Fund Essentials®

investing for income

THE Vanguard GROUP®

Vanguard® bond funds

A convenient, low-cost choice for investors who seek income

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Reliable income, especially during retirement, is one of the main reasons **investors turn to bonds**. Although other types of investments generate monthly interest income—money markets, certificates of deposit, and bank savings accounts, to name a few—these instruments typically provide lower yields than bonds.

So if you seek income, or are looking to diversify your portfolio, **consider investing in a taxable bond mutual fund**. By adding bond funds to your portfolio, you'll earn monthly interest income that you can either receive as cash or reinvest for compounded growth. And what better place to look than Vanguard, one of the largest managers of bond fund assets.*

*Based on bond fund assets of approximately $185 billion as of 3/31/2006.

Unless otherwise noted, all mutual fund industry data provided by Lipper Inc.

Bond
Fund Basics

What Is a Bond?

A bond is a type of debt issued by the U.S. government or a government agency, corporations, or municipalities. It is essentially an "IOU" that obligates the issuer to pay the holder a specified sum of money, usually at specified intervals, and to repay the principal amount of the loan at maturity. The holder of the bond does not have ownership privileges, as a stockholder does.

What Is a Bond Mutual Fund?

A bond fund is a pooling-together of many investors' money to purchase a broadly diversified selection of bonds. There are several ways to categorize bond funds. They may invest in taxable bonds (those issued by the U.S. government or corporations) or tax-exempt bonds (also known as municipal bonds). (This brochure focuses on investing in taxable bonds.) A bond fund may invest in short-, intermediate-, or long-term bonds. Typically, short-term funds invest in bonds with average maturities ranging from 1 to 3 years; intermediate-term funds, an average maturity of 5 to 10 years; and long-term funds, 20 to 30 years. Finally, there are actively managed bond funds and bond index funds, which seek to track the performance of a market benchmark.

Choices for bond fund investors

Type of holdings	Average maturity	Style of fund management
Taxable bonds (U.S. Treasury, U.S. government agency, corporate) • Investment-grade • High-yield Tax-exempt bonds (municipal bonds) • Investment-grade • High-yield	• Short-term • Intermediate-term • Long-term	• Actively managed • Index

Advantages of Bond Funds

You may find it advantageous to invest in bond funds, rather than in individual bonds, for a number of reasons. Here's a closer look at those reasons.

Regular monthly income. Bond funds typically distribute all of their interest income in the form of dividends each month. This income may either be paid in cash or reinvested to purchase additional fund shares. Individual bonds, however, generally pay interest every six months, and that interest cannot be reinvested automatically.

Lower investment amounts. Individual bonds may have minimum investments as high as $10,000. By contrast, bond fund minimum investments are often considerably lower, so even if you have limited funds to get started, you can participate in the bond market. (For example, the minimum initial investment of most Vanguard bond funds is $3,000 per fund for all account types.

Diversification. A bond fund may hold hundreds, or even thousands, of bonds from a few or many different issuers. This diversification means that the failure of one issuer to pay interest or principal has only a slight effect on your principal. By contrast, if you own individual bonds, you can lose most or all of your investment if an issuer defaults. However, diversification does not ensure a profit or protect against a loss in a declining market.

Professional investment management. You can rely on professional fund managers—who have access to extensive research and market information—to decide which bonds to buy and sell. This service is valuable because few investors have the time or expertise to manage portfolios of individual bonds.

Convenience. Bond funds offer daily liquidity; you can buy or sell shares whenever you like. In addition, many funds offer checkwriting and telephone redemption options, which allow you to access your account when necessary.

Is your portfolio **stock-heavy?**

Especially during times when the stock market encounters rough waters, it's wise to invest in bond funds for diversification. Adding bonds to a stock-laden portfolio can help smooth out the ups and downs. In the past, portfolios that included a mix of stocks and bonds have shown less volatility than all-stock portfolios.

Disadvantages of Bond Funds

Along with their advantages, bond funds also have some potential disadvantages.

