LEVEL3 PASSIVE PORTFOLIO

# The Level3 Approach: Getting Exposure to Segments That Have Performed Well

The portfolio looks to improve upon the long-term return of the market-cap-weighted S&P 500 using index funds of smaller companies, value-oriented stocks and real estate.

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**The need for a simple, basic long-term approach** for those who do not want to be active investors prompted AAII founder James Cloonan to develop the Level3 Passive Portfolio while writing his book "Investing at Level3" (www.level3investing.com).

For individual investors who wish to manage their own portfolio but do not have the desire to get involved in individual stock selection, the Level3 Passive Portfolio can be used as a complete equity portfolio. For those who may wish to select individual stocks and actively managed funds on a limited basis but keep the majority of their portfolio in index funds, it can be used as one portion of a whole portfolio. We started tracking the actual portfolio on May 31, 2016, as shown in Figure 1.

The Level3 Passive Portfolio is composed of four exchange-traded funds (ETFs) selected based upon long-term observations and research on market segments and strategies that had performed well over the long term relative to the S&P 500 index.

Large-cap domestic stocks as measured by the S&P 500 have offered investors a long-term annual rate of return around 10%. The Level3 Passive Portfolio looks at how investors can potentially improve upon the long-term return of the market-cap-weighted S&P 500 by incorporating index funds that extend the reach of the S&P 500 into smaller companies, value-oriented stocks and real estate.

Changes to the Level3 Passive Portfolio 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. Many of these ETFs are called smart beta indexes because they vary the weighting of stocks held in the index using factors such as valuation or size instead of the more common market-cap weighting.

When investing in these smart beta funds, it is important to understand that they are designed to provide concentrations of segments such as value and momentum, making them more like actively managed stock funds. The performance over short periods will probably diverge (for better or worse) from traditional index funds.

Looking at the recent performance, the Level3 Passive Portfolio continues to lag the S&P 500 since its formation. The Level3 Passive Portfolio declined 9.5% in 2018 compared to a loss of 4.4% for the SPDR S&P 500 ETF (SPY). This is partly due to the continuing dominance of the mega-cap stocks for the last several years and partly due to the underperformance of the real estate sector, which bounced back more strongly than the market in January. As the famous investor John Neff noted, "It's not always easy to do what's not popular, but that's where you make your money."

Table 1 provides the target weights, recent

**FIGURE 1**

**Level3 Passive Portfolio vs. Comparison (Through 1/31/2019)**

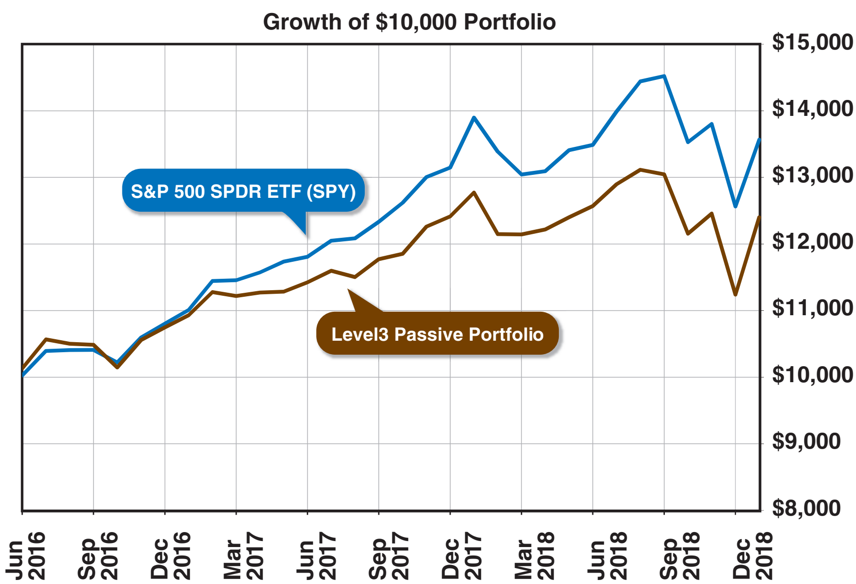

**TABLE 1**

## Level3 Passive Portfolio

| Fund (Ticker) | Weight | Return Since 5/31/2016 (%) | Total Return (%) YTD | 2018 | 2017 | 2016* | Div Yield (%) | Avg P/B Ratio (X) | Exp Ratio (%) | % in Top 10 Hldgs (%) | Total Assets ($ Mil) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Invesco S&P 500 Equal Weight (RSP) | 30% | 29.9 | 9.8 | (7.8) | 18.5 | 8.2 | 1.8 | 2.50 | 0.20 | 2.4 | 14,589 |
| Invesco Russell 1000 Equal Weight (EQAL) | 30% | 27.5 | 10.6 | (8.9) | 17.2 | 7.9 | 1.5 | 2.22 | 0.20 | 2.8 | 386 |
| Vanguard Mid-Cap Value (VOE) | 30% | 24.7 | 9.9 | (12.4) | 17.1 | 10.7 | 2.5 | 1.69 | 0.07 | 10.9 | 8,688 |
| Vanguard Real Estate (VNQ) | 10% | 12.8 | 11.8 | (5.9) | 4.9 | 2.2 | 4.2 | 2.22 | 0.12 | 41.6 | 30,675 |
| **Weighted Avg of ETFs in Portfolio**** | | **25.9** | **10.3** | **(9.3)** | **16.3** | **8.3** | **2.2** | **2.15** | **0.15** | **9.0** | **10,166** |
| **Actual Level3 Passive Portfolio***** | | **24.0** | **10.3** | **(9.5)** | **15.5** | **7.5** | **—** | **—** | **—** | **—** | **—** |
| **Comparison:** | | | | | | | | | | | |
| SPDR S&P 500 (SPY) | | 35.7 | 8.0 | (4.4) | 21.7 | 8.0 | 1.9 | 3.04 | 0.10 | 20.9 | 250,220 |

*May 31 to December 31, 2016.
**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 1/31/2019.

performance and basic characteristics of the ETFs in the portfolio.

