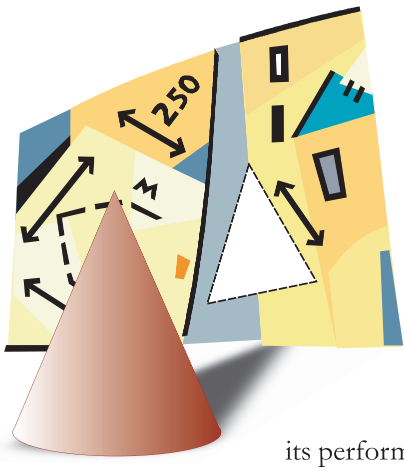
Replacing a Mutual Fund With an ETF in the Model Fund Portfolio

By James B. Cloonan



Small and mid-cap stocks continue to underperform large caps.

As a result, the Model Fund Portfolio now lags the S&P 500 index, as measured by the Vanguard 500 Index fund (VFINX); their returns are 5.1% and 8.2%, respectively, for the year as of September 30. This outperformance by large-cap stocks takes place about 30% of the time and affected the performance of the All-ETF Portfolio as well. Recent results for the Model Fund Portfolio can be viewed in Table 1; Table 4 gives performance for the All-ETF Portfolio. Longer-term results for the Model Fund Portfolio are shown in Figure 1 and Table 2.

The stock market has turned much more volatile recently. If you are a true long-term investor, that portends higher future returns as short-term investors panic and keep prices down to where they provide higher long-term returns.

Portfolio Changes

Table 1 shows the current holdings for the Model Fund Portfolio. There are two changes, as listed in Table 3.

We are selling FMI Common Stock Fund (FMIMX). We just could not justify the 1.19% expense ratio based on the performance. In addition, the fund is closed to new investors, and we believe that managers do best with new funds flowing in. When mutual funds have to sell holdings in order to buy new stocks, they tend to sell the wrong stocks. FMI Common Stock fund was up 1.6% year-to-date.

Aston/Fairpointe Mid Cap N (CHTTX) is also closed to new investors, but its performance is better and its expense ratio somewhat lower. Investors holding it should continue to do so. Those following the model portfolio who do not own Aston/Fairpointe Mid Cap fund should make up their portfolio from the remaining eight funds.

We are adding First Trust US IPO ETF (FPX) to the portfolio. First Trust US IPO is an exchange-traded fund

Figure 1. Model Fund Portfolio vs. Comparison (Through 9/30/2014)

