

EXPECT THE UNEXPECTED: REFLECTING ON A TUMULTUOUS PERIOD

Vanguard | 08/05/2011

On August 2, Congress approved an increase in the federal debt ceiling, turning down the pressure—temporarily, at least—on the debate over U.S. fiscal policy. We asked **Vanguard CEO Bill McNabb** to reflect on recent events and offer some guidance for anxious investors.

This has been an interesting year for investors—and that's putting it gently. As you look back on the last few months, what lessons have we learned?

One thing that really stands out is the utter unpredictability of events, both in the world at large and in the financial markets. For example, no one could have foreseen the terrible disasters that hit Japan or the outbreak of political instability in the Middle East. Even the European debt crisis and the debate over the debt ceiling in the United States haven't unfolded precisely as anyone might have anticipated.

What this tells us as investors is that we always need to expect the unexpected. My colleague Joe Davis, who is Vanguard's chief economist, likes to say that it's important to "treat the future with the humility it deserves." In other words, predictions aren't particularly useful when making investment decisions. I think we're better off relying on experience and solid principles that have stood the test of time.

Given the uncertain outlook, should investors make changes to their portfolios?

Clients sometimes get tired of hearing us tell them to "stay the course," especially during periods of volatility and uncertainty, but history doesn't lie. Sticking with a sound long-term investment plan—a plan that's tailored to your personal goals, time frame, and willingness to bear market risk; a plan that includes the appropriate asset allocation and broad diversification—has generally proven to be the best course of action, regardless of what's happening in the markets.

This was also Vanguard's message during the bear market of 2000–2001, and investors who listened to us back then were, by and large, happy they did so once the markets rebounded. It was our message during the trauma of 2008–2009—and again, investors who were cautious and stayed true to their long-term strategies tended to fare better than investors who panicked and altered course. Consistency may not be exciting, but experience tells us it's smarter than constantly shifting your strategy based on the latest market trends.

Note: Past performance is not a guarantee of future results, and diversification does not ensure a profit or protect against a loss in a declining market.

Markets were rattled by the debt ceiling debate. Shouldn't we be concerned?

Concerned? Perhaps. Surprised? No. I think there's a case to be made that the stock market has actually held up fairly well this summer amid the drama in Washington. When you look at what was at stake, things could have been significantly worse.

That's not to say we're in the clear. The markets are rightly apprehensive about the federal debt and budget deficits, about the continuing solvency crisis in Europe, and about the deteriorating fiscal situation in Japan. Governments here and overseas need to get their finances in order, and they need to do it sooner rather than later. We at Vanguard have been very insistent about that.

Once the markets are confident that credible long-term debt strategies are in place in the United States, Europe, and Japan, I think we'll see things begin to settle down a bit in the equity markets, and investors will be able to focus once again on the things that have always mattered most, such as corporate profitability and



economic growth.

Are you concerned about the possibility of a "double dip" recession or a new bear market?

That's always a possibility—always. But to be fair, people were asking me that same question at the beginning of 2011, and we went on to witness several months of very healthy stock performance. At this particular moment, major U.S. stock indexes are in or near negative territory for the year, but that could change almost overnight. Again, we have to expect the unexpected.

For the past year or so, Vanguard's outlook for the U.S. economy has been cautiously optimistic. It remains so today, though now we're more cautious than optimistic, given the weak economic data that have been released in the past two months. But as far as the stock market is concerned, I'm encouraged by the fact that corporate profits are currently strong and valuations are reasonable. Of course, over the short term we know the market can be quite volatile, particularly while Congress is still debating how to deal with our massive budget deficits. But there are plenty of other indicators that give me reason to remain bullish about long-term performance. The U.S. economy remains the largest, most flexible, most liquid, and most productive in the world. I'm convinced that will remain the case for the foreseeable future.

Notes:

All investments are subject to risk.
Past performance is not a guarantee of future results.