Variable income. The dividend paid by a bond fund is not fixed, as it is for an individual bond. Therefore, the actual dividend that bond-fund investors receive may go up or down as the fund buys and sells individual bonds in different interest rate environments.

No fixed maturity date. A fund maintains an average, "rolling" maturity by selling off bonds that are aging and replacing them with newer ones, which may create taxable capital gains for fund holders. After five years, a 5-year bond fund will still have an average maturity of five years, while a 5-year bond would have matured and had its principal and interest paid off.

Potential capital gains or losses. You may have to redeem your bond fund at prices that are higher or lower than the original purchase price, thus realizing a taxable capital gain or loss. If you hold an individual bond, though, you can hold it to maturity and receive the face amount of the bond.

Key Characteristics of Bond Funds

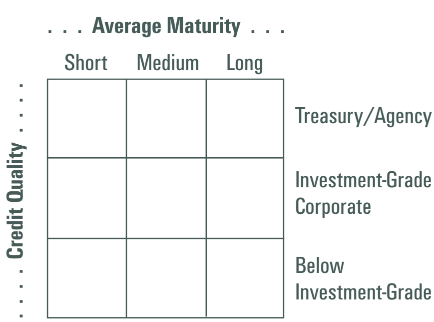
When you consider an investment in bond funds, there are three important characteristics to keep in mind: average credit quality, average maturity, and average duration.

Average credit quality. Independent bond rating agencies, such as Standard & Poor's and Moody's Investors Service, evaluate the ability of taxable bond issuers to repay loans. These agencies then assign a letter rating, ranging from AAA or Aaa (highest quality and highly unlikely to default) to D (in default). The lower the rating, the higher the interest rate the borrower must pay to entice investors to purchase the bond. Bond funds can invest in a wide range of bonds having varying credit-quality ratings. However, the weighted average rating of all bonds in the fund provides a measure of the fund's average credit quality.

Average maturity. The average length of time before bonds in a fund reach maturity is known as the fund's average maturity. The average maturity affects the fund's yield as well as the risk to investors' principal. For example, prices of longer-term bond funds are substantially more volatile than those of shorter-term funds, because the long-term holders of bonds are lending money for longer periods—and thus taking a greater risk that their principal may not be repaid or the borrower may default.

Average duration. This measurement can be used to judge how much a bond fund's share price may rise or fall in response to a change in interest rates. To calculate the estimated percentage change in the fund's share price, simply multiply a change in interest rates by the fund's average duration. An increase in interest rates will cause share prices to fall; likewise, a decrease in interest rates will cause share prices to rise. For example, suppose you own an intermediate-term bond fund that has an average duration of 5.3 years. If interest rates increase by 1%, you can expect the price of the fund to decrease by 5.3%.

Segments of the bond market



Most bond funds tend to fall into one of the nine boxes in this grid, showing the focus of a fund in terms of two attributes, average maturity (short, medium, or long) and average credit quality (Treasury/agency, investment-grade corporate, or below investment-grade).

You can find a wealth of information about bond fund investing on our website. Simply click on www.vanguard.com today to learn more.

What Are the Risks?

Bonds are generally considered less risky than stocks, but as with any investment, there is always some risk involved. Before you purchase bond funds, these are the chief risks you should consider:

Interest rate risk. Share prices of bond funds decrease when interest rates rise, and they increase when interest rates fall. The longer the average maturity or duration of a bond fund, the higher the risk of significant price fluctuations caused by changes in market interest rates.

Credit risk. Bonds can lose value if an issuer's credit rating is lowered or if the issuer defaults by failing to make interest or principal payments. But, because a mutual fund invests in many bonds, the impact of a downgrade or default by any one issuer is significantly lessened. Unlike corporate bonds, Treasury bonds have extremely low credit risk because they are backed by the full faith and credit of the U.S. government. Note: U.S. government backing of Treasury or agency bonds applies only to the fund's underlying securities; it does not prevent share-price fluctuations.

Income risk. Income from bond funds may fall because of declining interest rates. If you need current income for living expenses, you should be able to tolerate a fluctuating yield from your bond funds. Income risk is higher for short-term bond funds and lower for long-term bond funds. Bond investments are also subject to inflation risk.

