

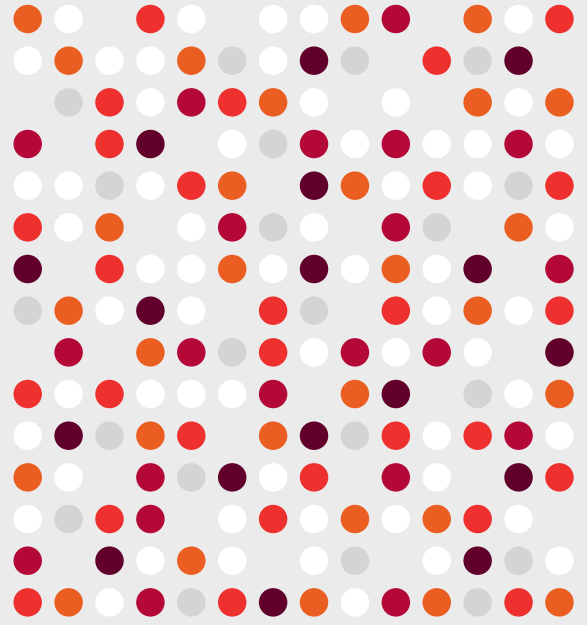
Vanguard®

Vanguard ETF quarterly report

December quarter 2018

In this edition:

- ETFs have their second largest year of cash inflows
- Fixed interest was the best performing asset class in 2018
- Investors diversify portfolios into fixed interest and international equities



Quarterly market review

After a strong September quarter, broad equity markets reversed course and posted correction-worthy negative returns; while fixed interest markets benefitted from investors shifting into less risky assets. For Australian investors, the last quarter of 2018 undid most of the spectacular growth seen in Australian and international shares over the year. Elevated volatility in financial markets returned yet again. While unsettling for investors who have grown accustomed to placid markets and stellar returns, it's important to understand that these episodes are more consistent with the long-term average level of volatility for equities.

There was no shortage of explanations for the market's volatility in the fourth quarter—building anxiety around US-China trade negotiations, a hawkish Federal Reserve, a record-setting US government shutdown—if something seemed bearish, it was offered as a possible cause. In reality, a key driver of the volatility was that investors reacted negatively to anything and everything that sounded like bad news for the economy. More bad news exacerbates the situation by motivating the sell orders that create negative returns.

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ETF trading

The Australian ETF market attracted \$1.9 billion in Q4 2018, pushing the full year's inflows to \$6.4 billion, making it the second biggest year in cash flows (behind the \$8.1 billion received in 2017). The final quarter saw the return of some home country bias, with Australian equities receiving 37% of cash flows. However on an annual basis international equities received just under half of the new cash flows, and for the first time ever fixed interest ETFs attracted more money than Australian equity ETFs.

\$1.9B

ETF new cash flows
for the quarter

The outperformance of the fixed interest asset class has caught many by surprise given the expectations at the beginning of 2018 (for interest rates and inflation to rise globally). The fact that fixed interest was the best performing asset class in 2018, highlights the importance of maintaining long term portfolio diversification across all market cycles.

Pleasingly, investors are embracing the benefits of fixed interest with 23% of cash flows invested into the asset class over the year, up from 17% in 2017.

International equities had a reduced level of inflows in the fourth quarter, however it was still comfortably the most sought after asset class in 2018. Within the asset class investors are preferring to diversify their exposure into broad market products. Vanguard's VGS (All world ex-Australia) and VEU (All world ex-US) received the most cash flows within the asset class.

From an issuer perspective, Vanguard received the most cash flows in 2018, with 42% of total cash flows being invested in Vanguard's ETFs. Across Vanguard's product suite, the largest cash flows went to VAS (Australian equities), followed by the international equity ETFs VGS and VEU. Vanguard has finished 2018 as the leading provider of ETFs in Australia, with assets under management of \$12.1 billion.

Industry cash flow by asset class

Asset class	Quarter		YTD	
	(\$m)	%	(\$m)	%
Australian Equity	702	36.6	1,278	20.0
Global Equity	605	31.6	3,152	49.3
Infrastructure	48	2.5	127	2.0
Australian Fixed Income	436	22.8	1,189	18.6
Global Fixed Income	53	2.8	281	4.4
Australian Property	47	2.4	107	1.7
Global Property	6	0.3	61	1.0
Commodity	43	2.3	107	1.7
Currency	-102	-5.3	-183	-2.9
Mixed	78	4.1	282	4.4
TOTAL	1,915		6,400	

Source: ASX Monthly Report and Vanguard.

