Our enduring approach to selecting active managers

We’re actively different
Sophisticated investors around the world appreciate the difficulty of outperforming through active investing. At Vanguard, we believe that discipline, low costs and top talent are crucial, and that success is best measured over the long term.

That’s our approach with our own active management, and also when we hire sub-advisors for particular strategies. While we don’t manage day-to-day investing within our sub-advised funds, we hold our manager selection, oversight and retention processes to the high standards you’d expect from Vanguard.
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A global leader in active management

Vanguard’s history of active management goes back to our beginnings. When The Vanguard Group, Inc.—parent company of Vanguard Investments Canada Inc.—started operations in 1975, our entire lineup comprised 11 active funds.

More than four decades on, we’ve become one of the world’s largest active managers, with $1.6 trillion in active funds under management globally. That’s about one-quarter of our total $6.4 trillion in assets under management.¹

An ownership structure that benefits our fund investors

Vanguard’s ownership structure has been key to our success as an active manager.

We’re not publicly traded or owned by a small circle of individuals focused on their own interests. The Vanguard Group, Inc., is owned by its U.S.-domiciled funds and ETFs. Those funds, in turn, are owned by their investors. This unique mutual structure aligns our interests with those of our investors and drives the culture, philosophy and policies throughout the Vanguard organization worldwide. Because we have no competing loyalties, we make every decision with our clients’ needs in mind.

Comparing Vanguard’s ownership structure with the typical fund company

¹ Source: The Vanguard Group, Inc., as of March 31, 2018. Assets are in Canadian dollars.

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A history of competitive performance

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 U.S.-domiciled active funds outperforming their Lipper peer group averages

<table>
<thead>
<tr>
<th>Period</th>
<th>Equity funds</th>
<th>Balanced funds</th>
<th>Fixed income funds</th>
<th>Money market funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year</td>
<td>72%</td>
<td>76%</td>
<td>82%</td>
<td>100%</td>
</tr>
<tr>
<td>3 years</td>
<td>88%</td>
<td>90%</td>
<td>91%</td>
<td>100%</td>
</tr>
<tr>
<td>5 years</td>
<td>88%</td>
<td>86%</td>
<td>95%</td>
<td>100%</td>
</tr>
<tr>
<td>10 years</td>
<td>93%</td>
<td>94%</td>
<td>91%</td>
<td>100%</td>
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</table>

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 December 31, 2017.
Distinctive manager selection and oversight

Just as we seek discipline in our sub-advisors, we apply it ourselves when evaluating sub-advisors for hire and retention. We conduct an exhaustive, qualitative review of prospective sub-advisors, looking beyond their performance record to focus on the drivers of performance. We take the time that’s needed to identify managers we believe will add value for years or even decades to come.

That’s true whether we seek two or three managers with complementary styles for one mandate or a specifically skilled manager to whom we’d solely entrust a mandate.

What makes our manager selection and oversight process so distinctive?

**Freedom to do what’s best for clients**

Vanguard’s unique ownership structure allows us to focus on clients’ interests. This freedom to do what’s best for clients makes us an attractive partner for like-minded investment managers.

Because of our global scale and unique structure, we can continually lower costs to help investors earn more over time.

**A focus on drivers, not outcomes**

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 process 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.

Our evaluation of prospective sub-advisors begins years before we have a need for them.

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.

Such an approach allows for a day-to-day evaluation of current managers and a system for building a deep bench of potential managers.
CEO-led search and oversight focused on long-term drivers

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 sub-advisors 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 sub-advisor. Twice a year it strategically assesses the fund lineup. Final hire and fire decisions are made by The Vanguard Group’s board of directors, of which the CEO is a member.

Hire and fire decisions are difficult and subjective. We don’t take them lightly and we recognize that even the best managers can have periods of underperformance. 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.

Integrated, multi-level manager search and fund oversight

<table>
<thead>
<tr>
<th>Portfolio Review Department</th>
<th>Full-time responsibility for fund oversight and manager search</th>
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<tbody>
<tr>
<td></td>
<td>• Monthly formal evaluation of drivers and outcomes for each manager</td>
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<tr>
<td></td>
<td>• Ongoing interactions, including conference calls and site visits, with current managers</td>
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<tr>
<td></td>
<td>• More than 200 meetings with potential managers each year</td>
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<table>
<thead>
<tr>
<th>Global Investment Committee</th>
<th>Ongoing fund oversight and decision-making (senior management panel led by The Vanguard Group CEO)</th>
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<tbody>
<tr>
<td></td>
<td>• Annual meeting with each manager</td>
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<tr>
<td></td>
<td>• Semiannual strategic assessment of fund lineup</td>
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<td></td>
<td>• Frequent communication with Portfolio Review Department</td>
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<tr>
<th>Board of Directors</th>
<th>Final approval of decisions about funds and advisors</th>
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<tbody>
<tr>
<td></td>
<td>• Seven board meetings each year</td>
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<td></td>
<td>• Meets with internal and external managers</td>
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A philosophy that employs managers based upon the nature of the assignment

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

Where we would employ a single sub-advisor for a fund, we would select a firm with which we had partnered over a long period and/or one with skill in a specialty investment strategy. Having a single sub-advisor naturally increases business risk, so we choose only those partners we’ve come to know best.

