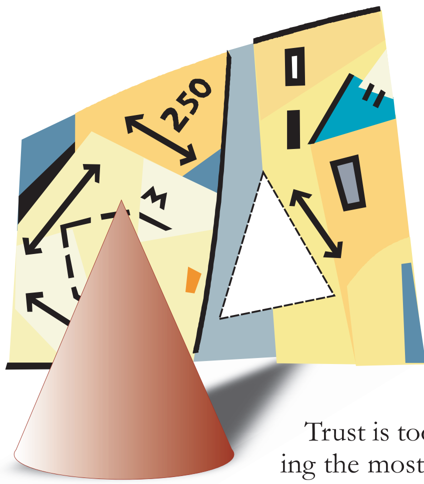
Model ETF Portfolio: Beats Benchmark, But Total Recovery Not Yet Complete

By James B. Cloonan



Our model portfolio of exchange-traded funds (ETFs) is benefiting handsomely from the positive movement in the stock market this year.

As of the end of the third quarter, the AAII Model ETF Portfolio is having an excellent year. The year-to-date return is 38.2%, compared to a return of 22.7% for our ETF benchmark.

The longer-term results can be seen in Table 1 and Figure 1. The portfolio remains slightly behind the benchmark over the complete time period since it was started. However, the primary reason for the difference in long-term performance is that the benchmark does not have a real estate component.

The Model ETF Portfolio's real estate components are iShares Cohen & Steers Realty Majors (ICF) and SPDR DJ Wilshire International Real Estate (RWX). While these two funds continue to lag, they seem to be catching up. Long-term real estate has proven to be an important part of a portfolio for both return and risk reduction.

Wanted: Better Micro-Cap ETFs

I am disappointed in the performance of First Trust Dow Jones Select MicroCap Index (FDM; see the bottom of Table 1 for a description), but it appears the best of only three micro-cap ETFs (the other two micro-cap ETFs are PowerShares Zacks Micro Cap Portfolio and iShares Russell Microcap Index Fund).

In my judgment the weakness in First Trust is too much emphasis on growth factors, ignoring the most important value measure (price relative to book) and eliminating too many smaller companies. The alternative funds have much the same problems.

Figure 1. Model ETF Portfolio vs. Benchmarks (Through 9/30/2009)

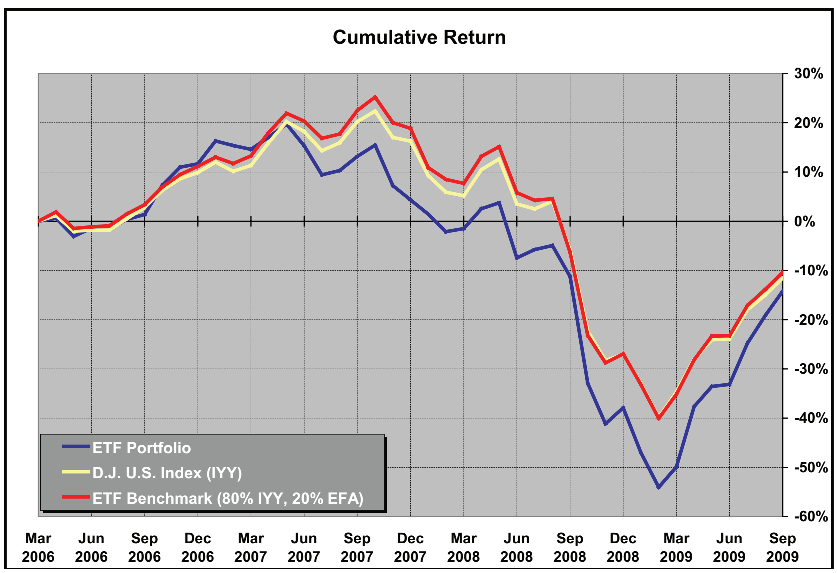


Table 1. AAII's Model ETF Portfolio

ETF (Ticker)	Weight in Portfolio (%)	YTD Return (%)	1-Year Annual Return (%)	Annualized Return Since 4/1/2006 (%)
First Trust Dow Jones Select MicroCap Index (FDM)	16	16.4	(12.3)	(7.7)
PowerShares FTSE RAFI US 1000 (PRF)	16	40.0	6.2	(1.2)
Rydex S&P MidCap 400 Pure Value (RFV)	16	46.7	(2.0)	(2.2)
Rydex S&P SmallCap 600 Pure Value (RZV)	16	86.1	16.5	(2.2)
iShares Cohen & Steers Realty Majors (ICF)	16	14.7	(32.3)	(10.8)
SPDR S&P International Small Cap (GWX)*	5	41.4	10.5	na
SPDR DJ Wilshire International Real Estate (RWX)*	5	38.6	(1.5)	na
Vanguard FTSE All-World Ex-U.S. (VEU)*	5	34.6	5.0	na
Vanguard Emerging Markets (VWO)	5	62.8	17.3	(5.2)
Portfolio Return**		**38.2**	**(3.3)**	**(5.7)**
Optional Investment:				
iShares Lehman 1-3 Year Treasury Bond (SHY)		0.6	3.3	1.4
Benchmarks:				
iShares D.J. U.S. Index (IYY)		21.3	(6.1)	(5.3)
iShares MSCI EAFE Index (EFA)		28.5	3.1	(4.8)
ETF Benchmark (80% IYY/20% EFA)		22.7	(4.2)	(5.2)

**Funds have not been in existence long enough for certain performance numbers to be calculated.*
***Performance of actual portfolio including reinvested dividends.*

Sources: Yahoo! Finance and Morningstar Principia. Data as of 9/30/2009.

