

Fund Essentials™



index

investing



THE **Vanguard** GROUP

Vanguard® index funds

Twenty-five years of leadership



The power of indexing is undeniable. From its inauspicious debut in 1976, Vanguard® 500 Index Fund, the first index fund for individual investors, has attracted **millions of investors** to become the biggest mutual fund in the world. Over the past 25 years, Vanguard has become the clear leader in indexing. We now offer more than 20 index funds spanning every sector of the U.S. stock and bond markets, as well as stock markets around the world. This brochure shows you how you can put the **power of Vanguard's index funds** to work in your portfolio.

Vanguard index funds

Give your portfolio the indexing advantage. If you're looking for a low-cost way to closely track the performance of particular market benchmarks, index funds may be appropriate for you. Vanguard advocates using index funds as the "core" of your investment portfolio. For many investors, it may even be possible to construct a soundly balanced portfolio that uses only index funds. In any case, at least 50% of your portfolio assets should probably be invested in index funds, with the remainder in a carefully chosen mix of actively managed funds, depending on your investment objective, time horizon, and risk tolerance.

This brochure explains several ways your portfolio can benefit from indexing and then introduces you to several Vanguard index funds that may help you meet your goals.

What is **indexing**?



Indexing is an investment approach that seeks to track the performance of a specific stock or bond benchmark, or index. Index funds do this by holding all (or a representative sample) of the securities in the index being tracked. This "passive" investment strategy emphasizes broad diversification, low portfolio trading activity, and low costs. No attempt is made to use "active" management strategies or to make "bets" on individual securities.

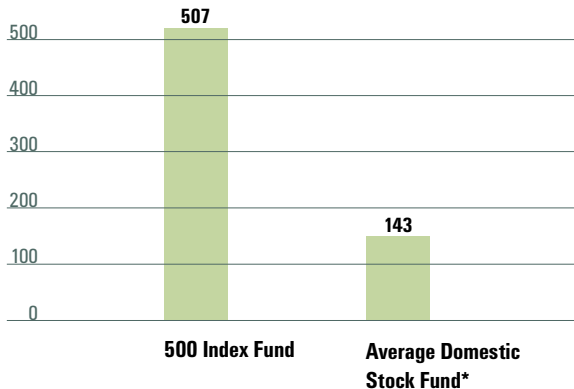
The benefits of indexing

Broad diversification. When it comes to diversification, it's difficult for actively managed funds to compete with index funds, because index funds generally hold most or all of the securities in their target indexes. In contrast, an actively managed fund typically holds a much smaller selection of securities that the adviser believes are likely to outperform its index. Index funds may hold hundreds or even thousands of securities; actively managed funds typically hold far fewer than that. Although the diversification provided by index funds cannot protect investors against broad market declines, it does reduce the risk posed by a dramatic decline in any one security or economic sector. (Of course, some index funds offer exposure to a broader range of securities than others due to the composition of their benchmarks.)

The chart below shows the magnitude of the difference in the number of securities held by Vanguard® 500 Index Fund and comparable actively managed domestic stock funds.

Number of securities held

As of 6/30/2001



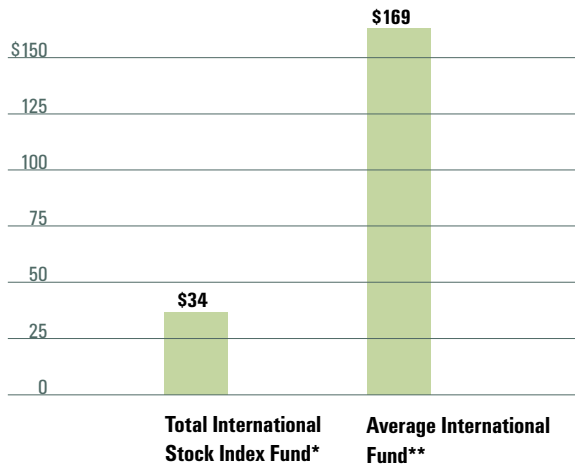
*Source: Morningstar.

