

Wide International Value Horizons

With approximately 220 stocks from around the globe, Vanguard International Value represents a broadly diversified international investment. The fund's investable universe consists of 10,000 stocks from anywhere but the U.S., and as if this diversification wasn't enough, Vanguard has chosen to work with three separate managers. But both of the managers share the belief that international value investing requires a thorough understanding of the handpicked companies.

Q: How would you describe the investment philosophy of your fund?

A: We believe that the multi-manager structure provides investors with diversity of thought and diversity of the portfolio. Vanguard International Value Fund features three investment advisors that employ a bottom-up strategy to construct a portfolio of undervalued stocks in developed and emerging markets.

The managers are Sanford C. Bernstein & Co., LLC, a unit of Alliance Bernstein, LP; and Hansberger Global Investors, Inc, and Lazard Asset Management. Currently, Bernstein and Hansberger oversee approximately 45% of fund assets, while Lazard, who joined the fund's management team in July of this year, manages about 10%.

Hansberger's investment process is driven by fundamental company research. The managers seek to add value by selecting one stock at a time, looking for industry leaders with a sustainable competitive advantage. They believe that stock picking in the international arena requires a comprehensive understanding of a company's operations, the metrics that define good businesses, as well as an awareness of sector opportunities and country nuances.

Hansberger is much less concerned with share price movements and market trends than with the inherent value of stable companies, strong products, and sound management. They concentrate on the underlying economic and business fundamentals of each investment.

Bernstein's investment philosophy is research-driven and value-based; they seek to buy the greatest amount of long-term earnings for the best price. Investors often overreact to near term events, causing securities to become mispriced relative to their true values or long-term earnings prospects. Bernstein attempts to separate fact from emotion in understanding companies and industries that may be undergoing stress, and looks to exploit mispricings created by investor overreaction.

Lazard's investment process employs a relative value approach that seeks an appropriate trade-off between low relative valuation and high financial productivity of individual securities. The portfolio management team uses Return on Equity ("ROE") as the primary measure of financial productivity, while secondary measures include Return on Assets ("ROA"), cash ROE, and operating margin. Lazard's research analysts take a global sector approach to stock selection that generally supersedes country and regional boundaries. Sector weights can differ meaningfully from the benchmark because the investment process is research-driven, relying on bottom-up stock analysis. Lazard's strategy uses a concentrated approach by targeting 30 to 50 international stocks.

Q: What is your definition of international? Are all the holdings outside the U.S.?

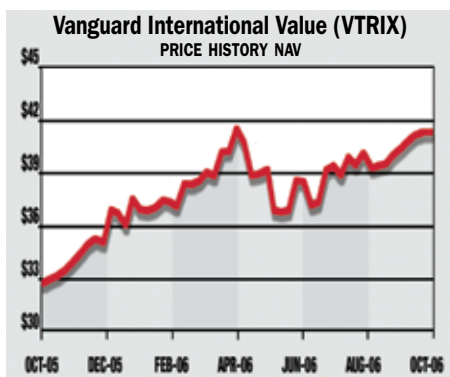
A: Correct. The fund invests in companies of all market caps located primarily in developed- markets but also in emerging



JOSEPH BRENNAN is a Principal and head of Vanguard's Portfolio Review Group. Brennan and the team of analysts he leads are responsible for overseeing the performance and monitoring of Vanguard's funds and advisers on an ongoing basis. The Portfolio Review Group is also responsible for new fund development and manager search efforts.

Brennan and his team work closely with Vanguard International Value Fund's advisors, Sanford C. Bernstein & Co., LLC, a unit of Alliance Bernstein, LP; Hansberger Global Investors, Inc.; and Lazard Asset Management LLC.

“Vanguard’s International Value Fund offers broadly diversified exposure to companies outside the United States. The fund’s investment advisors employ fundamental research to construct portfolios of undervalued stocks in developed and emerging markets.”



markets in Eastern and Western Europe, the Far East, Latin America, and Canada.

Q: How would you define your universe? How many stocks belong to it?

