

Keeping Fund Portfolio Unchanged Despite Tough Start to 2010

By James B. Cloonan

In order to provide overall mutual fund data more quickly, our annual “Individual Investor’s Guide to the Top Mutual Funds” was moved to the February AAI Journal.

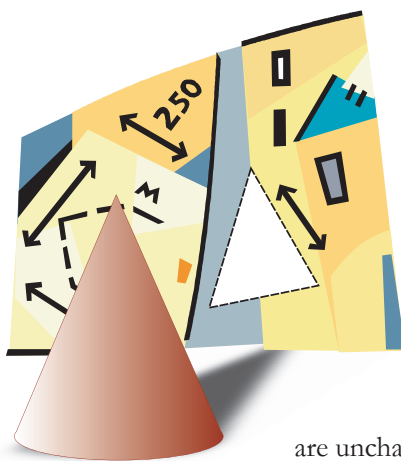
Consequently, the Model Mutual Fund Portfolio discussion will now appear in the March and August *Journal* issues.

The Model Fund Portfolio trailed the overall market as measured by the Vanguard Total Stock Market Index fund (VTSMX) in January—returning -4.1% to the benchmark’s -3.5%—as both took a rest after a strongly bullish 2009. Longer term, the portfolio still outperforms, as can be seen in Figure 1 and Table 1.

Adapting the Rules

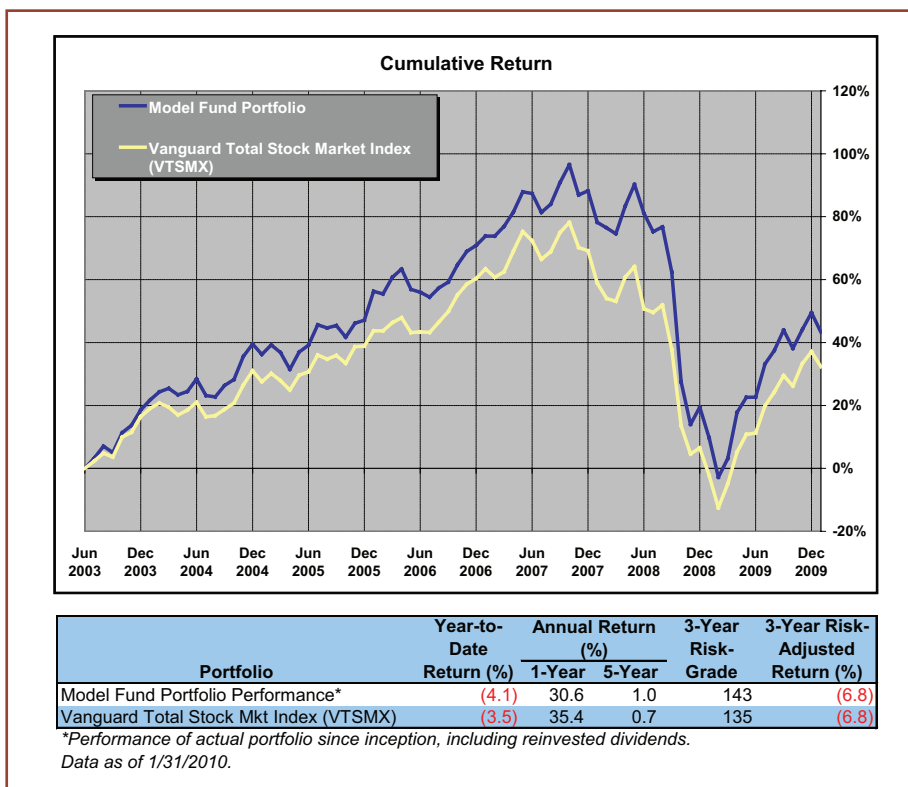
We have made no changes in the portfolio. As we discussed in last August’s article, the distortion caused by 2008 makes it impossible to apply the three-year rule (a fund cannot have a loss over any three-year period). We simulated five-year and 10-year performance with 2008 eliminated and on that basis all of the funds outperformed the S&P 500.

We are investigating how we can



adjust the three-year rule to allow for a scenario like 2008 without winding up with all bear-market or commodity funds. While the current funds provide a balanced portfolio and all have excellent long-term results, we don’t want to overlook any funds that might improve the portfolio. All of the other rules are unchanged; the complete selection rules are listed in

Figure 1. Model Fund Portfolio Performance vs. Benchmark



the box on page 32.