Low costs. The expense ratios of index funds are typically much lower than those of their actively managed competitors. These low costs can provide a powerful long-term edge. Because index funds don't have to pay a fund adviser to analyze and select stocks, they can pass on a higher percentage of their investment returns to shareholders. Also, the buy-and-hold approach used by index funds leads to much lower transaction costs and generally higher tax efficiency.

For example, as the chart below shows, the 0.34% expense ratio of Vanguard® Total International Stock Index Fund is about *one-fifth* the 1.69% charged by the average international fund. That's a substantial difference that affects your bottom line.

The cost advantage of index funds

Amount deducted annually from a \$10,000 investment



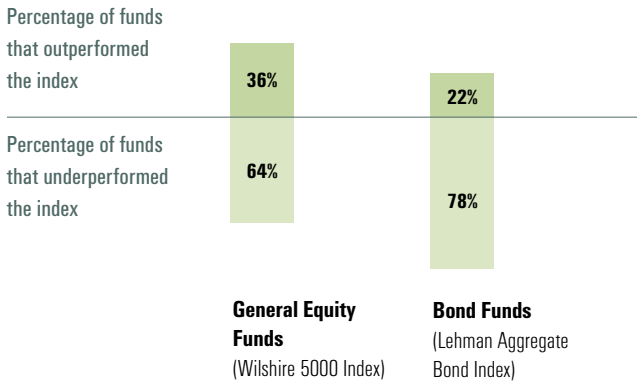
*Average weighted expense ratio based on expenses incurred by three underlying funds.

**Data as of December 31, 2000.

History of competitive performance. Thanks to their broad diversification and low costs, index funds have proved to be an effective way to achieve competitive returns over the long run (although past performance is no guarantee of future returns). In fact, the low costs associated with indexing can provide a powerful long-term edge for both stock and bond investments, as indicated below. The chart shows the percentage of stock and bond funds that underperformed and outperformed their respective indexes from 1981 to 2000.

Equity and bond fund performance versus their indexes*

1981-2000



*The returns of the indexes have been reduced by 0.82% and 0.42% per year, respectively, to reflect approximate index fund costs.

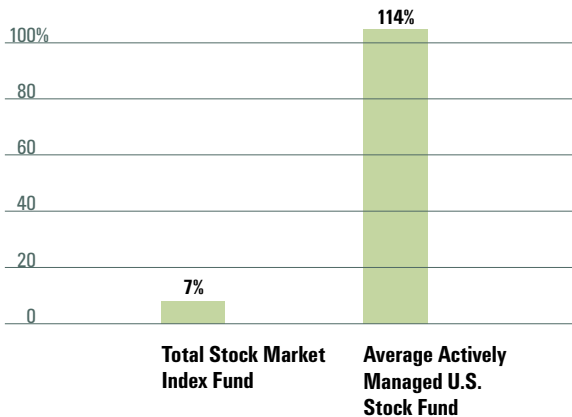
Simplicity. There's nothing complicated about index funds. They have a precise, easily understood objective—to track the performance of a specific stock or bond market index whose composition is always known. With index funds, you'll always know how your money is being invested.

Relative consistency. Any investment—including an index fund—carries uncertainty. However, since index funds closely follow the ups and downs of their respective indexes, they are more likely to provide returns consistent with those of their benchmarks than actively managed funds, whose returns are less predictable.

Tax advantages. Because index funds typically engage in much lower portfolio turnover than actively managed funds, most index funds tend to realize—and thus distribute—only modest capital gains to shareholders. This is particularly important for shareholders who hold index funds in taxable accounts.

The advantage of low turnover in index funds

Annual turnover rates, 2000



Traditional mutual fund managers typically buy and sell frequently, which can ultimately lead to increased portfolio costs that are passed along to shareholders.

What are the risks?

As with any bond or stock investment, index funds carry risks. Here is a closer look at some of the risks involved.