How to Choose the Right Bond Fund

To determine whether a particular bond fund is right for you, consider the following questions to help you focus on the right type of bond funds to meet your goals.

How much risk can you live with? The degree of risk you can comfortably tolerate dictates whether you should invest in a short-, intermediate-, or long-term bond fund. If you're worried about price fluctuations, you may want to consider funds that have shorter average maturities, because they exhibit lower price volatility than longer-term funds. If you have a long-term horizon, seek stable income, and can live with greater price swings, you are more likely to choose a long-term fund. Again, remember that, unlike corporate bonds, Treasury bonds have extremely low credit risk because they are backed by the full faith and credit of the U.S. government.

How much income do you need? Your income needs influence the degree of risk that you can comfortably take on in your investment. If your income needs are substantial, you will choose a fund with a longer average maturity—and so take on greater risk to your principal. Or you might decide to invest in a high-yield fund, which invests in bonds that have lower credit quality. If a high level of income is not a priority, then you can invest in a fund with a shorter average maturity and higher-quality securities.

Which is more important—credit quality or yield? If you are seeking a fund that holds bonds of the highest credit quality, you will likely want to invest in U.S. government bond funds. If you prefer higher yields, you may opt for corporate bond funds, which have somewhat lower credit quality. Keep in mind that most bond funds are broadly diversified, so the added credit risk associated with a corporate bond fund is relatively modest.

Are you in a high tax bracket? You are most likely to benefit from the tax-exempt income produced by tax-exempt bond funds if you're in one of the higher tax brackets.* The chart below shows the probability that such a fund may be right for you. You may wish to consult a tax advisor to discuss your specific tax situation.

Your federal income tax bracket	Is a tax-exempt bond fund appropriate?
15%	Not likely
25%	Likely
28%	Quite likely
33%	Highly likely
35%	Highly likely

Once you are confident that a tax-exempt fund is suitable for you, you must determine whether it's more appropriate for you to invest in a tax-exempt or a taxable bond fund, by comparing the funds' yields on an equal scale (that is, by taking away the benefit of the tax-exempt fund's tax advantage). You can do this by calculating the taxable-equivalent yield for the tax-exempt investment. If the taxable-equivalent yield of a tax-exempt bond fund is

*Although the income from a municipal bond fund is exempt from federal income tax, capital gains realized either through a fund's trading or from your redemption of shares are taxable. For some investors, a portion of income from a municipal bond fund may be subject to the alternative minimum tax, as well as to state and local taxes.

greater than the yield of a taxable fund, then the tax-exempt fund is likely the better choice. To calculate taxable-equivalent yield, use this formula:

$$\frac{\text{Yield of Tax-Exempt Fund}}{1.00 - \text{Your Tax Bracket}} = \text{Your Taxable-Equivalent Yield}$$

This example shows you how to do the calculation.

Suppose you are considering whether to invest in one of two bond funds:

1. A taxable bond fund that has a current yield of 4.0%.
2. A tax-exempt bond fund that has a current yield of 3.0%.

Follow these four steps to obtain a taxable-equivalent yield.

1. Convert your marginal tax rate to a decimal figure (for instance, 0.28 if you are in the 28% bracket).
2. Subtract the decimal figure from 1.00 (1.00 – 0.28 = 0.72).
3. Divide the tax-exempt yield by the result calculated in Step 2 (3.0% ÷ 0.72 = 4.17%).
4. Compare the taxable-equivalent yield of the tax-exempt bond fund to the yield of the taxable bond fund (4.17% versus 4.0%).

In a high **tax bracket?**

Consider one of Vanguard's tax-exempt bond funds, listed at the end of this brochure. You will find more information about these funds in our Fund Essentials brochure, *Investing for Tax-Exempt Income*. Vanguard is one of the leading providers of tax-exempt bond funds and offers an extensive selection of funds to meet your needs. For more information, call us at 800-662-7447 or visit our website at www.vanguard.com.