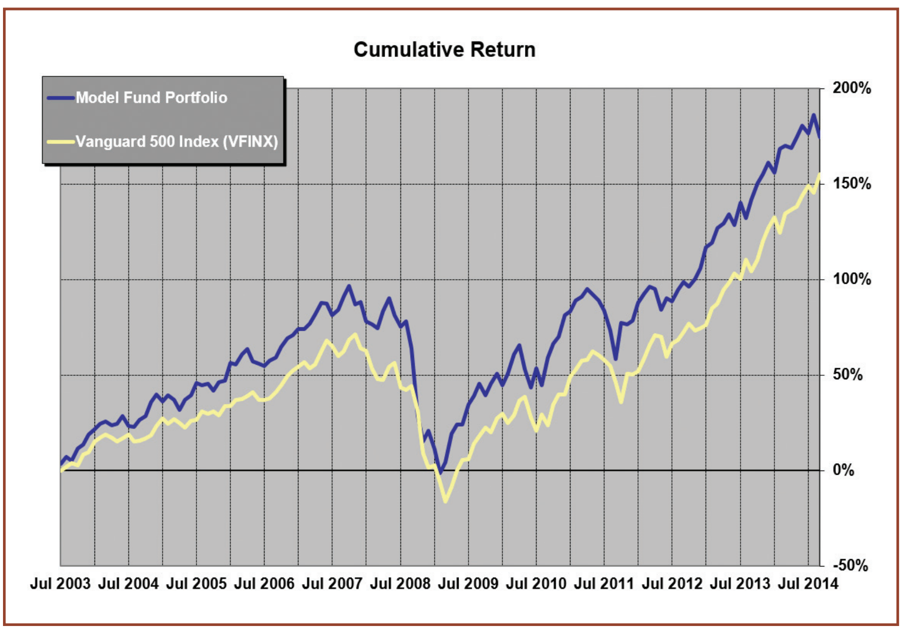


Table 1. Model Fund Portfolio

Type	Fund (Ticker)	Market Cap Size	YTD Return (%)	Annual Return (%) 1-Yr	5-Yr	10-Yr	Since 6/30/03	Fund Assets ($ Mil)	Exp Ratio (%)	Std Dev (36 Mo. Ann'l) (%)	Worst 3-Yr Cal Period (%)
MF	Aston/Fairpointe Mid Cap N (CHTTX)*	Large-Cap	5.1	14.8	17.8	11.7	12.4	2,608.4	1.12	16.2	(7.9)
MF	Fidelity Capital & Income (FAGIX)	na**	5.7	11.2	10.9	9.1	9.5	10,712.4	0.73	6.6	(7.2)
MF	Fidelity OTC (FOCPX)	Large-Cap	10.1	18.9	18.4	12.5	nmf	8,354.2	0.76	16.0	(8.3)
ETF	First Trust US IPO (FPX)	Large-Cap	6.7	17.7	22.1	nmf	nmf	533.5	0.60	14.0	(13.7)
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	7.6	18.0	17.0	9.6	10.7	8,735.9	0.40	12.0	(11.4)
ETF	Guggenheim S&P MidCap 400 Pure Val (RFV)	Mid-Cap	1.6	11.1	15.4	nmf	nmf	114.9	0.38	14.8	(4.3)
ETF	Guggenheim S&P SmallCap 600 Pure Val (RZV)	Small-Cap	(5.4)	6.1	12.1	nmf	nmf	183.0	0.35	17.9	(7.9)
ETF	iShares MSCI Frontier 100 (FM)	Large-Cap	18.3	26.1	nmf	nmf	nmf	799.5	0.79	nmf	nmf
ETF	Vanguard REIT Index (VNQ)***	Large-Cap	14.0	13.2	15.9	8.6	nmf	24,907.4	0.10	14.9	(11.9)
Avg of Funds in Actual Model Fund Portfolio†			**7.1**	**15.2**	**16.2**	**10.3**	**10.9**	**6,327.7**	0.58	13.8	**(9.1)**
Actual Fund Portfolio Performance††			**5.1**	**13.4**	**13.6**	**8.1**	**9.4**	**—**	**—**	**12.6**	**(6.4)**
Optional Investment:											
ETF	iShares Barclays 1-3 Year Treasury Bond (SHY)		0.3	0.4	0.9	2.4	3.0	9,024.6	0.15	0.4	1.3
Comparison:											
MF	Vanguard 500 Index (VFINX)	Giant-Cap	8.2	19.5	15.5	8.0	8.6	28007.3	0.17	10.6	(8.4)

**CHTTX is closed to new investors. Current shareholders can continue to invest in the fund. Other investors should simply use the other eight funds to form their portfolio.*
***Distressed securities - stock and bond.*
****Vanguard REIT Index Investors mutual fund (VGSIX) returns used before October 2004.*
†A simple average of the funds in the current Model Fund Portfolio.
††Performance of actual portfolio since inception (June 2003) including reinvested dividends.
nmf = no meaningful figure.

Source: Morningstar, Inc. Data as of 9/30/2014.