A: Broadly, the universe of potential investments consists of all stocks outside the United States. Hansberger selects securities from a global universe of more than 10,000 companies in more than 50 different countries. Bernstein looks for companies in developed markets with market cap of more than \$750 million and for companies in emerging markets with market cap of above \$75 million. The investable universe for Lazard includes companies with a market capitalization of \$3 billion or greater domiciled in those countries that make up the MSCI ACWI ex-U.S. Index.

Security liquidity is an important consideration in all three advisors' investment decisions. Before they invest, they evaluate each market's liquidity based upon its investable market cap, the breadth, depth and number of investable companies, trading volumes, transaction costs, settlement costs and bid/ask spreads.

Q: In terms of portfolio construction, what benchmarks do you use? Are there specific areas or sectors where the fund is more concentrated?

A: The fund typically holds about 200 stocks. The benchmark is the Morgan Stanley Capital International (MSCI) Europe, Australasia, Far East (EAFE) Index. Although the fund is not intended to mirror any specific index, the advisors use this benchmark, as well as the MSCI All Country World ex U.S. Index, when constructing their portfolios.

Currently, the largest concentration of the fund is in Japan, with 21.3% of the as-

sets, UK with about 21%, and France with 12%.

Sectorwise, the fund currently invests about 30% of its assets in the financial sector, about 12% in energy, and about 11% in consumer discretionary.

Q: Screening a universe of 10,000 stocks seems like a serious task. Would you explain how the managers narrow that list down? What parameters do you monitor and why?

A: Since Hansberger is driven by fundamental research, it has four offices around the globe and its analysts perform about 1,400 company visits annually. The analysts focus on the companies they believe to be undervalued relative to their normalized earnings power over a full economic cycle, or to their NAV.

Investment decision-making is centralized in the main office in Florida, but they have a team approach with each office and analyst being responsible for specific country and industry assignments. Stocks that meet Hansberger's valuation criteria are reviewed by fellow analysts, the chief investment officer, and the portfolio managers. The peer review process involves the entire investment team. Each security is discussed to ensure that it fits in with the firm's philosophy and to quantify the reasons and the time horizon for the investment. A prime consideration is to determine fundamental issues that could prompt revaluation of buy candidates.

For Bernstein the process starts with a broad universe of all the companies in developed and emerging markets outside the U.S. They screen this universe with a proprietary quantitative return model to pinpoint the companies with the most attractive valuation and success attributes. The model derives an expected return for all companies on a daily basis, considering them both from a global industry-based perspective and a country-based standpoint. The model includes valuation factors like price/cash earnings and price/book value, as well as success factors like return on equity and price momentum. The most attractively ranked stocks are then subject to fundamental research by company and industry analysts.

Then the analysts create forecasts of earnings, balance sheet strength, and cash flows for the next 3 to 5 years. They present their estimates and views to a group of senior investment professionals, typically the chief investment officers and directors of research. This review process challenges the analyst's assumptions and conclusions to make sure that they are consistent, insightful, and robust. Once the group has identified the stocks with high-quality expected returns and attractive business prospects, the firm's Investment Policy Group selects stocks for the portfolio.

Lazard's relative value investment philosophy is based on bottom-up stock selection. The firm assesses the trade-off between valuation and financial productivity for an individual security. Lazard believes financial productivity determines appropriate valuations; therefore assessing a company's financial productivity is an important part of the firm's research process. Lazard's analysts, organized into sector teams, seek to provide a global perspective on companies, conforming to Lazard's belief that where and how a company does business is more important than where it is domiciled.

This bottom-up research process is the key driver of value-added and country or regional allocations are an outcome of this stock selection process. Companies are evaluated by comparing a company's ability to generate a return on capital with its valuation. Research is conducted to identify the appropriate measures for financial productivity and valuation in each industry, focusing on measures as previously discussed, that have successfully predicted outperformance in the past.

Q: What would be a reason to sell a stock?

A: Each advisor maintains a systematic sell discipline. At Hansberger, shares are sold if the price rises to a specific sell target, if share fundamentals deteriorate, if there is a loss of confidence in management, or if superior alternatives are found. Bernstein's sales are also initiated when a stock has appreciated to their forecast of fair value or when the company's fundamentals or business prospects deteriorate to the point of changing their conviction in the stock.

Q: What is the turnover of the fund?