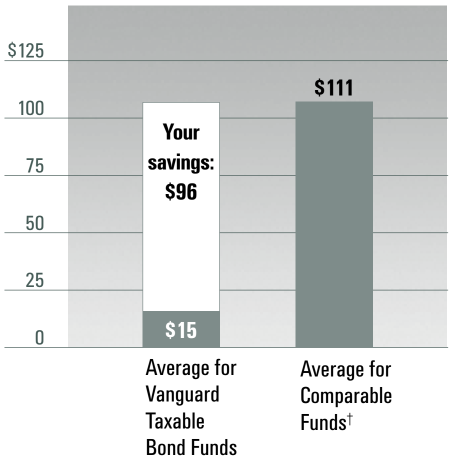
Why Vanguard Bond Funds?

When you compare Vanguard bond funds with those of competitors, you'll find that the Vanguard funds have several important advantages.

High credit quality. Each of our taxable bond funds maintains high credit-quality standards relative to comparable funds. In fact, the most recent mutual fund industry data confirm that our taxable bond funds hold a higher percentage of investment-grade bonds (those rated BBB or better by Standard & Poor's) than do their peer funds. So when you invest in these funds, you won't have to worry that your higher returns are the result of investments in riskier, lower-rated holdings.

Low costs. Cost is the most significant difference between bond funds that hold securities with similar credit quality and maturity. As the chart on page 14 shows, the average expenses of Vanguard's taxable bond funds are approximately *one-seventh* the industry average. So when you invest in a Vanguard taxable bond fund, more of your fund's return stays in your account, where it can continue to work for you.

The Vanguard low-cost advantage



Low costs allow Vanguard's taxable bond funds to pass along more of their investment returns to you. The chart at left illustrates the amount deducted annually from a $10,000 investment.

†Data as of 12/31/2005.

Skilled management. As of March 31, 2006, Vanguard managed more than $135 billion in taxable bond fund assets. The professionals who oversee our taxable bond funds are skilled at evaluating and selecting bonds that satisfy our high credit-quality standards and also offer attractive yields.

Vanguard Bond Funds to Meet Your Needs

Our broad selection of low-cost bond funds can help meet the needs of many investors. The funds shown here represent just some of our taxable bond funds. Each of these funds seeks to provide a high level of current income. They follow various investment strategies and cover the entire spectrum of maturities—from short-term to intermediate-term to long-term. (A list of our other taxable bond funds, as well as our tax-exempt bond funds, can be found inside the back cover.)

Short-Term Federal Fund invests primarily in short-term bonds issued by U.S. government agencies. The fund is expected to maintain an average maturity of 1 to 3 years. *(For more information, request the Vanguard® Bond Funds prospectus.)*

Short-Term Investment-Grade Fund invests primarily in short-term, high-quality corporate securities and maintains an average maturity of 1 to 3 years. This fund usually generates the highest income of all our short-term bond funds. *(Request the Vanguard Bond Funds prospectus.)*

Total Bond Market Index Fund seeks to track the performance of the Lehman Brothers Aggregate Bond Index, which measures the performance of the entire U.S. bond market—including government, corporate, and mortgage-backed bonds. *(Request the Vanguard Bond Index Funds prospectus.)*

GNMA Fund invests primarily in Government National Mortgage Association securities, which offer timely payment of principal and interest backed by the U.S. government. Although the fund doesn't observe specific maturity guidelines, its average maturity normally falls within a range of 3 to 10 years. *(Request the Vanguard Bond Funds prospectus.)*

Intermediate-Term Treasury Fund invests primarily in direct government obligations, such as U.S. Treasury bonds and other securities backed by the full faith and credit of the U.S. government. The fund generally maintains an average maturity of 5 to 10 years. *(Request the Vanguard Bond Funds prospectus.)*

Long-Term Treasury Fund invests primarily in long-term U.S. Treasury bonds, whose principal and interest payments are backed by the full faith and credit of the U.S. government. The fund generally maintains an average maturity of 15 to 30 years. *(Request the Vanguard Bond Funds prospectus.)*