Prices can fall. Prices of bond, balanced, and stock index funds can decline for short or long periods due to investor pessimism, poor corporate profits, or other reasons, so it's possible to lose money if you sell shares when prices have fallen. If you're considering a small-cap stock index fund, note that prices of small-company stocks often fluctuate more significantly than those of large-company stocks. And if you're interested in international funds, keep in mind that international stock funds may fluctuate more than U.S. funds because of currency and political volatility.

Investors lose the opportunity to outperform the market.

Index funds attempt simply to track the performance of their respective benchmark as closely as possible, not outperform it. So it isn't possible to beat the market by investing in index funds, but remember that relatively few actively managed funds have been able to outperform index funds over long periods of time.

Why Vanguard index funds?

Not all index funds are the same. There are several reasons why you should consider Vanguard if you're looking for index funds.

Indexing pioneer. Vanguard was the first fund company to offer index funds for individual investors. We have been in the indexing business since 1976, and, with more than \$200 billion in index fund assets (as of March 31, 2001), are widely recognized as the world's largest manager of index funds for individual investors.

Largest selection of index funds. Since introducing Vanguard 500 Index Fund in 1976, we've added more than 20 low-cost stock, bond, and balanced index funds to our roster, making Vanguard the largest provider of index mutual funds in the industry.

Experience and tracking ability. The thorough knowledge of indexing that our Quantitative Equity Group and Fixed Income Group have achieved over 25 years has enabled us to develop strategies and proprietary methods that are more likely to deliver consistent and reliable results. Our sophisticated portfolio management tools help us keep costs low and seek to ensure that our index funds track their indexes more closely over both short- and long-term time periods than competitive index funds.

A broad selection of index funds to meet your goals

We're confident that Vanguard has one or more **index funds** to suit your investment objectives. The following pages describe some of the more than 20 Vanguard index funds **you might consider** for the core of your portfolio.

Total Stock Market Index Fund seeks to track the investment returns of the Wilshire 5000 Total Market Index, which includes virtually all regularly traded U.S. stocks. This fund offers a convenient way to match the performance of the entire domestic stock market.

500 Index Fund seeks to track the Standard & Poor's 500 Index, a widely used barometer of the performance of large-capitalization U.S. stocks. It enables investors to match the performance of a substantial portion of the largest domestic stocks.

Mid-Cap Index Fund seeks to track the investment results of the S&P MidCap 400 Index, which measures the performance of stocks of midsize companies. The fund is a convenient way to match the performance of companies that have market capitalizations of \$1.5 to \$12 billion.

Small-Cap Index Fund seeks to track the investment performance of the Russell 2000 Index, a barometer of the small-company segment of the stock market. It is ideal for investors who want to target U.S. companies that have an average market value of less than \$1.5 billion.

Total International Stock Index Fund seeks to track the Total International Composite Index, which measures the performance of nearly all markets outside the United States and Canada. This “fund of funds” invests in three Vanguard index funds—European Stock Index Fund, Pacific Stock Index Fund, and Emerging Markets Stock Index Fund—to gain broad exposure to stocks from 34 countries.

Developed Markets Index Fund seeks to track the Morgan Stanley Capital International (MSCI) Europe, Australasia, Far East (EAFE) Index. This fund of funds invests in the European Stock Index Fund and Pacific Stock Index Fund to gain wide-ranging exposure to stocks from 20 countries.

Total Bond Market Index Fund seeks to track the Lehman Aggregate Bond Index, a mix of corporate, government, and mortgage-backed bonds that represents the total universe of domestic, publicly traded, investment-grade bonds that have maturities of more than one year. It is suitable for investors who want to participate in the U.S. bond market as a whole.

Balanced Index Fund invests 60% of its assets in stocks that track the Wilshire 5000 Total Market Index (which represents the entire U.S. stock market) and 40% in bonds that track the Lehman Aggregate Bond Index. The fund offers broad diversification across the two asset classes.