ETF Descriptions

U.S. Domestic ETF Holdings

- **First Trust Dow Jones Select MicroCap Index Fund (FDM):** Stocks are selected from the universe of micro-cap stocks (defined as the cap of the lowest two deciles of the NYSE) based on a combination of value and growth factors. Very small and illiquid stocks are eliminated. The weighting of each stock is based on a modified market cap. It uses the shares in the float (as defined by the fund) rather than total shares to determine the market cap.
- **PowerShares FTSE RAFI US 1000 Portfolio (PRF):** The index tracks 1,000 U.S. stocks based on proprietary fundamental factors measuring financial strength (book value, cash flow, sale, and dividends), and the stocks are then weighted based on financial strength.
- **Rydex S&P MidCap 400 Pure Value (RFV):** Stocks for this index are selected from the S&P MidCap 400 based on a number of value criteria.
- **Rydex S&P SmallCap 600 Pure Value (RZV):** Stocks are selected from the S&P SmallCap 600 based on a number of value criteria.
- **iShares Cohen & Steers Realty Majors Index Fund (ICF):** I feel this is the best REIT exchange-traded fund at this time, but wish it contained more smaller REITs and was not market-cap-weighted.

International ETF Holdings

- **SDPR S&P International Small Cap (GWX):** An index of small-cap (market cap under $2 billion) stocks of developed nations, and capitalization weighted.
- **SDPR DJ Wilshire International Real Estate (RWX):** Basically an index of non-U.S. REITs and other foreign real estate holdings.
- **Vanguard FTSE All-World Ex-U.S. (VEU):** A cap-weighted index of the equities of 47 countries.
- **Vanguard Emerging Markets (VWO):** Focuses on emerging markets and follows the MSCI emerging markets index.

Optional ETF Holding

- **iShares Lehman 1-3 Year Treasury Bond (SHY):** Use of this exchange-traded fund as a way of controlling portfolio risk shows my preference for the low-risk element to be as low risk as possible. With a three-year investment horizon, this exchange-traded fund has virtually no risk.

Updates for the ETF Portfolio will appear in the May and November issues of the AAII Journal. See the ETF Portfolio area of AAII.com for more information.

Model ETF Portfolio: Selection Rationale

The rationale used in building the Model ETF Portfolio is to achieve diversification across the equity classes listed below while maintaining a weighting that, in our assessment of historical data, will provide the maximum opportunity for long-term rates of return. We have a bias toward smaller-cap and value stocks and so does history.

Across national boundaries—U.S. versus foreign:

We begin with an 80% U.S. and 20% foreign portfolio but this could change. Foreign stock returns involve currency relationships as well as the usual equity analysis. The initial weighting takes into consideration the fact that many U.S. companies have significant foreign involvement.

In foreign investments:

- Style will be diversified. We will seek emphasis on value stocks when it is possible.
- We will seek a heavier weighting in the small-capitalization area than the typical portfolio.
- We will diversify across equities and real estate, but will not use foreign bonds for risk reduction—at least not initially.

In U.S. investments:

- We will diversify across equities, real estate, and short-term bonds. Short-term bond ETFs will be included as an option for investors who need further risk reduction. However, they will not be in the actual Model ETF Portfolio.
- Our style diversification will aim for a heavier emphasis on value than the overall market.
- The capitalization weightings will place considerably more emphasis on small-capitalization stocks than the overall market. We will seek to achieve this not only by including small-cap ETFs but by choosing larger-cap ETFs that do not weight solely on capitalization.

Which specific ETFs?

Although the above outlines the areas in which we will look for ETFs, it does not explain how we will choose specific ETFs when there are multiple ETFs in an area.

It will be many years before we have enough history to develop a solid set of criteria as we have for the Model Mutual Fund Portfolio. Many of the sponsors of ETFs, however, have a history with other investment vehicles that can provide a guide, as can liquidity, expense ratios, and the philosophy espoused in prospectuses. Over time, we should be able to harden our criteria.

How the portfolio is managed

We will not make trades solely for the purpose of rebalancing, except under unusual conditions. When we make trades for other reasons, we will do so in a way that repositions the portfolio back toward the initial weighting.

The current recommended initial weighting is to give each domestic holding an equal weight (for a total of 80% in domestic ETFs) and each foreign issue an equal weight (for a total of 20% in foreign stock ETFs). If you choose not to hold a particular ETF, maintain the equal weightings in each of the domestic and foreign areas, and keep the balance of 80% domestic stock ETFs and 20% foreign stock ETFs.

I feel that including a micro-cap ETF in the portfolio is essential, but wish there was an ETF that performed closer to the AAII Shadow Stock Model Portfolio (our own portfolio of micro-cap value stocks).

There are no changes being made to the Model ETF Portfolio at this time, and we continue to believe that these funds will outperform the benchmark over the short and intermediate term. Over the long term, we would expect some things to change and will adjust accordingly.

During much of the three-and-a-half years of the portfolio's existence, smaller cap and value stocks have performed below their long-term averages. This appears to be reverting back to normal, and we continue to believe that value stocks, and small- and micro-cap stocks, will be the best performers over the long run. For that reason, they should be over-weighted—as they are in our ETF Portfolio.

The stock market continues to do its own thing and all of the various explanations and/or predictions from analysts and market pundits seem baseless.

According to the election year cycle, next year (2010) should be an average year (meaning about a 12% S&P 500 return). But 2008, and 2009-to-date, have made election-year cycle predictions seem silly. Of course, that may mean they will start to be meaningful again. I can see no market reason to deviate from your long-term asset allocation.

I will be reviewing the Model ETF Portfolio in this column again in May 2010, but you can follow it on a continuing basis at AAII.com. You can also view performance figures for the entire universe of ETFs in the AAII Guides area of AAII.com.

James B. Cloonan is founder and chairman of AAII.