A: It is very low relative to the peers. Over the past five years, the fund had an average turnover rate of about 31%.

Q: What major risks do you or the managers perceive? How do they measure, monitor, and control them?

A: The risks include currency risk, investment style risk, country risk, and manager risk. Given that the returns of international stocks include both the equity performance and the currency effect versus the U.S. dollar, the performance of Vanguard International Value Fund, by any measure, may be quite volatile.

Each of the managers has a different approach to risk management. Hansberger has organized the portfolio construction to best reflect the individual stock ideas generated by the fundamental research. As they monitor their activities, stock selection is the primary factor of performance. Although they are aware of the index composition, the index is not a primary driver of country or sector allocations.

However, Hansberger is keenly aware of the index risk generated by their bottom-up stock selection. They monitor country differences and compare regional allocations. These include Europe ex-UK, United Kingdom, Japan and others. Allocations outside the range of 70% to 130% to these major regions would prompt a discussion between the portfolio team and the policy committee for possible remedies. Sector allocations have greater range possibilities relative to the benchmark, or a minimum of 50% and a maximum of 150%.

Bernstein only takes risk when they believe they are being paid to do so. They employ a risk model that disassembles the risk of each security into different components, including global equity, country, industry, local industry, and company-specific risks. This allows them not only to estimate the risk of every security in their universe, but also its correlation to other securities. Therefore, they can use these risk estimates to forecast the volatility and the tracking error in the portfolio and this information is incorporated in the portfolio construction process. In addition, Bernstein uses proprietary attribution tools to evaluate the effective-

ness of their security selection, the impact of their country over- or underweights and the currency exposure. The Investment Policy Group looks at both short and long-term results of the performance attribution in order to clearly understand the sources of risk and return.

Though industry, sector and country weights are a by-product of Lazard's fundamental, bottom-up analysis, Lazard continually monitors these exposures to gauge the risk in the portfolio. To manage these risks, portfolio management teams rely on quantitative processes to gain insight. Optimization programs (such as BARRA Aegis and Northfield Optimizer) are utilized by Lazard to monitor exposure to various measures of risk including: industries, sectors, countries, and style characteristics (such as large or small cap bias). Individual security exposure is also limited to control risk and maintain liquidity.

Q: Could you give us some examples of successful stock picks based on your research process? Have you had disappointments with certain equities?

A: In the past year, our holdings in energy and financials added significant value. In addition, emerging markets exposure remained a key driver in the period as Brazil, China, and Russia contributed significantly to both absolute and relative results. However, the fund's South Korean holdings detracted from relative results despite a 4.5% advance in the period.

Among the largest contributors to the fund's performance in the first quarter of 2006 were Brazil's Petróleo Brasileiro and Russia's OAO Lukoil. Yanzhou Coal Mining, another large holding, also performed well.

Within financials, first-quarter performance was aided by positions taken in bank and insurance companies based in emerging markets such as China, Korea, Hong Kong, and Brazil. Even the fund's successful holdings in developed markets tended toward companies with substantial dealings in emerging countries, including the Dutch bank ABN-AMRO and Japan's Sumitomo Trust & Banking. **T**

Vanguard International Value

Symbol	VTRIX
Website	www.flagship.vanguard.com/
Address	Vanguard Group Inc. 100 Vanguard Boulevard Malvern, PA 19355
Tel. No.	800-662-7447
Inception	5/16/1983

PORTFOLIO

Total Net Assets*	\$6,500
Avg Mkt Cap (\$ Weighted)*	N/A
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	32%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$3,000
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$3,000

RISK (AGAINST MSCI AC WORLD INDEX)

Alpha	-0.01
Beta	1.04
R-Squared	0.94
Ann Std Deviation	11.1
Sharpe Ratio	1.81

RETURNS VS. MSCI EAFE INDEX

	VTRIX	Index
1 Year (Cum.)	31.22%	27.52%
3 Year (Ann.)	22.59%	21.41%
5 Year (Ann.)	17.73%	14.56%

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	2.00%
Total Expense Ratio	0.50%

PORTFOLIO MANAGER

Team Managed	
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*millions **within 2 months of purchase

Data through: 10/31/06

Source: Company Documents; Lipper

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