Table 2. Model Fund Portfolio Annual Performance

	Average Annual Return (%) Model Fund Portfolio	Average Annual Return (%) Vanguard 500 Index (VFINX)	Cumulative Return of $10,000 ($) Model Fund Portfolio	Cumulative Return of $10,000 ($) Vanguard 500 Index (VFINX)
2003*	18.6	15.0	11,858	11,503
2004	17.7	10.8	13,955	12,742
2005	5.4	4.8	14,711	13,350
2006	16.1	15.6	17,086	15,436
2007	10.2	5.4	18,820	16,267
2008	(35.9)	(37.0)	12,071	10,245
2009	24.9	26.5	15,080	12,959
2010	20.3	14.9	18,136	14,892
2011	(1.7)	2.0	17,827	15,186
2012	15.5	15.8	20,597	17,589
2013	26.7	32.2	26,097	23,250
2014 YTD**	5.1	8.2	27,429	25,159
Since Inception**	9.4	8.6	26,097	23,250

**June 30 to December 31, 2003*
***Through September 30, 2014. Portfolio was started on June 30, 2003.*

that tracks an index of larger U.S. initial public offerings. It modifies the capital weighting so that very large-capitalization companies do not dominate. The theory that large-cap IPOs provide excess returns for the first two years has been tested by this fund for nine years now, and I feel convinced.

First Trust US IPO should be equally weighted with the other eight funds (seven others if you don't own Aston/Fairpointe Mid Cap) in the portfolio—subject, of course, to your particular needs. You can accomplish this most easily by selling FMI Common Stock fund and putting the proceeds into the First Trust US IPO fund.

Changes to the All-ETF Portfolio

We are not selling any holdings in the All-ETF Portfolio, but the addition of First Trust US IPO requires a rebalancing, as indicated in Table 4. Since First Trust US IPO is a large-cap fund, we split the original 40% allocation to Guggenheim S&P 500 Equal Weight (RSP) in half to 20% and bought First Trust US IPO with the proceeds. With the recent change, our Model Fund Portfolio now has three traditional mutual funds and six exchange-traded funds.

As more actively managed ETFs appear and traditional mutual funds resist cutting fees, we expect ETFs to eventually dominate the fund area. But it will take a long, long time because investors resist making changes.

Model Fund Portfolio: Selection Rationale

First Methodology

The fund selection rationale consists of two distinct approaches. The first approach is to select actively managed funds where the managers have shown a long-term ability to outperform the market after allowing for additional portfolio risk, regardless of the sector invested in. A fund must have the following characteristics to be considered for the Model Fund Portfolio:

1. It must be a pure no-load fund. Short-term holding penalties are allowed if paid to the fund and not the manager.
2. It must have been active for 10 years. However, exceptions are possible.
3. It must have outperformed the S&P 500 index over the past five-year and 10-year periods.
4. In its worst three-year (calendar) period, it must not have had a loss; or, in particularly difficult market periods, its loss must have been substantially less than that of the S&P 500 index.
5. Its expense ratio must not be above 1.25%. Lower ratios will increase desirability.
6. Fund assets must not be over $10 billion. Some exceptions are permitted, depending on fund objectives.
7. It must currently be open to individual investors, with a minimum investment of $25,000 or less.

The above rules apply to new fund selections. Funds will not automatically be eliminated if they later violate the rules without considering other factors.

Second Methodology

The second methodology selects investment approaches that have provided excess returns or reduced portfolio risk to investors over the long term and then searches for the best traditional fund or exchange-traded fund (ETF) in that area. Factors to be considered are:

1. The liquidity of the fund.
2. The resources of the management company, in the case of ETFs.
3. The investment returns and risk over as long a term as possible, given the newness of so many ETFs.
4. Selection of areas with demonstrated long-term excess returns: value stocks, small-cap stocks, real estate and special areas where individuals cannot easily invest. An example of a fund in a special area would be Fidelity Capital & Income fund (FAGIX), which invests in distressed securities.