Key fund facts

	Inception Date	Investment Focus	Benchmark	Number of Holdings*	Fund Expense Ratio**	Comparative Fund Expense Ratio***
Total Stock Market Index Fund†	April 27, 1992	Large-capitalization blend	Wilshire 5000 Total Market Index	3,443	0.20%	1.36%
500 Index Fund†	August 31, 1976	Large-capitalization blend	S&P 500 Index	507	0.18%	1.36%
Mid-Cap Index Fund	May 21, 1998	Mid-capitalization blend	S&P MidCap 400 Index	405	0.25%	1.43%
Small-Cap Index Fund†	September 3, 1960	Small-capitalization blend	Russell 2000 Index	2,190	0.27%	1.43%
Total International Stock Index Fund	April 29, 1996	International	Total International Composite Index††	1,365	0.34%†††	1.69%
Developed Markets Index Fund	May 8, 2000	International	MSCI EAFE Index	939	0.32%†††	1.69%
Total Bond Market Index Fund	December 11, 1986	Bonds	Lehman Aggregate Bond Index	790	0.22%	1.07%
Balanced Index Fund†	November 9, 1992	Balanced	Wilshire 5000 Total Market Index/Lehman Aggregate Bond Index	3,283 Stocks/ 485 Bonds	0.22%	1.29%

*As of 6/30/2001.

**For the fund's latest fiscal year.

***As of 12/31/2000.

†Also offers Admiral™ Shares, a lower-cost share class that offers lower expenses. There is a \$250,000 minimum initial investment.

††Consists of the MSCI EAFE Index plus the Select Emerging Markets Free Index.

†††Average weighted expense ratio based on expenses incurred by the underlying funds.

The minimum initial investment for all funds shown is \$3,000 (\$1,000 for IRAs and UGMA/UTMA accounts).

Each fund has a \$10 annual maintenance fee for accounts with balances of less than \$10,000. This fee, which is paid directly to the fund, more fairly allocates the cost of servicing these accounts.

Vanguard—a smart choice for index funds

In addition to the eight funds already described, to the right are several other Vanguard index funds. You can get more details about all of our funds by visiting our website, **Vanguard.com™**, or by calling us at **1-800-642-8999**.

Open your account online today

Once you've selected the funds that best meet your needs, you can open your account online using secure e-signature technology. Visit our website at www.vanguard.com/?invest to get started.

Other Vanguard index funds

Stock Funds (domestic)

Small-Cap Value Index Fund

Small-Cap Growth Fund

Value Index Fund

Growth Index Fund

Extended Market Index Fund

Calvert Social Index™ Fund

REIT Index Fund

Stock Funds (international)

Emerging Markets Stock
Index Fund

European Stock Index Fund

Pacific Stock Index Fund

Bond Funds

Short-Term Bond Index Fund

Intermediate-Term Bond
Index Fund

Long-Term Bond Index Fund



THE **Vanguard** GROUP

Post Office Box 2600
Valley Forge, PA 19482-2600

Calvert Social Index is a trademark of Calvert Group, Ltd.

Lehman Brothers® is a trademark of Lehman Brothers, Inc.

MSCI® and *EAFE*® are trademarks of Morgan Stanley Capital International Inc.

Russell 2000® is a trademark of Frank Russell Company.

Standard & Poor's®, *S&P*®, *S&P 500*®, *Standard & Poor's 500*, *500*, and *S&P MidCap 400* are trademarks of The McGraw-Hill Companies, Inc., and have been licensed for use by The Vanguard Group, Inc. Vanguard mutual funds are not sponsored, endorsed, sold, or promoted by Standard & Poor's, and

Standard & Poor's makes no representation regarding the advisability of investing in the funds.

Wilshire 5000® is a trademark of Wilshire Associates Incorporated.

All other marks are the exclusive property of The Vanguard Group.

Vanguard funds are offered by prospectus only. Prospectuses contain more complete information on risks, advisory fees, distribution charges, and other expenses and should be read carefully before you invest or send money. Prospectuses can be obtained directly from The Vanguard Group.

World Wide Web

www.vanguard.com

Toll-Free Information

1-800-642-8999

 Printed on recycled paper.

© 2001 The Vanguard Group, Inc.
All rights reserved.
Vanguard Marketing
Corporation, Distributor.

INXIV 072001