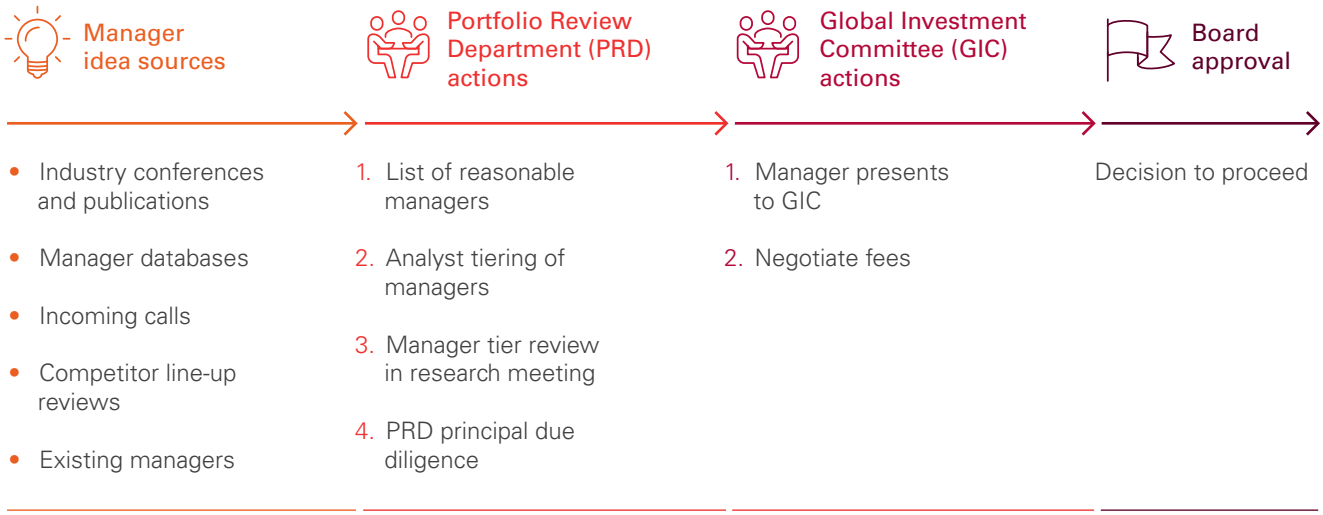
A CEO-led search and oversight process focused on long-term drivers

Portfolio Review Department	Global Investment Committee	Board of Directors
Full-time responsibility for fund oversight and manager search	Ongoing fund oversight and decision-making (senior management panel led by the Vanguard Group CEO)	Final approval of decisions about funds and managers
• Monthly formal evaluation of drivers and outcomes for each manager • Ongoing interactions, including conference calls and site visits, with current managers • More than 200 meetings with potential managers each year	• Annual meeting with internal and external managers • Semi-annual strategic assessment of fund line-up • Frequent communication with Portfolio Review Department	• Seven board meetings each year • Meets with internal and external managers

Our approach in detail – locating top talent

Our proactive and exhaustive search process enables us not only to identify quality managers, but also to understand what they specifically do best.



When we hire managers, we seek partnerships that will last for decades. This may include engaging with managers on succession planning or the transfer of ownership stakes and portfolio management responsibilities from one generation of investors to the next at the firm.

We're patient with our managers. We appreciate that active investing is challenging, that styles go in and out of favour and that underperformance will occur. More important than performance is that the drivers of performance that led to selecting that manager remain in place.

Knowing that long-term performance matters more than short-term gives the manager breathing room and benefits not only the relationship, but also clients who seek long-term stability and clarity.

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Vanguard's external partners have an average tenure of 15 years

Our approach in detail – what we seek

When we search for managers, we investigate criteria similar to those used throughout the industry: the firm, its people, its philosophy and its processes. But applying these criteria is subjective, and the human judgement and the robustness of the evaluation process can vary widely.

We believe that a long-term approach to manager selection and oversight – the same long-term approach we advocate for investing – provides several important advantages compared with a short-term focus.

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> A steady, motivated, highly ethical firm

Our multiple interactions with managers and prospective managers give us a firsthand view of the firms' culture and ethics.

- Do strong ethics come from the top of the organisation?
- Are they shared throughout the investment team and the whole firm?

Getting the culture and ethics right is critical to an organisation's long-term success.

It's important that key investment personnel have a direct stake in that success. It's also important that ownership be distributed across the team rather than concentrated with one individual, as ownership concentration may increase key-person risk and could create ownership transfer challenges.

We're cautious when we encounter uninvolved owners or owners whose primary business isn't asset management, as they may focus on wringing profits out of the firm as opposed to serving clients' needs and investing for the future.