Portfolio Management Notes

- The Model Fund Portfolio is meant to be a portfolio, and we suggest you invest in the entire portfolio on an equal investment basis—that is, invest equal dollar amounts in each fund initially. If you are building an All-ETF Portfolio, see the recommended weightings shown in Table 4.
- If a fund is closed, create your portfolio from the remaining funds.
- You may make adjustments based on your non-fund holdings. For example, if you have partnership or individual holdings in investment real estate (not personal housing), you may reduce or eliminate any REIT funds.
- There is no need to rebalance on a regular basis. Rebalancing can be accomplished when there are portfolio changes or if one holding gets way out of line. We will notify you of any rebalancing in the Model Fund Portfolio.

The Mystery Cycle

In my October column, I mentioned what I call the mystery cycle. I repeat it here for those who do not follow the Model Shadow Stock Portfolio.

The election cycle indicates an above-average return in the year prior to the U.S. national election; this has been widely discussed and will be in the news as we approach 2015. Twenty years ago, I came across another cycle for which I can find no rationale but that has been pervasive for the last 100 years. It is the positive impact on the market of years ending in 5. This cycle is particularly important in years when it coincides with the election cycle. This combination occurs only every 20 years, and the year 2015 is one of those years.

I have always been suspicious of data like this that indicates a possible anomaly when I can't find a rationale for the behavior. In the election cycle we have the rationale that government spending and talk of government spending prior to the election boosts

Table 3. Portfolio Transactions

Fund	Reason
Buy	
First Trust US IPO ETF (FPX)	more upside potential
Sell	
FMI Common Stock Fund (FMIMX)	high expense ratio compared to its performance

Table 4. Alternative All-ETF Portfolio

Fund (Ticker)	Weight*	YTD Return (%)	Annual Return (%) 1-Yr	Annual Return (%) Since 12/31/12
First Trust US IPO ETF (FPX)	20%	6.7	17.7	48.6
Guggenheim S&P 500 Equal Weight (RSP)	20%	7.6	18.0	57.9
Guggenheim S&P MidCap 400 Pure Val (RFV)	20%	1.6	11.1	40.5
Guggenheim S&P SmallCap 600 Pure Val (RZV)	20%	(5.4)	6.1	37.2
iShares MSCI Frontier 100 (FM)	10%	18.3	26.1	48.6
Vanguard REIT Index (VNQ)	10%	14.0	13.2	16.8
Average of ETF Funds in Portfolio†		**3.8**	**15.3**	**41.6**
Actual All-ETF Portfolio Performance		**3.8**	**15.3**	**41.6**
Comparison: Spider S&P 500 (SPY)		8.2	19.6	43.1

**Weights adjusted at the close of 9/30/2014 with the addition of FPX.*
†An average of the ETFs in the current Model Fund Portfolio.

Source: Morningstar, Inc. Data as of 9/30/2014.

expectations, but I cannot think of any cycle for years ending in 5, or any 10-year cycle, to explain this rather dramatic impact. While it could be coincidence, it is also possible that I simply can't find the explanation. Note that although the data covers a large number of years, the actual sample size is small.

I must admit that in 1995, I was extra bullish and was rewarded. I will be a little extra bullish in 2015, although I hesitate to suggest that anyone should do the same. Here are the numbers.

Average annual returns since 1935:
11.0% = S&P 500 index
20.7% = year 3 of the election cycle
28.4% = years ending in 5
42.4% = year 3 + years ending in 5

0 = number of times year 3 was negative

Just an observation.

Outlook

Nothing has really changed over the last few months. There seems to be a balance between those nervous about protecting profits, who sell with every market run up, and those who missed out on part of the long market rise and view every pull back as a chance to get in.

With all the volatility and negative attitudes, it is still an up year that is not far from average. Large caps, which had fallen way behind, are catching up a bit; small caps, which have had a record run, are giving up part of their lead.

The mid-year election is upon us, and it is considered more important than usual because control of the U.S. Senate is up for grabs. We cannot predict whether the results will significantly affect the market, but we will know by the time the next Model Fund Portfolio column appears in the March 2015 *AAII Journal*.

In the meantime you can follow the model portfolios at AAII.com. ➤

James B. Cloonan is founder and chairman of AAII.