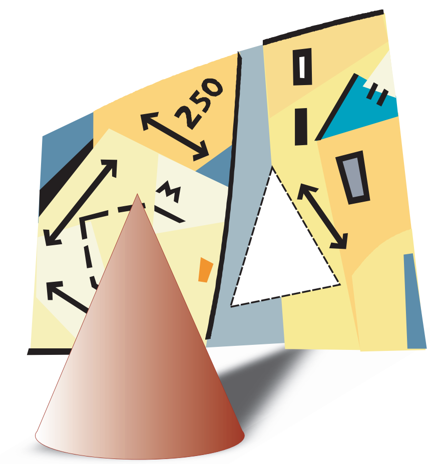
Model Fund Portfolio: Two ETFs Replaced With Lower-Cost Equivalents

By James B. Cloonan



Large-cap growth stocks, especially technology stocks, continue to lead the market this year.

The S&P 500 index as represented by the exchange-traded fund (ETF) SPDR S&P 500 (SPY) leads the Model Fund Portfolio 9.3% to 7.0% year to date.

For performance figures over longer periods, please see Figure 1 and Tables 1 and 3.

Portfolio Changes

Table 1 lists the mutual funds and ETFs that currently make up the Model Fund Portfolio.

Two exchange-traded funds were replaced during the end of June portfolio review, as summarized in Table 2.

- Guggenheim S&P MidCap 400 Pure Value (RFV) was sold and replaced with Vanguard Mid-Cap Value (VOE).
- Guggenheim S&P SmallCap 600 Pure Value (RZV) was sold and replaced with Vanguard Small-Cap Value (VBR).

In both cases the change was made because the replacement fund offers a lower expense ratio and tighter bid/ask spread.

Vanguard Mid-Cap ETF (VOE) has been a component of my new Level3 Passive Portfolio since its inception at the end of May 2016 (see Table 4).

There were no other changes in the Model Fund Portfolio.

News

Guggenheim has reduced the expense ratio on its Guggenheim S&P 500 Equal Weight ETF (RSP) from 0.40% to 0.20%. This will increase the return to investors. I wish Vanguard and others would start competitive equally weighted S&P 500 funds, but they have spent so much effort defending capitalization-weighting that it would be difficult for them to do so even if they wanted to. Perhaps one of the other large mutual fund companies will see the opportunity.

Looking Forward

Nothing has changed in Washington and nothing is

Figure 1. Model Fund Portfolio vs. Comparison (Through 6/30/2017)