Slow Recovery

Three of our long-term best-performing funds—CGM Realty (CGMRX), CGM Focus (CGMFX), and Meridian Value (MVALX)—have not recovered as much as might be expected after the bear market.

We have always put more emphasis on long-term performance and so will have patience with them.

Mixed Signals

The future, as usual, is unclear. Perhaps more than usual, the sources impacting the U.S. stock market lie outside our borders. The world economic system is certainly becoming more integrated, and what happens in Iceland or Greece will eventually have an effect on us.

January saw a fall in the stock market and that often correlates with a down
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Figure 2. Performance of Current Model Portfolio vs. Benchmark

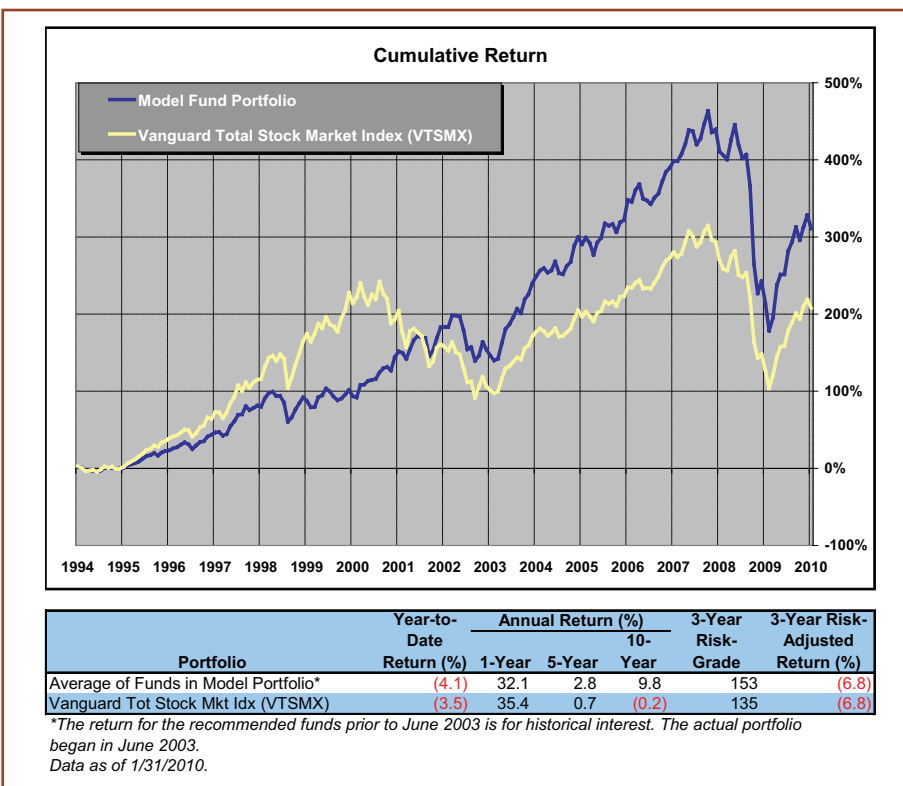


Table 1. Model Mutual Fund Portfolio

Fund (Ticker)	Style	Market-Cap Size	YTD Return (%)	Annual Return (%)			Fund Assets (\$ Mil)	Exp Ratio (%)	3-Yr Risk-Grade	3-Yr Risk-Adj Ret (%)
				1-Yr	5-Yr	10-Yr				
CGM Focus (CGMFX)	Low Value	Giant-Cap	(10.4)	6.8	5.6	18.0	3,231.6	0.97	182	(6.7)
CGM Realty (CGMRX)	High Value	Mid-Cap	(7.0)	46.7	7.4	18.4	1,172.1	0.86	226	(13.6)
FMI Common Stock (FMIMX)	High Value	Small-Cap	(1.6)	43.8	6.0	10.2	817.7	1.26	150	(0.4)
Madison Mosaic Mid-Cap Fund (GTSGX)	Very Low Value	Mid-Cap	(3.3)	32.2	0.0	6.6	136.7	1.25	131	(6.4)
Manning & Napier Pro-Blend Ext A (MNBAX)	Very Low Value	Giant-Cap	(1.4)	30.4	4.6	6.3	567.3	1.10	91	0.7
Meridian Value (MVALX)	Low Value	Mid-Cap	(3.9)	20.7	1.5	7.7	881.4	1.12	128	(5.3)
Northern Small Cap Value (NOSGX)	High Value	Micro-Cap	(3.2)	33.0	1.4	7.1	1,303.9	1.00	162	(10.0)
Royce PA Mutual/Inv (PENN)	Moderate Value	Small-Cap	(4.0)	44.3	3.0	9.6	3,462.5	0.91	157	(6.3)
Stratton Multi-Cap (STRGX)	High Value	Large-Cap	(4.7)	21.1	0.2	7.2	68.8	1.07	143	(5.9)
Tamarack Microcap Value "S" (TMVSX)*	Very High Value	Nano-Cap	(1.4)	42.3	(1.7)	7.3	148.8	1.08	164	(14.6)
Avg of Funds in Model Fund Portfolio**			(4.1)	32.1	2.8	9.8	1,179.1	1.10	153	(6.8)
Actual Fund Portfolio Performance***			(4.1)	30.6	1.0	na	1,179.1	1.10	143	(6.8)
Vanguard Tot Stock Mkt Idx (VTSMX)	Low Value	Giant-Cap	(3.5)	35.4	0.7	0.2	57,210.4	0.18	135	(6.8)

*James Cloonan has been an advisor to the TMVSX fund since its inception as the Babson Shadow Stock Fund in 1987.

**A simple average of all funds in the actual Model Fund Portfolio.

***Performance of actual portfolio since inception including reinvested dividends.

Source: Morningstar, Inc., RiskGrades.com. Data as of 1/31/2010.

Model Mutual Fund Portfolio: Selection Rules

To make it into the Model Mutual Fund Portfolio, a fund must meet the following criteria:

- 1) **It must be a pure no-load fund.** While it may charge a penalty for short-term redemptions, the penalty must be paid to the fund and benefit the shareholders. I feel this type of penalty is desirable particularly for small-cap and mid-cap funds to offset the transaction costs caused by short-term traders.
- 2) **It must have been in existence for at least 10 years.** However, it makes sense to consider exceptions to this rule in certain circumstances. The major exception is if the results to date almost guarantee qualification at the 10-year mark.
- 3) **It must have had higher returns than the S&P 500 index on both an absolute and risk-adjusted basis for the most recent five-year and 10-year periods.** I am interested in future performance, and the funds with the highest returns in the past are not necessarily those that will perform best in the future. But I feel that better funds always outperform the market (S&P 500 index) in the long and intermediate run, and risk-adjusted return is an essential risk control.
- 4) **It must never have had a three-year period with negative returns.** This requirement seeks consistency. In addition, I feel an investment horizon of three years is the minimum for equity investing. This rule emphasizes the importance of never having to sell your portfolio holdings at a loss. We only go back 10 years for this criterion.
- 5) **Net assets must be less than \$9 billion for giant- and large-cap funds, \$4 billion for mid- and small-cap funds, and \$1 billion for micro- and nano-cap funds.** I believe it is too difficult to invest in areas that offer unusual opportunities with a cumbersome amount of assets.
- 6) **It must have an expense ratio no greater than 1.25% if assets are less than \$3.5 billion and 1% or less if assets are over \$3.5 billion.** Many of the selected funds will be smaller in size, and I can therefore justify the 1.25% level, which is somewhat above the

average for no-load stock funds. However, I believe that a higher expense ratio not only will cost in the future (past expenses are reflected in past returns), but says something about management's attitude. However, there may be justifiable exceptions.

- 7) **It must currently be open to individuals, with a minimum investment of less than \$25,000 and available to residents of larger states.** However, I will follow openings and closings of otherwise qualified funds.
- 8) **If more funds qualify than are needed, new qualifiers are listed in terms of preference based on a number of quantitative and qualitative factors.** These may include: stability of risk, turnover ratio, manager tenure, and shareholder services, in addition to basic criteria.
- 9) **Funds can be sold for violation of the above rules or if we feel that because of other changes there are better funds available.** However, we do not anticipate much turnover.

How many funds should you hold?

