

After the Storm, Stability Returns to the Model Mutual Fund Portfolio

By James B. Cloonan

The Model Mutual Fund Portfolio and the general market are up a bit year-to-date.

After 2008, I guess anything positive is good. The fund portfolio (up 2.6%) was behind the overall market as measured by the Vanguard Total Stock Market Index fund (VTSMX), which was up 4.4%.

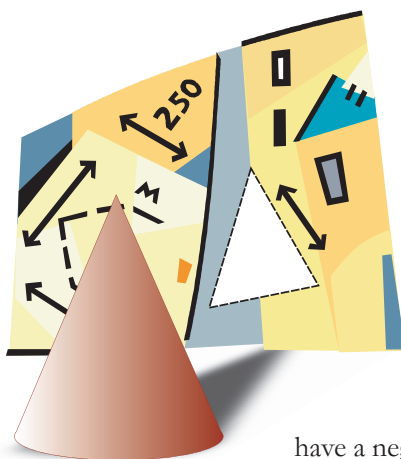
The portfolio has been in existence for five years now, and has outperformed the Vanguard Total Market benchmark over that period, as can be seen in Figures 1 and 2, and in Table 1.

Weathering the Market

Certainly we have had every kind of market during that period, which included 2008—a year, I hope, that is a once-in-an-investing-lifetime event.

Because of the recent market volatility and the effects of 2008, we did not change any of the funds in our portfolio.

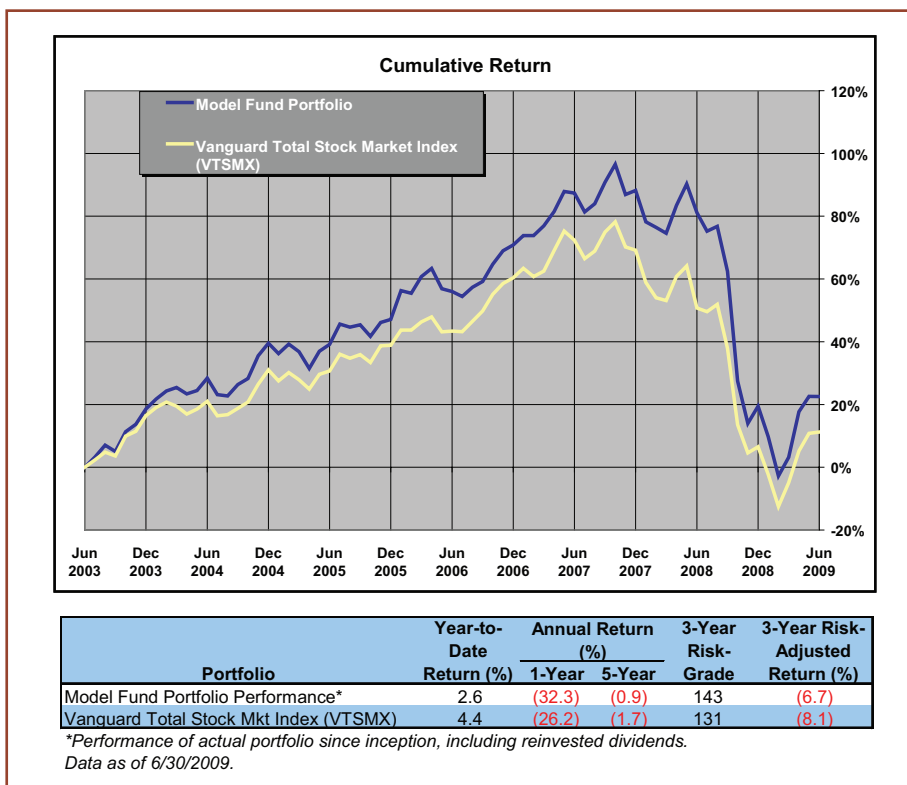
However, just as an experiment, we did apply our current selection criteria (see Selection Rules box on page 32) to the existing universe of stock mutual funds. We could not find 10 funds that met our selection criteria—even when we eased up by only applying the new “no three-year loss rule” only to the



last 10 years, rather than the last 15 years (we have made this a permanent change to the rules).

The three-year loss rule was put in because we feel three years is the minimum investment horizon for stock investing. But thanks to 2008, most stock mutual funds have a negative return for the three-year period of 2006

Figure 1. Model Fund Portfolio Performance vs. Benchmark



through 2008.

However, we believe that 2008 was truly unusual, and therefore we are not selling any of the portfolio's holdings based on the past three years' results. We continue to feel the existing portfolio is well-balanced and consists of excellent funds.

When the overall market stabilizes, we will once again consider changes that might provide improvement.

Other Changes

Looking at the year-to-date results, we see that the three funds that were the best over the long run—CGM Focus (CGMFX), CGM Realty (CGMRX), and Meridian Value (MVALX)—are poor performers this year.

Even if we are getting some balancing from changes in the market, these funds still have superior long-term returns.