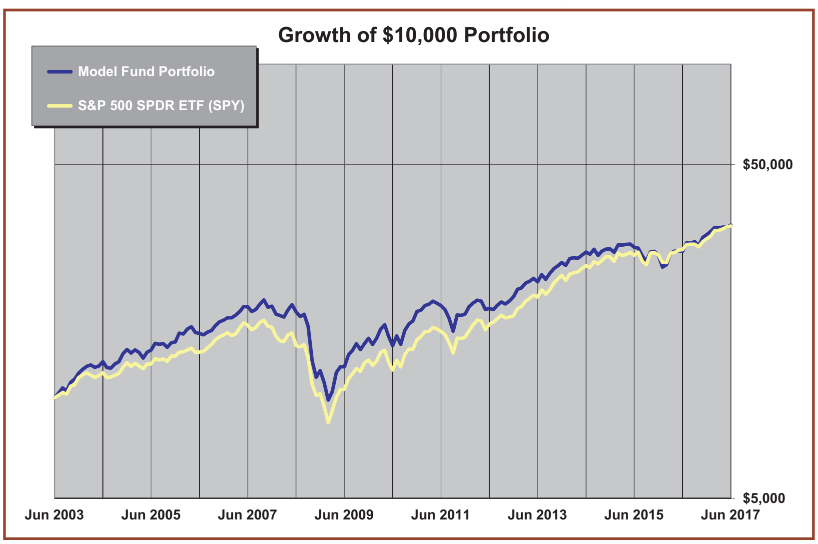


Table 1. Model Fund Portfolio

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)	Mid-Cap	5.1	29.8	15.2	9.0	11.4	1,503.3	1.12	15.4	(7.9)
MF	Fidelity OTC (FOCPX)	Large-Cap	23.5	36.4	20.2	12.3	13.0	11,682.4	0.91	15.3	(9.3)
ETF	First Trust US IPO (FPX)	Large-Cap	10.7	18.9	18.0	10.2	nmf	840.9	0.60	12.3	(2.3)
ETF	Guggenheim S&P 500 Eq Wt Cons Stpl (RHS)	Large-Cap	5.5	(1.5)	15.1	11.5	nmf	511.8	0.40	10.3	2.4
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	7.8	16.8	15.1	7.8	10.4	13,526.2	0.20	10.7	(11.4)
ETF	SPDR S&P Insurance (KIE)	Large-Cap	7.0	25.9	18.8	5.9	nmf	885.5	0.35	12.2	(13.7)
ETF	Vanguard Mid-Cap Value (VOE)*	Mid-Cap	6.9	18.0	15.7	7.6	nmf	7,342.0	0.07	10.8	(12.1)
ETF	Vanguard REIT Index (VNQ)**	Large-Cap	2.6	(1.9)	9.3	6.2	10.3	33,954.0	0.12	14.8	(11.9)
ETF	Vanguard Small-Cap Value (VBR)*	Small-Cap	2.4	19.1	15.0	7.5	nmf	11,276.3	0.07	13.4	(8.9)
Avg of Funds in Actual Model Fund Portfolio†			**8.0**	**18.0**	**15.8**	**8.7**	**11.3**	**9,058.0**	**0.43**	**10.6**	**(8.3)**
Actual Fund Portfolio Performance†			**7.0**	**19.9**	**12.2**	**5.8**	**8.9**	**—**	**—**	**11.6**	**(6.4)**
Optional Investment:											
ETF	iShares Barclays 1-3 Year Treas Bond (SHY)	Bonds	0.4	(0.2)	0.5	1.8	2.4	10,971.7	0.15	0.8	0.3
Comparison:											
ETF	SPDR S&P 500 (SPY)	Giant-Cap	9.3	17.8	14.5	7.1	8.8	236,737.5	0.10	10.2	(8.4)

nmf= no meaningful figure.
**Added to Model Fund Portfolio at end of June 2017.*
***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.

Source: Morningstar, Inc. Data as of 6/30/2017.

getting done. Maybe that's a blessing. The economy and corporate earnings continue to look favorable for the market. There still seems to be a lot of cash waiting for a stock market pullback. If we don't get one soon, investors holding cash will probably surrender and buy stocks.

Earnings seem to be the primary driver of equities at this time. This is as it should be. Continued growth in earnings not only leads to stock price increases, but also to full employment and higher wages.

Please follow the Model Fund Portfolio at AAII.com until the next update in the November *AAII Journal*.

Investment Rationale and Processes

Level3 Passive Portfolio

This portfolio is intended to be either the complete equity portfolio for those investors who wish to manage their own portfolio, but do not choose to be involved in individual stock selection, or one portion of a whole portfolio for those who may wish to select individual equities and actively managed funds on a limited basis but keep the majority of their portfolio in index funds.

The portfolio consists of index ETFs that should have, based on their approach, returns above that of the S&P 500 index. As a portfolio, it is more diversified than the S&P 500, which should reduce portfolio downturns that are based on the impact of a few sectors.

Portfolio changes should be relatively rare and will occur only when a new or different ETF is felt to be more effective at accomplishing a similar objective than one of the current holdings. There are some new index ETFs with promising approaches, but there will be a period of observation before they can be considered.