- If you buy mutual funds through a discount broker, having 10 funds is easy enough. If you want fewer funds, you can apply your own criteria to reduce the group.
- It is not necessary to have a portfolio of 10 funds. All of these funds are so effectively diversified that their average risk is reduced only slightly when combined with others in the portfolio.
- On the other hand, you do not want to winnow your selection down to just one fund. While these funds in the past have had similar diversification benefits, changes specific to each fund may alter its level of diversification—for instance, a fund may get a new manager who changes direction, or there may be a change in philosophy. For that reason, you should hold at least four different funds.
- No matter how many funds you buy, equal dollar amounts are invested in each fund initially.
- Well-diversified mutual funds do not have to be changed very often, so the screen will only be performed twice a year.

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market for the entire year. On the other hand, New Orleans—an “original” NFL team—won the Super Bowl and this correlates with an up year in the stock market. (Conversely, a win by a former American Football League team would have signaled a down market according to the Super Bowl Indicator.) If I had to choose an indicator of the stock market in the near future, it would be the pessimism among the pundits. This is frequently a bullish sign.

Actually, I see nothing to suggest altering one’s normal investment allocations. The next article on the Model Fund Portfolio will be in the August 2010 *AAIL Journal*. In the meantime, you can keep up with all the Model Portfolios at AAIL.com. ▲

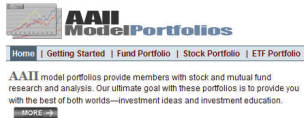
James B. Cloonan is founder and chairman of AAIL.

Cap Size and Style

We categorize mutual funds by both the size and style of their stock holdings. Size is measured by the average market capitalization (share price times the number of shares outstanding) of the stocks held by the fund, and style is based on the price-to-book value ratios (price per share divided by net assets per share) of the underlying stocks. Here is how we break down these categories:

Size Category	Market Cap
Giant-Cap	\$15 billion and greater
Large-Cap	\$7 billion to \$14.9 billion
Mid-Cap	\$2.5 billion to \$6.9 billion
Small-Cap	\$700 million to \$2.4 billion
Micro-Cap	\$300 million to \$699 million
Nano-Cap	\$0 to \$299 million

Style Category	Price-to-Book-Value Ratio
Very High Value	0.80 and below
High Value	0.81 to 1.30
Moderate Value (Blend)	1.31 to 1.50
Low Value (Growth)	1.51 to 1.90
Very Low Value (High Growth)	1.91 and above



AAIL MODEL PORTFOLIOS

Investment Education Coupled With Impressive Returns

For over 30 years, AAIL’s major emphasis has been on investment education and information. Over the years, however, we have become increasingly aware that many of our members want more specific guidance in developing an effective investment program.

This initiative is being carried out at AAIL.com’s Model Portfolios area. Although not intended as a complete advisory service, each approach that we present shares the same philosophy: an emphasis on consistency, risk control, and selections that are ideal for individual investors, not institutions.

AAIL Model Portfolio	Year-to-Date Return (%)	1-Year	3-Year	5-Year	10-Year	3-Year Risk-Adjusted Return (%)**
Mutual Fund Portfolio	-4.1	30.6	-6.2	na*	143	-6.7
Shadow Stock Portfolio	-3.1	68.0	-6.9	14.1	206	-3.2
ETF Portfolio	-2.6	72.2	-7.6	na	193	-4.2
Vanguard 500 Index (VFIAX)	-3.6	33.1	-7.3	-0.9	131	-7.6

Date as of 1/31/2010.
*The average 10-year annual return for the funds currently in the Model Fund Portfolio is 9.8%. The actual model portfolio began in June 2003.
** See “Important Concepts.”

www.aail.com/aaiiportfolios

The Model Shadow Stock Portfolio

The Shadow Stock Portfolio provides guidance for investing in the promising micro-cap value sector of the market. Specific direction is provided as to how this model portfolio, and variations on it, fit into an investment program.

Annual Return (as of 1/31/2010)
10-Year +14.1%

The Model Mutual Fund Portfolio

The funds that we highlight in the Mutual Fund Portfolio must pass stringent requirements that include consistency, risk control, modest fees, and low turnover. AAIL examines the different selection criteria on an ongoing basis, discussing variations that can affect risk.

Annual Return (as of 1/31/2010)
10-Year* +9.8%

*The average 10-year annual return for the funds currently in the Model Fund Portfolio is 9.8%. The actual model portfolio began in June 2003.

AAIL Model Portfolios can be found at www.aail.com/aaiiportfolios, or by simply clicking on the Intro to Portfolios link in the AAIL.com navigation bar.