We have adjusted the price-to-book-

Figure 2. Performance of Current Model Portfolio Holdings vs. Benchmark

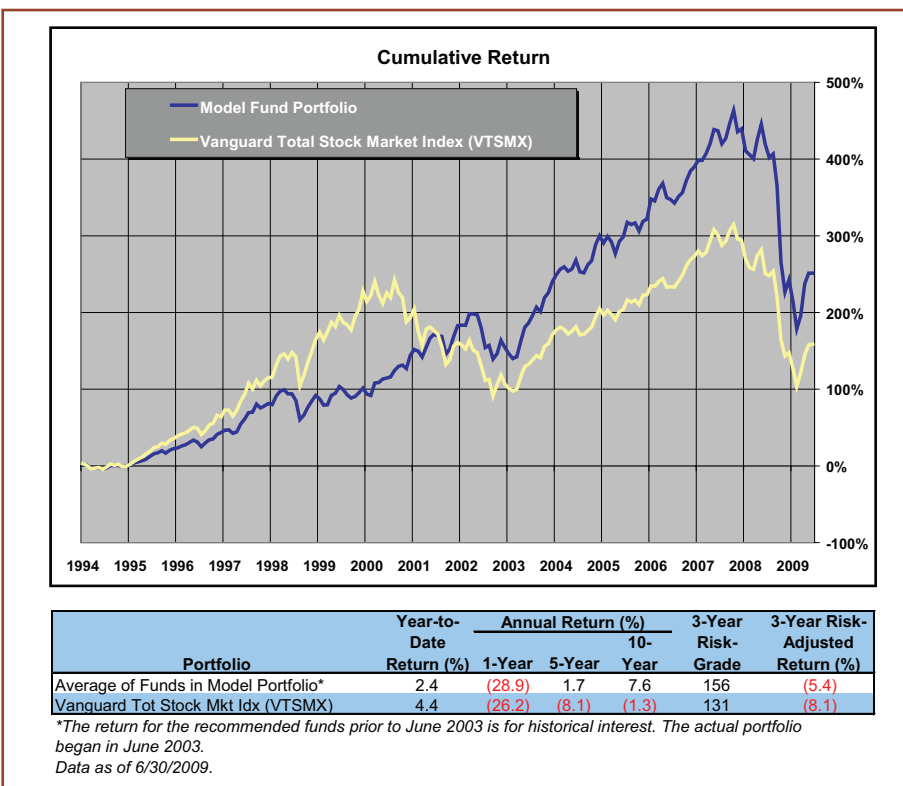


Table 1. Model Mutual Fund Portfolio

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	(6.4)	(58.6)	7.1	15.9	3,538.2	1.27	192	(1.8)
CGM Realty (CGMRX)	High Value	Mid-Cap	(6.7)	(52.4)	7.5	13.7	897.7	0.86	258	(2.5)
FMI Common Stock (FMIMX)	High Value	Small-Cap	10.3	(7.7)	3.6	7.2	607.8	1.22	148	(0.5)
Madison Mosaic Mid-Cap (GTSGX)	Very Low Value	Mid-Cap	5.2	(23.2)	(1.1)	5.2	114.7	1.26	132	(6.5)
Manning & Napier Pro-Blend Ext A (MNBAX)	Very Low Value	Giant-Cap	7.5	(11.9)	3.2	4.7	428.9	1.10	89	(4.1)
Meridian Value (MVALX)	Low Value	Mid-Cap	0.6	(25.7)	(0.6)	7.7	832.0	1.09	124	(6.2)
Northern Small Cap Value (NOSGX)	High Value	Micro-Cap	(6.3)	(23.4)	(0.7)	5.2	1,093.5	1.00	159	(7.9)
Royce PA Mutual/Inv (PENNX)	Moderate Value	Small-Cap	8.2	(25.8)	0.8	7.3	2,666.0	0.89	158	(5.8)
Stratton Multi-Cap (STRGX)	High Value	Large-Cap	5.9	(32.4)	0.5	4.2	68.9	1.07	138	(12.7)
Tamarack Microcap Value "S" (TMVSX)*	Very High Value	Nano-Cap	5.5	(27.4)	(3.2)	5.2	144.7	1.07	163	(5.7)
Avg of Funds in Model Fund Portfolio**			2.4	(28.9)	1.7	7.6	1,039.2	1.10	156	(5.4)
Actual Fund Portfolio Performance***			2.6	(32.3)	(0.9)	na	1,039.2	1.08	143	(6.9)
Vanguard Tot Stock Mkt Idx (VTSMX)	Low Value	Giant-Cap	4.4	(26.2)	(1.7)	(1.3)	45,177.0	0.16	131	(8.1)

*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 6/30/2009.

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.

value ranges for the style categories (see the box at right) to match current market conditions.

The Outlook: Crystal Unclear

In the current environment, there isn't anything clear about the market or the economy. The prophets are pretty equally balanced between being bullish and bearish.

There is probably slightly more bearishness for the short term (the rest of 2009) than for the intermediate term (2010–2011).

By the next Model Mutual Fund Portfolio column in February 2010, there might be more clarity on the economy. In the meantime, you can keep up with the Model Mutual Fund Portfolio 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 provide members with stock and mutual fund research and analysis. Our ultimate goal with these portfolios is to provide you with the best of both worlds—investment ideas and investment education.

AAIL Model Portfolio	Year-to-Date Return (%)	Annual Return (%)			3-Year Risk-Adjusted Return (%)**	
		1-Year	5-Year	10-Year		
Mutual Fund Portfolio	2.6	-32.3	-7.7	na*	143	-6.7
Shadow Stock Portfolio	28.2	-24.1	-9.8	10.8	200	-5.0
Vanguard 500 Index (VFINX)	3.2	-26.2	-8.3	-2.3	127	-8.7

Data as of 6/30/2009
* The average 10-year annual return for the funds currently in the Model Fund Portfolio is 7.6%. The actual model portfolio began in June 2003.
** See "Important Concepts"

www.aail.com/aailportfolios

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.

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 6/30/2009)

10-Year +10.8%

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 6/30/2009)

10-Year* +7.6%

*The average 10-year annual return for the funds currently in the Model Fund Portfolio is 7.6%. The actual model portfolio began in June 2003.

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