



FUND SPY

Outstanding Global Diversification at a Low Cost

Vanguard Total International Stock Index earns our top rating of Gold

Daniel Sotiroff Jan 2, 2020

Vanguard Total International Stock Index's extensive portfolio and rock-bottom expense ratio make it an attractive long-term investment. It earns a Morningstar Analyst Rating of Gold. The fund tracks the FTSE Global All Cap ex U.S. Index, which includes stocks of all sizes from foreign developed and emerging markets. It weights them by market cap, which benefits investors by capturing the market's collective opinion of each stock's value while keeping turnover low. Market-cap weighting can be tough to beat because the market tends to do a good job valuing stocks over the long term. Occasionally it will increase the fund's exposure to expensive stocks when investors get excited about an area of the market, but this doesn't undermine its long-term efficacy. This is one of the broadest portfolios in the foreign large-blend Morningstar Category. Its exceptional diversification mitigates the impact of holding the worst-performing names. It owns more than 7,000 stocks and has only 8% of assets in its 10 largest positions. Its regional composition looks modestly different from a typical fund in the category because it has a larger dose of emerging-markets stocks. But their weight in the portfolio isn't large enough to materially increase the fund's risk or compromise its category-relative performance. Performance has not distinguished this fund from its competitors. Despite its low fee advantage, the total return of the fund's Admiral share class was on par with the category average over the 10 years through November 2019. Its middling total return was driven by the lackluster performance of foreign markets, which performed poorly by historical standards over this decade. This fund's broad portfolio and relatively low fee should help it perform better within the category when foreign markets post stronger returns.

Process | High

This fund earns a High Process Pillar rating because it diversifies risk better than a majority of its category peers while keeping turnover and trading costs in check. Vanguard's portfolio managers use full replication to track the FTSE Global All Cap ex U.S. Index. This benchmark starts with all stocks listed outside of the U.S. and sorts them by their free-float-adjusted market cap. It targets firms that land in the top 98% of each country's market cap. The index uses buffer rules around the cutoff point to keep turnover low, and it applies some additional liquidity requirements to ensure that its holdings are investable. The index weights its final constituents by market cap, which helps further mitigate turnover and trading costs. It reconstitutes semiannually in March and September.

This fund captures the entire foreign stock market. Its comprehensive portfolio effectively diversifies stock-specific risk, with only 8% of assets in its 10 largest holdings. This also causes it to look similar to the average of its category peers in important respects. Sector weightings are comparable, with financials and industrials stocks collectively representing one third of the portfolio. Country and regional allocations aren't far off the category average either. The fund modestly differs from its peers in this regard, but the gap doesn't pose a significant threat to its category-relative performance. Eurozone stocks represent the largest regional allocation, at 21% of the fund, while Japan and the United Kingdom make up an

additional 17% and 11%, respectively. The fund does not hedge its currency risk, so its exposure to currencies like the euro, yen, and pound can add to its volatility. Stocks listed on emerging-markets exchanges account for a little less than 20% of this fund, while a typical competitor has a 6% stake. Allocating to these companies improves the fund's reach and shouldn't materially affect its risk or performance. The fund includes small caps but weights its holdings by market cap. So, it tilts toward large-cap multinationals, with companies like Nestle, Toyota, and BP among its biggest names.

People | Above Average

The portfolio managers on this fund are part of Vanguard's Equity Index Group. This wider team has a global footprint and uses the latest in portfolio management technology to track this fund's target index. They earn an Above Average People Pillar rating. Christine Franquin and Michael Perre share responsibility for this fund. They are both principals at Vanguard and captain some of Vanguard's largest index-tracking funds listed in North America. Perre joined Vanguard's crew in 1990 while Franquin came aboard 2000. This duo not only oversees the portfolio but also executes trades on a day-to-day basis. Vanguard typically rotates portfolio managers around from one fund to another every few years to improve their breadth and depth of expertise. They also have access to Vanguard's trading desks around the world, enabling them to make the most cost-efficient transactions in various global markets.

Vanguard's portfolio managers are compensated with a bonus that factors in the gross, pretax performance of the fund relative to its objectives. This includes the manager's record of tracking a benchmark index over the prior 12 months. These characteristics align the interests of the managers and investors.

Parent | High

The Vanguard Group entered a new era in early 2019 with the passing of its founder and conscience, John C. Bogle. Unlike its mid-1970s origins, when outflows were the norm and its survival was in question, Vanguard now wears the crown as the world's biggest retail asset manager. More than 90% of its USD 5.6 trillion in global assets under management, as of June 2019, are in the United States; but the firm has designs to grow its non-U.S. business, especially in the United Kingdom, Australia, Canada, Japan, China, and Mexico. Vanguard gained its stature by following Bogle's playbook: pairing relatively predictable strategies, both passive and active, with minimal costs. That's enriched Vanguard's investors, and those outside its flock who have benefited from industrywide fee compression. While Vanguard's passive business now faces stiff price competition from its biggest rivals, inflows into its U.S. strategies still dominate. Not content, Vanguard aims to transform investment advice, too. In May 2015, it launched Personal Advisor Services, a burgeoning discretionary asset-management business that pairs automation and human advice; and in September 2019 it disclosed plans to launch a digital-only counterpart. Vanguard's industry leadership readily merits a High Parent rating, but the firm must stay on its guard to prioritize investor interests over merely expanding its kingdom.

Performance

This fund's category-relative performance has not stood out from its peers. The total and risk-adjusted returns of its Admiral share class were similar to the category average for the 10 years through November 2019. Its low fee and broadly diversified portfolio have not yet translated into a strong category-relative track record. Over the past decade, many of the fund's better-performing competitors had a growth orientation that aided their performance. These more successful strategies tended to hold stable, profitable stocks that held up well

during downturns, which helped them perform better than the market. Investing in these types of companies can work for short stretches, but costs tend to have a greater impact on performance over longer periods of time. This fund's expense ratio ranks among the lowest in the category and should aid its category-relative performance when foreign markets post stronger returns. Stocks listed in Japan and the U.K. collectively account for a little less than one third of this fund's assets. So, these two markets can play a role in how the fund performs. Over the past decade, Japanese stocks have aided performance, while those listed in the U.K. have been less of an advantage.

Price

It's critical to evaluate expenses, as they come directly out of returns. The share class on this report levies a fee that ranks in its Morningstar category's cheapest quintile. Based on our assessment of the fund's People, Process and Parent pillars in the context of these fees, we think this share class will be able to deliver positive alpha relative to the category benchmark index, explaining its Morningstar Analyst Rating of Gold.