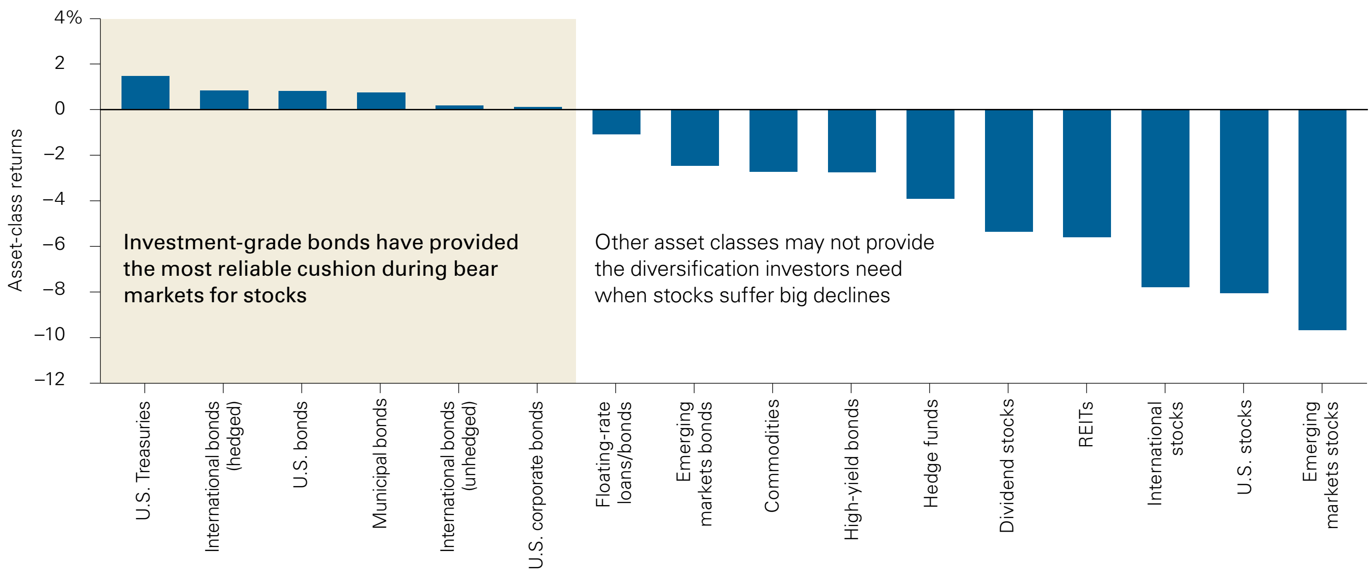
FIXED INCOME SERIES

Investment-grade bonds are among the best diversifiers of equity risk[1]

Average monthly asset-class returns during periods of bottom-decile returns for U.S. stocks, 1992–2012



1 Investment-grade bonds include U.S. Treasuries and other fixed income securities with a credit rating of Baa3 or higher by Moody's or a credit rating of BBB- or higher by Standard & Poor's or Fitch.

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. The data in the above chart represent monthly asset-class returns over 26 periods of bottom-decile performance for U.S. stocks from February 1992 through December 2012. (Bottom decile refers to periods when returns were among the bottom 10% for that asset class, in this case U.S. stocks.) U.S. stocks are represented by Dow Jones Wilshire 5000 Index through April 22, 2005 and MSCI US Broad Market Index thereafter; emerging markets stocks are represented by MSCI Emerging Markets Index; international stocks by MSCI EAFE Index; REITs by FTSE NAREIT Equity REITs Index; dividend stocks by Dow Jones U.S. Select Dividend Index; commodities by Dow Jones-UBS Commodity Index; high-yield bonds by Barclays U.S. Corporate High Yield Bond Index; emerging markets bonds by Barclays Emerging Markets USD Sovereign Bond Index; hedge funds by the median fund of hedge funds from Morningstar, Inc.; floating-rate bonds by Credit Suisse Leveraged Loan USD Index; investment-grade corporate bonds by Barclays U.S. Corporate Index; U.S. bonds by Barclays U.S. Aggregate Bond Index; U.S. Treasuries by Barclays U.S. Treasury Bond Index; international bonds (unhedged) by Barclays Global Aggregate ex-USD Bond Index and international bonds (hedged) by Barclays Global Aggregate ex-USD Bond Index. Dow Jones U.S. Select Dividend Index starts in January 1992, Barclays Emerging Markets USD Sovereign Bond Index starts in January 1993, hedge-fund data start in 1994, and Barclays Global Aggregate ex USD Bond Index starts in January 1990. For more information about this topic, see the Vanguard paper *Dynamic correlations: The implications for portfolio construction* (Philips, Walker, Kinniry, 2012).

Source: Vanguard calculations using data from Dow Jones, MSCI, FTSE, Credit Suisse, Barclays, and Morningstar.

- Many of the asset classes purchased to generate yield, such as high-yield or floating-rate bonds, behave more like equities than bonds during periods of equity market stress.
- As the chart shows, the lower the credit quality of the bonds, the more their returns correlate with those of stocks during bear markets, reducing their diversification benefit.
- Given current low yields, bonds may not provide the same level of returns and downside risk protection in a balanced portfolio as they have in the past, when higher yields provided a bigger buffer.

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All investing is subject to risk, including possible loss of principal.

Bond funds are subject to interest rate risk, which is the chance bond prices overall will decline because of rising interest rates, and credit risk, which is the chance a bond issuer will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. Investments in stocks and bonds issued by non-U.S. companies are subject to risks including country/regional risk and currency risk. Emerging markets stocks and bonds are subject to national and regional political and economic risks and to the risk of currency fluctuations. These risks are especially high in emerging markets. High-yield bonds generally have medium- and lower-range credit quality ratings and are therefore subject to a higher level of credit risk than bonds with higher credit quality ratings.

Diversification does not ensure a profit or protect against a loss.

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