> An emphasis on qualitative criteria, not short-term performance

Drivers

Firm

- Ethics
- Stability
- Ownership structure
- Account and asset trends
- Diverse client base
- Incentives

People

- Deep investment team
- Succession / contingency
- Limited turnover of key professionals
- Tenure and experience
- Proven expertise in subject matter
- Demonstrated ability to handle large mandates

Philosophy

- Shared by investment professionals
- Enduring
- Easily articulated

Process

- Understandable
- Stable / proven
- Repeatable

Outcomes

Portfolio

- Clear reflection of philosophy and process
- Characteristics consistent with expectations
- Risk profile aligned with the investment strategy

Performance

- Long-term history of competitive results compared with benchmarks and peers
- Performance consistent with investment approach

Firms with a steady-to-growing client base

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An emphasis on people with a positive group dynamic

We look for a firm with a steady-to-growing client base. Rapid asset growth or decline can destabilise a firm operationally. Start-up firms with few assets under management can be viable provided they have adequate funding and a healthy pipeline of prospective business.

Adequately resourced firms are in a better position to attract and keep investment talent and afford the research, data and systems necessary to develop and maintain a competitive advantage.

We seek experienced, confident, passionate investment managers as our partners. They have a client-first mentality and a healthy respect for the challenge of outperforming the market, because they've been there and they've made mistakes. Their experience has given them confidence and shown them the danger of overconfidence.

In the end, active equity investment success comes down to superior stock selection. Exceptional investment professionals can estimate a stock's fair value, explain why their view differs from the consensus, and communicate the triggers that will eventually prove them right.

They make their passion clear through persistent effort in good times and bad. They won't rest on their laurels when they succeed or abandon a sound strategy that hasn't yet worked out.

Such qualities in a prospective manager shine through as we meet with them face-to-face, many times, at their own place of business.

We look for a positive group dynamic, evident through mutual respect and participation among team members. We'd be wary of a firm with a star portfolio manager almost entirely responsible for the investment strategy's success.

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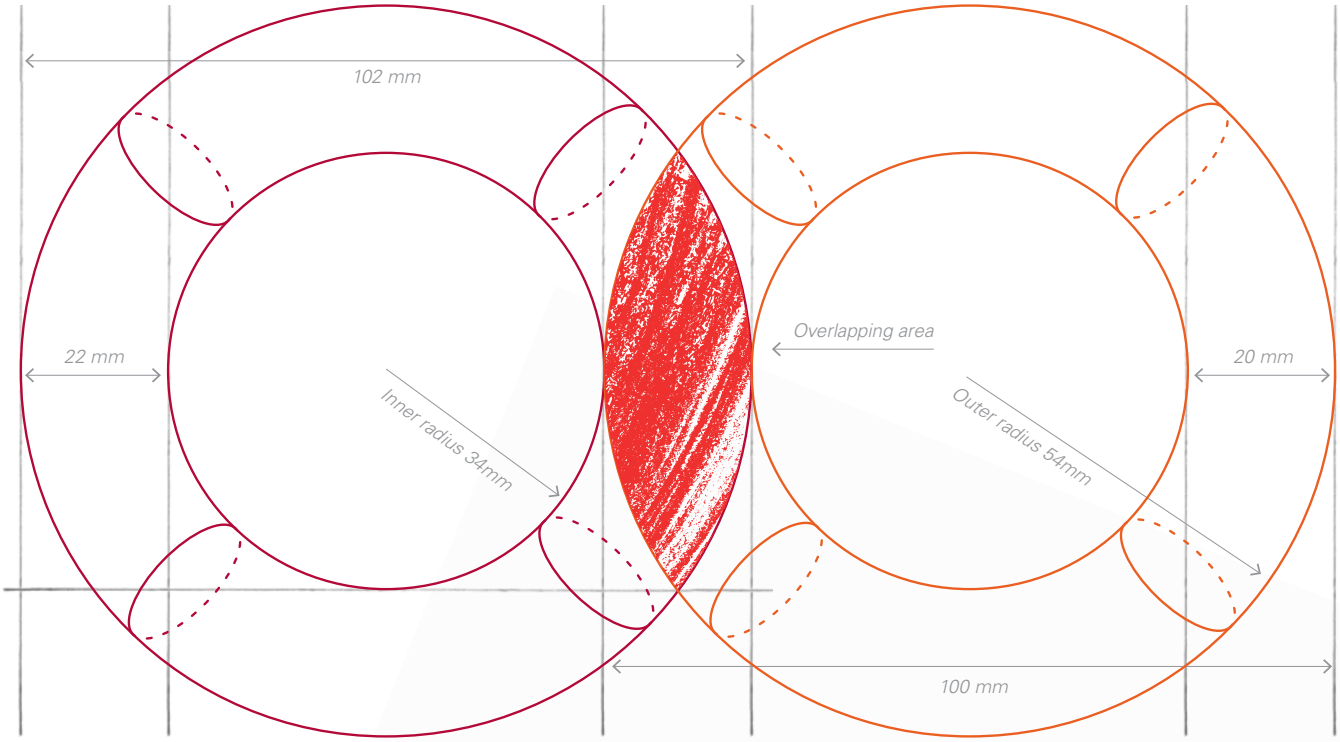
Investment professionals with a vested interest in success

We want the investment professionals to have a vested interest in the firm's success. However, specific compensation is less meaningful than whether the compensation methodology is clear and resonates with key employees.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A core philosophy about how they add value

Every investment manager will endure periods of underperformance.