Level3 Portfolio Holdings

Four ETFs make up the Level3 Passive Portfolio. The weights of the

Table 2. Model Fund Portfolio Transactions

Buy

Fund (Ticker)
Vanguard Mid-Cap Value (VOE)
Vanguard Small-Cap Value (VBR)

Sell

Fund (Ticker)	Reason
Guggenheim S&P MidCap 400 Pure Value (RFV)	switching to lower-cost equivalent
Guggenheim S&P SmallCap 600 Pure Value (RZV)	switching to lower-cost equivalent

Table 3. Model Fund Portfolio Annual Performance

	Average Annual Return (%)		Cumulative Growth of $10,000 ($)	
	Model Fund Portfolio	S&P 500 SPDR ETF (SPY)	Model Fund Portfolio	S&P 500 SPDR ETF (SPY)
2003*	18.6	15.0	11,858	11,500
2004	17.7	10.7	13,955	12,735
2005	5.4	4.8	14,711	13,350
2006	16.1	15.6	17,086	15,438
2007	10.2	5.4	18,820	16,268
2008	(35.9)	(36.9)	12,071	10,273
2009	24.9	26.4	15,080	12,981
2010	20.3	14.9	18,136	14,914
2011	(1.7)	2.0	17,827	15,207
2012	12.6	15.8	20,075	17,608
2013	26.7	32.2	25,436	23,279
2014	9.9	13.6	27,962	26,439
2015	(4.5)	1.3	26,711	26,793
2016	15.3	11.8	30,807	29,957
2017 YTD**	7.0	9.3	32,960	32,735
Since Incep**	**8.9**	**8.8**	**32,960**	**32,735**

**June 30 to December 31, 2003.*
***Through June 30, 2017. Portfolio was started on June 30, 2003.*

holdings in the portfolio are very likely to change over time based on experience.

A more thorough discussion of the ETFs in the Level3 Passive Portfolio and other new funds that might qualify when they have sufficient volume and history are discussed in my book "Investing at Level3" (www.level3investing.com).

Guggenheim S&P 500 Equal Weight ETF (RSP)

This exchange-traded fund has outperformed the cap-weighted S&P 500 index over the 14 years of its existence. Other indexes also indicate that equal weighting provides higher returns. Equal weighting gives more weight to value stocks and smaller-cap stocks in an index, which leads to superior performance over the long run.

This fund, because of its size and history, is given a portfolio weight of 40%.

PowerShares Russell 1000 Equal Weight ETF (EQAL)

This ETF includes the top 1,000 stocks by capitalization size and gives some exposure to mid-cap stocks. Mid-cap stocks historically have had higher returns than large caps. It is a new fund, however, and uses an innovative approach that needs some observation before comparing it to Guggenheim S&P 500 Equal Weight ETF.

For now, it is weighted at 20% of the portfolio.

Vanguard Mid-Cap Value ETF (VOE)

Mid-cap value has had higher returns than large stocks or mid-cap growth stocks.

It is weighted at 20% of the portfolio.

Vanguard REIT Index ETF (VNQ)

The returns of real estate investment trusts (REITs) have exceeded the returns of the S&P 500 over the long run and provide diversification as well.

This ETF is weighted at 20%.

The Model Fund Portfolio

The new approach to the Model Fund Portfolio is more aggressive than in the past, now including some holdings with an intermediate-term focus. The portfolio focuses on:

- Actively managed funds that seem able to adjust to the market and outperform the S&P 500 over the intermediate and long term,
- Actively managed funds in investment areas that have proven to outperform in the intermediate and long term, and
- Some index funds in investment areas that have been long-term winners.

Portfolio changes are only made every three months, and are sent out in the monthly Model Portfolios Update email.

Portfolio Management Notes

For the Model Fund Portfolio, the initial holdings are equally weighted. For the Level3 Passive Portfolio, the initial weightings are as previously indicated and as shown in Table 4. The approach to rebalancing in both cases is to keep it to a minimum. While momentum is less of a factor with funds than it might be with stocks, and transaction costs for funds are much less than for stocks, rebalancing frequently is a distraction and can make taxes a significant consideration.