YTD cash flow and AUM by issuer

Issuer	Cash flow \$m	Cash flow %	AUM \$m
AMP/BetaShares	0.4	0.0	66.8
Beta Shares	1,180.7	18.4	5,508.4
ETFS	239.8	3.7	1,126.3
Fidelity	11.3	0.2	11.3
InvestSMART	41.2	0.6	37.3
iShares	643.1	10.0	10,713.1
K2	2.2	0.0	32.7
Legg Mason/BetaShares	65.9	1.0	64.9
Magellan	213.7	3.3	1,439.6
Montgomery	25.8	0.4	82.6
Perennial	22.8	0.4	21.1
Antipodes	19.6	0.3	19.1
Russell	74.0	1.2	656.5
Schroders	12.5	0.2	55.6
State Street	8.6	0.1	5,382.6
Switzer	55.2	0.9	119.7
The Perth Mint	37.5	0.6	167.2
Platinum	317.1	5.0	437.1
UBS	-3.1	0.0	253.3
VanEck	759.5	11.9	2,136.0
Vanguard	2,678.9	42.0	12,078.3
Total	6,406.6		40,409.5

Source: ASX Monthly Report and Vanguard.

2019: Down but not out

Economic and market outlook

For 2019 we expect growth in all major economies to decelerate relative to 2018. We anticipate Australian GDP to hover between 2% and 3% and US GDP to converge to 2%. These forecasts seem below trend but are actually in line with both economies' potential output. Investors risk over-reacting to this expected slowdown, as the slope of the US yield curve (the difference between the current yields of 10-year and 3-month Treasury bonds) nears 'inversion'. A recession warning is triggered when the 3-month yield curve is greater than the 10-year yield. While some investors are worried that a 'global recession' could start in the US and ripple through other economies, according to our analysis most fundamentals of the US economy are not flashing warning signals. In short, economic growth should shift down but not out. We expect the Federal Reserve to make a single short-term interest rate increase in 2019.

We should expect the unexpected in financial markets. Volatility arises because investments are inherently risky and perform in ways we cannot anticipate. Remarking that 'this time is different' can lead investors to chase returns and time markets at the expense of long-term performance. Establishing a plan and a diversified, strategic asset allocation that reflects investors' comfort levels with changable market conditions could be the difference between staying on target towards their long-term goals and veering well off-course through a change that soothes their emotions.

While the start of a new calendar year is a great time for investors to review their portfolio, they should avoid the temptation to make wholesale changes to their asset allocation based on the latest market and economic news. The New Year is, however an opportune time for investors to review their long-term goals and ensure their asset allocation is still aligned to their objectives.

Portfolio Allocations

One thing we know is that you can't control investment markets. Volatility is part of investing. What investors can control is their investment strategy—having the framework in place to give them the best chance of meeting their goals and objectives and aligning investments to their risk profile.

At the start of 2018, the generally accepted expectation by market commentators was that globally, both inflation and interest rates were going to rise. This backdrop can present short term challenges and medium term opportunities for fixed interest. If investors needed exposure to the asset class, advice from some quarters was to consider shortening duration or switching to floating rate investments. Fast forward 12 months and the Australian Government Bond ETFs were the best performers within the asset class, and they were amongst the best performers overall in 2018.

The final quarter of 2018 was a reminder of the importance of maintaining exposure to fixed income in the portfolio. Whilst

many broad market equity strategies (domestic and international) had double digit falls, Vanguard's range of domestic fixed income products were able to offset some of these falls delivering quarterly returns of +2.5% (VGB), +2.2% (VAF) and +1.4% (VACF).

Vanguard's range of fixed interest ETFs offer investors exposure to diversified benchmarks, which contain the largest number of holdings of all the comparable offerings in the market. In the case of the Vanguard Australian Corporate Fixed Interest ETF (VACF), the portfolio has exposure to 373 holdings across 153 issuers. This type of diversification is not a feature of other strategies in the market such as floating rate products, which primarily offer exposure to financial institutions.

The benefits of holding fixed interest securities as part of a balanced portfolio are timeless. When held in a diversified form across a variety of maturity dates and investment grade issuers, fixed income asset class returns provide a narrower, less volatile range of investment outcomes than equities.



Whitepaper:

Vanguard 2019 economic and market outlook: Down but not out

In its annual global economic and market outlook, Vanguard outlines its expectations for growth, inflation, monetary policy, and more.