Where we would employ two or three managers for a fund, we would seek complementary investment styles—generally within broad style categories such as value or growth—with an eye towards mitigating volatility while preserving the potential for long-term outperformance.

One of the many characteristics we consider for multi-advisor funds is the correlation of the sub-advisors’ projected excess returns. If each sub-advisor plays its defined role, we should be able to deliver low correlation across sub-portfolios, potentially reducing the overall volatility of the fund.

Loyal relationships with talented managers

When we hire sub-advisors, 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 sub-advisors. We appreciate that active investing is challenging, that styles go in and out of favour and that underperformance will occur. More important than performance itself 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.

An exhaustive approach to manager search

<table>
<thead>
<tr>
<th>Manager idea sources</th>
<th>Portfolio Review Department actions</th>
<th>Global Investment Committee actions</th>
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</thead>
<tbody>
<tr>
<td>Industry conferences and publications</td>
<td>List of reasonable managers</td>
<td></td>
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<tr>
<td>Manager databases</td>
<td>Analyst tiering of managers</td>
<td></td>
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<tr>
<td>Incoming calls</td>
<td>Manager review in research meeting</td>
<td></td>
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<tr>
<td>Competitor lineup reviews</td>
<td>PRD principal due diligence</td>
<td></td>
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<tr>
<td>Existing managers</td>
<td>Manager presents to GIC</td>
<td>Negotiate fees</td>
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<tr>
<td></td>
<td>Board approval</td>
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Source: Vanguard, as of December 31, 2017.

Vanguard’s active equity sub-advisors have an average tenure of 14 years.2

2 Source: Vanguard, as of December 31, 2017.

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Sub-advisors: What we seek

When we search for sub-advisors, 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 judgment 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.

A steady, motivated, highly ethical firm

Our multiple interactions with sub-advisors and prospective sub-advisors give us a first-hand view of the firms’ culture and ethics. Do strong ethics come from the top of the organization? Are they shared throughout the investment team and the whole firm? Getting the culture and ethics right is critical to an organization’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 quality, not short-term performance

<table>
<thead>
<tr>
<th>Drivers</th>
<th>Outcomes</th>
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<tr>
<td>Firm</td>
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<tr>
<td>• Ethics</td>
<td>• Clear reflection of philosophy and process</td>
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<tr>
<td>• Stability</td>
<td>• Characteristics consistent with expectations</td>
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<tr>
<td>• Ownership structure</td>
<td>• Risk profile aligned with the investment strategy</td>
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<tr>
<td>• Account and asset trends</td>
<td></td>
</tr>
<tr>
<td>• Diverse client base</td>
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<tr>
<td>• Incentives</td>
<td></td>
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<tr>
<td>People</td>
<td></td>
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<tr>
<td>• Deep investment team</td>
<td>• Long-term history of competitive results compared with benchmarks and peers</td>
</tr>
<tr>
<td>• Succession/contingency</td>
<td>• Performance consistent with investment approach</td>
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<tr>
<td>• Limited turnover of key professionals</td>
<td></td>
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<tr>
<td>• Tenure and experience</td>
<td></td>
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<tr>
<td>• Proven expertise in subject matter</td>
<td></td>
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<tr>
<td>• Demonstrated ability to handle large mandates</td>
<td></td>
</tr>
<tr>
<td>Philosophy</td>
<td></td>
</tr>
<tr>
<td>• Shared by investment professionals</td>
<td></td>
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<tr>
<td>• Enduring</td>
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<tr>
<td>• Easily articulated</td>
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<tr>
<td>Process</td>
<td></td>
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<tr>
<td>• Understandable</td>
<td></td>
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<tr>
<td>• Stable/proven</td>
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<tr>
<td>• Repeatable</td>
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</table>
We look for a firm with a steady to growing client base. Rapid asset growth or decline can destabilize 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.

An emphasis on people, not just numbers

We seek experienced, confident, passionate investment managers as our partners. They have 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 among team members. We’d be wary of a firm with a star portfolio manager almost entirely responsible for the investment strategy’s 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.
A core philosophy about adding 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, and 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 minimize the potential for regulatory errors and fraud.

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

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 sub-advisors.

Firms should have a culture of ethical stewardship, with senior leadership setting the tone.
A deeper inspection: Aligning drivers with outcomes

To assess whether a manager is likely to generate value as intended requires a close inspection of performance attribution. A quantitative analysis of what specifically generated a manager’s returns will help us evaluate vital qualitative aspects of 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
Analyzing 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 sub-advisor’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 penalized 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.
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 sub-advisor’s premises. We meet not only with portfolio managers and analysts, but also with compliance and risk-mitigation personnel.

We don’t take lightly any decision to terminate a relationship with a sub-advisor. We don’t have automatic sell criteria, and 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 also consider the manager’s role in the overall portfolio when more than one manager is involved with the mandate. If we don’t have enough conviction in a manager to increase the manager’s allocation from a low level, we might instead choose to end the relationship.

Sometimes, parting ways with a sub-advisor is in the best long-term interest of Vanguard clients. But we enter every relationship with a sub-advisor expecting it to endure and be mutually beneficial.
A final word about Vanguard

We believe investment companies should make money for investors, not from them. We’re committed to keeping costs low, 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 do just that. And the more returns investors keep, the more they can earn over time.
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