High-Yield Corporate Fund seeks a high level of current income by investing in speculative ("junk") bonds. Bonds held in this fund typically have higher-than-average credit ratings compared with those held in the average high-yield bond fund. *(Request the Vanguard High-Yield Corporate Fund prospectus.)*

Key
Fund Facts

	Interest Rate Risk	Credit Risk	Income Risk
Short-Term Federal Fund	Low	Extremely low	High
Short-Term Investment-Grade Fund	Low	Low	High
Total Bond Market Index Fund	Medium	Low	Medium
GNMA Fund	Medium	Extremely low	High
Intermediate-Term Treasury Fund	Medium	Extremely low	Medium
Long-Term Treasury Fund	High	Extremely low	Low
High-Yield Corporate Fund	High	High	Medium

Note: The minimum initial investment for each fund is $3,000 for all accounts. Each of the seven funds also offers Admiral™ Shares, a separate share class that offers lower expenses. The minimum initial investment for this share class is $100,000.

*Source: Moody's Investors Service, Inc., as of 3/31/2006.

**As of 3/31/2006.

***For the fund's latest fiscal year.

Explanation of Quality Ratings

Aaa: Bonds judged to be the best quality, carrying the smallest degree of investment risk.

Aa: Bonds regarded as high quality; together with Aaa bonds, known as high-grade bonds.

A: Bonds regarded as upper-medium quality.

Ba: Bonds considered to be predominantly speculative.

Note: Moody's often applies numerical modifiers (1, 2, and 3) in its rating classifications. The modifier "1" indicates that the bond ranks in the high end of its category, "2" indicates a midrange ranking, and "3" indicates a ranking in the lower end of the category.

Vanguard—
A Leader in Bond Funds

Vanguard is among the leading managers of bond mutual funds and offers one of the largest selections in the industry. As of March 31, 2006, our expert bond fund managers oversaw more than $185 billion in taxable and tax-exempt bond fund assets. You can get more details about all of our funds by visiting our website, **Vanguard.com**®, calling us at **800-662-7447**, or returning the enclosed postage-paid reply card.

Once you've selected the funds that best meet your needs, you can open your account online using secure e-signature technology. Visit our website at www.vanguard.com to get started.

Other Vanguard Bond Funds

In addition to the funds described in this booklet, here is a listing of all our other bond funds. If you've decided that a tax-exempt fund may be suitable for you, consider Vanguard's wide selection of tax-exempt bond funds or state-specific bond funds (if appropriate).

Taxable Bond Funds

Request the Vanguard Bond Funds prospectus for details on these three funds:

Short-Term Treasury Fund

Intermediate-Term Investment-Grade Fund

Long-Term Investment-Grade Fund

Request the Vanguard Bond Index Funds prospectus for details on these three funds:

Short-Term Bond Index Fund

Intermediate-Term Bond Index Fund

Long-Term Bond Index Fund

In a separate prospectus:

Inflation-Protected Securities Fund

Tax-Exempt Bond Funds

Request the Vanguard Municipal Bond Funds prospectus for details on these six funds:

Short-Term Tax-Exempt Fund

Limited-Term Tax-Exempt Fund

Intermediate-Term Tax-Exempt Fund

Insured Long-Term Tax-Exempt Fund

Long-Term Tax-Exempt Fund

High-Yield Tax-Exempt Fund

State-Specific Bond Funds

The following funds are available only to residents of the respective states:

California Intermediate-Term Tax-Exempt Fund

California Long-Term Tax-Exempt Fund

Florida Long-Term Tax-Exempt Fund

Massachusetts Tax-Exempt Fund

New Jersey Long-Term Tax-Exempt Fund

New York Long-Term Tax-Exempt Fund

Ohio Long-Term Tax-Exempt Fund

Pennsylvania Long-Term Tax-Exempt Fund

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For more information, visit www.vanguard.com, or call 800-662-7447 for Vanguard funds and 800-992-8327 for non-Vanguard funds offered through Vanguard Brokerage Services, to obtain a prospectus. Investment objectives, risks, charges, expenses, and other important information about a fund are contained in the prospectus; read and consider it carefully before investing.

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