You can download a copy of the report at this link:

<https://www.vanguardinvestments.com.au/adviser/adv/articles/insights/research-commentary/markets-and-economy/2019-economic-market-outlook-report.jsp>

Vanguard product summary

	ASX Ticker	Last Price#	MER	Quarter Return	1 Year Return	3 Year Return (p.a.)	Quarterly Cash Flow (\$m)	FUM (\$m)
Australian Equity ETFs								
Broad Market	VAS	\$72.13	0.14%	-8.42%	-3.18%	6.51%	\$396.4	\$3,086.3
Property	VAP	\$79.74	0.23%	-1.66%	3.11%	7.50%	\$17.6	\$1,108.0
High Yield	VHY	\$53.00	0.25%	-8.40%	-7.52%	4.04%	\$58.3	\$1,017.7
Large Companies	VLC	\$58.77	0.20%	-5.88%	-1.44%	5.36%	\$17.6	\$77.2
Small Companies	VSO	\$51.00	0.30%	-12.40%	-7.53%	8.20%	\$11.6	\$201.5
International Equity ETFs								
Developed Markets	VGS	\$64.85	0.18%	-11.08%	1.58%	7.57%	\$137.1	\$1,261.1
Developed (AUD hedged)	VGAD	\$59.17	0.21%	-13.58%	-7.55%	6.96%	\$58.9	\$443.5
All world Ex US	VEU	\$64.81	0.11%	-8.94%	-4.42%	5.84%	\$34.0	\$1,236.7
Total US Market	VTS	\$180.79	0.04%	-11.86%	5.40%	10.20%	\$18.8	\$1,319.9
Developed Europe	VEQ	\$49.92	0.35%	-10.86%	-6.20%	2.90%	\$10.8	\$200.9
Asia ex Japan	VAE	\$60.70	0.40%	-5.92%	-5.10%	8.90%	\$8.4	\$113.2
Emerging Markets	VGE	\$61.39	0.48%	-4.01%	-5.99%	8.34%	\$12.8	\$234.0
ESG	VESG	\$44.30	0.18%	-10.58%	n/a	n/a	\$2.5	\$3.3
Global Infrastructure	VBLD	\$48.80	0.47%	n/a	n/a	n/a	\$2.5	\$2.4
International Small Companies	VISM	\$45.47	0.32%	n/a	n/a	n/a	\$1.9	\$1.8
Minimum Volatility - Active	VMIN	\$49.39	0.28%	-7.34%	n/a	n/a	\$3.2	\$8.6
Global Value - Active	VVLU	\$43.10	0.28%	-15.16%	n/a	n/a	\$1.9	\$11.0
Fixed Income ETFs								
Australian Composite	VAF	\$49.64	0.20%	2.20%	4.35%	3.54%	\$39.9	\$771.6
Australian Government	VGB	\$50.06	0.20%	2.45%	4.60%	3.48%	\$17.7	\$167.0
Australian Corporate	VACF	\$51.08	0.26%	1.43%	3.75%	n/a	\$18.6	\$171.0
International Composite (AUD hedged)	VIF	\$48.60	0.20%	2.26%	2.53%	3.34%	\$16.1	\$238.6
International Credit (AUD hedged)	VCF	\$46.99	0.30%	0.42%	-0.27%	3.64%	-\$16.9	\$83.8
Global Aggregate (AUD hedged)	VBND	\$50.23	0.20%	1.61%	1.38%	n/a	\$12.0	\$40.9
ESG	VEFI	\$50.80	0.26%	1.73%	n/a	n/a	\$0.0	\$1.0
Diversified ETFs								
Conservative	VDGO	\$50.03	0.27%	-2.10%	0.76%	n/a	\$9.5	\$25.3
Balanced	VDDBA	\$49.68	0.27%	-4.43%	-0.15%	n/a	\$16.6	\$64.4
Growth	VDGR	\$49.20	0.27%	-6.86%	-1.14%	n/a	\$21.5	\$74.7
High Growth	VDHG	\$48.45	0.27%	-9.26%	-2.18%	n/a	\$30.0	\$112.8
TOTAL							\$959.2	\$12,078.3

Returns assume that an investor purchased shares at Net Asset Value and does not reflect transaction costs imposed on the creation and redemption of ETF units, the brokerage or the bid ask spread that investors pay to buy and sell ETF securities on the Australian Securities Exchange. Total returns are after management costs.
Source: Vanguard and Bloomberg.

For more information

Personal investors can transact in Vanguard ETFs through their financial adviser or stockbroker.
Our telephone service is available from 8am to 5pm, Monday-Friday AEST.

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