

Differences Due to Fair Value Pricing

Many investors are wondering why their international equity index funds have recently underperformed a benchmark such as the MSCI EAFE Index. This underperformance is largely due to the effects of fair value pricing as it applies to U.S. investors who are invested in non-U.S. equity mutual funds. As the table shows, fair value pricing is the reason for the reported underperformance for the one-, three- and five-year time periods for the Vanguard Developed Markets Index fund.

	1 Year	3 Year	5 Year
Vanguard Developed Markets Index (VDMIX)	-10.23%	-1.94%	-3.55%
MSCI EAFE Index	-9.36%	-1.13%	-3.46%
Tracking error	-0.87%	-0.81%	-0.09%
Difference due to fair value pricing	-0.95%	-0.93%	-0.21%

Returns thru September 30, 2011. Data provided by Vanguard.

What Is Fair Value Pricing?

If a U.S. mutual fund invests in securities that trade on foreign exchanges that close before the U.S. stock market closes, the fund must adjust its net asset value (NAV), which is an investment company's total assets minus its total liabilities. Mutual funds generally must adjust their NAV on a daily basis to account for news that has come out since the foreign markets closed. European exchanges, for example, close four hours before U.S. markets close at 4:00 p.m. Eastern, and the Tokyo exchange closes 14 hours before U.S. markets close.

If the mutual fund determines that foreign local closing market prices are stale, it will adjust its NAV accordingly. This adjustment is fair value pricing. In order to determine the fair value of a security, fund companies will typically seek quotes from multiple brokers and pricing services. The index returns, on the other hand, are calculated using only the closing values in the local market.

Fair value pricing attempts to establish a NAV that fairly values the fund for both existing and new shareholders. Fair value pricing is required by the SEC for mutual funds, except for closed-end funds, whose shares are not required to be repurchased by the fund. Fair value pricing is in place to protect shareholders, but it can cause confusion when comparing the return of an index with the return of a mutual fund. The index return is calculated using the closing prices on the local foreign exchange. These effects can be exaggerated when the market makes large moves at the beginning and/or end of a reporting period, which has recently been the case.

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