You should be able to achieve almost all the rebalancing necessary when you add and withdraw funds or when

Table 4. Level3 Passive Portfolio

Fund (Ticker)	Initial Weight	YTD Return %	1-Yr Return %	Return (%) Since 5/31/16
Guggenheim S&P 500 Equal Weight (RSP)	40%	7.8	16.8	16.7
PowerShares Russell 1000 Equal Weight (EQAL)	20%	6.4	14.2	14.9
Vanguard Mid-Cap Value (VOE)	20%	6.9	18.0	18.3
Vanguard REIT Index (VNQ)	20%	2.6	(1.9)	4.9
Weighted Avg of ETFs in Portfolio*		**6.3**	**12.8**	**14.3**
Actual Level3 Passive Portfolio**		**6.3**	**12.8**	**14.2**
Comparison				
SPDR S&P 500 (SPY)		9.3	17.8	18.1

**A weighted average return of the ETFs in the current Level3 Passive Portfolio.*
***Performance of actual Level3 Passive Portfolio, including reinvested dividends.*
Source: Morningstar, Inc. Data as of 6/30/2017.

For more on the Level3 approach, go to www.level3investing.com.

changes are made in the holdings. In the 14 years of the Model Fund Portfolio, no rebalancing has been thought necessary. If over time a holding gets significantly out of line, adjustments can be made.

Decisions will have to be made by the individual since every investor will have added assets at a different time, so everyone's weights will be different. But the following are some general guidelines:

- Don't rebalance any holding unless you have held it for over a year.
- If a holding is 25% below where it should be with the planned weight, bring it back to the appropriate level by selling some overweighted holdings to provide funds.
- If a holding is 33% above where it should be with the planned weight, bring it back to the appropriate level by selling the excess and using the funds to buy underweighted holdings. ➤

James B. Cloonan is founder and chairman of AAII. He is author of the book "Investing at Level3: Higher Returns With Minimal Risk for the Long-Term Individual Investor" (www.level3investing.com).

(continued from page 31)

the managers draw a line among the remaining constituents. Anything that's weighted below 1% will have its weighting proportionally bumped until it hits 1%, and then they'll continue to proportionally bump up until they've run out of proportional holdings.

What happens is that you get a capped, but very heavy, market capitalization weighting at the top. Then, in the middle or the lower middle, you get this long tier of equal-weighted securities weighted at 1% each and then you get the teeny tiny dribs and drabs. In between the 1% holdings and the capped holdings, you do get market-cap weighting, but it's pretty bizarre. It's also unclear what triggers the index to be rebalanced. There are not a lot of guidelines.

CR: *It sounds like this really emphasizes the need to spend the time looking at the index construction that these ETFs are following instead of just relying on the name only.*

EK: That's right. That's probably the biggest mistake that investors make. Frankly, it's not just individual investors who make this mistake, but investors of all stripes. They take a look at the ETF name, they think they know what it does and they hit the "buy" button. It would be nice if it were that simple.

CR: *For the active group, it seems like the big hurdle, particularly on the stock side, has been transparency. Do you expect this to continue without some change in the regulations?*

EK: What I can tell you sort of off the top is that there actually are plenty of actively managed ETFs. Most of them have very few assets in them. But there are clearly enough asset managers who don't consider having to disclose their portfolio in full on a daily basis as a barrier. Are there more who are holding back? Yes, there are more who are holding back.

We already have some pretty big names in the active space: Janus, Franklin Templeton, Legg Mason, JPMorgan, Natixis, PIMCO and Principal. These are household names that your members are going to recognize. ➤

Elisabeth Kashner is the director of ETF research for FactSet. Find out more at www.aaii.com/authors/elisabeth-kashner. Charles Rotblut is a vice president at AAII and editor of the AAII Journal. Find out more at www.aaii.com/authors/charles-rotblut and follow him on Twitter at twitter.com/CharlesRAAII.