We seek partners who, while always aiming to improve their investment processes, are steadfast in their core philosophy about how they add value.

We believe that managers with a well-defined investment philosophy that is universally shared throughout the firm have a better chance of weathering bouts of underperformance.

Putting philosophy into practice

A firm with an enduring investment philosophy must in the end be able to put that philosophy into practice.

Long-term success will depend on:

- A disciplined, repeatable, yet adaptable process
- Unambiguous decision-making
- Effective implementation of highest conviction ideas
- A culture of risk control

A disciplined, repeatable, yet adaptable process

Processes should be neither overly simplistic nor too complex and rigid.

A structured framework that helps screen out short-term noise and supports rigorous research and analysis should be evident. Yet discipline and consistency shouldn't stand in the way of improvement; we aim to partner with thoughtful managers who are capable of learning both from their mistakes and successes to improve their process and decision-making over time.

Unambiguous decision-making

The process around which investment decisions are approved must be clear and consistent over time, be it a consensus approach or the required sign-off by an individual or small group. A strong understanding of each person's role and influence in the decision-making process is essential especially when transitions occur within the investment team.

Effective implementation

Successful active management goes beyond identifying stocks that will outperform and avoiding those that will underperform. The successful manager must then implement those views in a portfolio.

Capacity constraints and trading costs can be meaningful hurdles that manifest themselves in reduced performance. So we closely assess each manager's portfolio liquidity, or capacity, trading style and frequency.

Managers with large positions, for example, may find buying and selling difficult without creating market impact costs. Avoiding market impact through slower building and exiting of positions may result in opportunity cost, or cause a portfolio to fall short of optimal implementation. And frequent trading can lead to costs that eat into returns.

Capacity constraints also can lead to style drift as managers invest in more liquid, larger cap stocks to reduce turnover or portfolio concentration. Such constraints can limit a manager's ability to translate conviction into action when a promising investment opportunity presents itself.

Firms are best able to mitigate risk of style drift and excessive trading costs if they employ robust trading processes and limit assets under management to levels that facilitate effective implementation.

A culture of risk control

Managers should be given the freedom to implement their ideas and not dilute their portfolio or stock-picking process purely for the sake of controlling risk. Firms nonetheless should take pains to avoid excessive or unintended risks and have robust operational and compliance systems in place to minimise the potential for regulatory errors and fraud.

We perform a thorough review of a firm's internal controls before entrusting them with any money. We also keep abreast of any litigation that might involve the firm. We regularly revisit the topic of risk control with existing managers.

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Beyond the systems in place, firms should have a culture of ethical stewardship of clients' assets, with senior leadership setting the tone

Our approach – a deeper inspection

To assess whether a manager is likely to generate value as intended requires a close inspection of performance attribution; we seek to differentiate a skilled manager from a lucky manager. A quantitative analysis of what specifically generated a manager's returns will help us evaluate vital qualitative aspects their approach.

Returns-based attribution

A manager's historical return patterns can be useful in determining the alignment of the manager's philosophy and process with their performance. For example, did the manager take on high levels of relative risk? If so, did the manager produce commensurate return?

Holdings-based attribution

Analysing past returns alone, however, doesn't reveal the true drivers of performance: the specific decisions a manager made in terms of stock selection, position sizing and sector/country positioning.

We also perform a thorough evaluation of a prospective manager's historical holdings for clues to investment strategy changes, style biases, the manager's strengths and weaknesses and the robustness of added value. These elements can spur a deeper discussion to better understand whether the manager's outcomes align with its drivers. For example, value managers should have consistent exposure to value stocks.

They shouldn't be penalised if value underperforms during the period or praised if value outperforms. Rather, they should be evaluated on their ability to select the best value stocks in relative terms.

Style drift

We don't find fault in style drift per se. A manager's gradual change to an investment strategy and the types of stocks they buy can be part of the manager's investment philosophy and process, and this may serve the mandate appropriately.

Types of style drifts that would raise concerns would be if a small-cap manager, for example, drifts into buying larger-cap stocks because of capacity limitations. Or if a value manager drifts into buying growth stocks because growth is outperforming.

Quantitative software tools allow a monthly inspection of such style exposures as value, growth, quality and momentum. Such analysis can serve as a milepost for discussions with the manager.

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Aligning drivers with outcomes

Manager oversight and retention

Once we've hired a manager, our systematic oversight helps ensure that our perceived drivers of outperformance remain intact. We use quantitative tools for regular performance attribution and risk reports. The insights we derive from them inform our regular interactions and formal reviews of a manager's drivers and outcomes.

We meet in-person with each manager at least twice a year, with at least one of the meetings on the manager's premises. We meet not only with portfolio managers and analysts, but also with compliance and risk mitigation personnel.

We don't do something simply for the sake of doing something. Rather, we prefer a patient approach, and to part company only when it appears that the drivers of performance— firm, people, philosophy and process— are reaching a point of deterioration where a manager no longer has a meaningful competitive advantage.

We enter every relationship with a manager expecting it to endure and be mutually beneficial. In fact, our partnership with our first active manager, Wellington, has endured for more than 40 years.

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We meet in-person with each manager at least twice a year

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