## Invesco S&P 500 Equal Weight Portfolio ETF (RSP)

This fund is given a portfolio weight of 30% in the Level3 Passive Portfolio.

The Invesco S&P 500 Equal Weight Portfolio ETF invests in the stocks that make up the S&P 500, but weights the holdings equally, with the holdings rebalanced quarterly. In effect, each quarter, the fund is selling the relative winning stocks that are potentially overvalued and investing the proceeds into last quarter's losers, which might be undervalued.

The percentage of the portfolio in the top 10 holdings helps to indicate the level of portfolio concentration and serves as a measure of portfolio risk. The higher the percentage, the more concentrated the ETF is in a few companies, and the more the ETF is susceptible to the market fluctuations of these few holdings. Because the stocks are held in equal proportion, the top 10 holdings of the equally weighted Invesco S&P 500 Equal Weight ETF make up only 2.4% of total assets versus 20.9% of a market-cap-weighted S&P 500 ETF that holds the same stocks.

The dividend yield on mutual funds and ETFs is calculated by dividing the income distributions over the last 12 months by the ending net asset value. Dividend distributions for funds and ETFs are made net of expenses. The dividend yield of the Invesco S&P 500 Equal Weight ETF is 1.8%, just below the 1.9% yield of the SPDR S&P 500 ETF. The Invesco S&P 500 Equal Weight ETF expense ratio is low at 0.20%, but above the 0.10% expense ratio of the SPDR S&P 500 ETF.

The price-to-book-value ratio (P/B) is a common measure of company value that equates the share price to the accounting equity value of the company. The higher the price-to-book ratio, the more investors have bid up the price of the company relative to its accounting value. Value investors typically seek out companies trading with lower price-to-book-value ratios, and much research supports the approach. The average price-to-book ratio of the market-cap-weighted SPDR S&P 500 ETF is 3.04 compared to 2.50 for the equally weighted Invesco S&P 500 Equal Weight ETF.

The total assets figure indicates the total dollars invested in the ETF and gauges the interest in the fund's strategy. Greater total assets under management should also result in lower expense ratios as fixed expenses are spread over a larger asset base. The Invesco S&P 500 Equal Weight ETF has $14.6 billion in total assets.

## Invesco Russell 1000 Equal Weight ETF (EQAL)

This fund is given a portfolio weight of 30% in the Level3 Passive Portfolio.

The Invesco Russell 1000 Equal Weight ETF includes securities in the Russell 1000 index, which consists of the top 1,000 stocks by capitalization size. This ETF is equally weighted across the nine sector groups, with each security within the sector given an equal weighting. The fund and the index are reweighted at the close of the third Friday in March, September and December. The index is also reweighted at the close of the last Friday in June when the Russell 1000 is reconstituted. This fund provides some additional exposure to mid-cap stocks over those found in the S&P 500. Mid-cap stocks historically have had higher returns than large caps. However, it is a newer fund and uses an innovative approach that needs some observation before comparing it to Invesco S&P 500 Equal Weight ETF.

The dividend yield of the Invesco Russell 1000 Equal Weight ETF is 1.5%, the lowest in the Level3 Passive Portfolio. On average, smaller companies normally pay out less in dividends than larger, more mature companies. The average dividend yield of large-cap mutual funds is 1.3% compared to 0.8% for mid-cap mutual funds and 0.6% for small-cap mutual funds.

The average price-to-book ratio for the stocks in this fund is 2.22 compared to 3.04 for the SPDR S&P 500 ETF. The top 10 holdings constitute 2.8% of the portfolio holdings. The ETF has $386 million in total assets, the lowest in the Level3 Passive Portfolio. The expense ratio is 0.20%.

## Vanguard Mid-Cap Value ETF (VOE)

This fund is given a portfolio weight of 30% in the Level3 Passive Portfolio.

This ETF tracks the CRSP U.S. Mid Cap Value Index, which targets stocks representing the value and lower-growing half of the mid-cap market and weights the stocks by market capitalization. CRSP classifies value securities using book-to-price, forward earnings-to-price, historical earnings-to-price, dividend-to-price and sales-to-price ratios. To measure growth, CRSP looks at future long-term growth and short-term growth in earnings per share, historical growth in sales and earnings, current investment-to-assets ratio and return on assets.

Historically, mid-cap value stocks have had higher returns than large-cap stocks or mid-cap growth stocks. The value focus of this fund helps to boost the dividend yield of the ETF. The Vanguard Mid-Cap Value ETF has a dividend yield of 2.5% compared to the SPDR S&P 500 ETF yield of 1.9%. The average dividend yield of mid-cap funds as a whole is 0.8%. The Vanguard Mid-Cap Value ETF has the lowest price-to-book ratio in the Level3 Passive Portfolio. At 1.69, its price-to-book ratio is almost half of the 3.04 ratio for the SPDR S&P 500 ETF.

The top 10 holdings in the ETF make up 10.9% of the portfolio holdings. The ETF had 211 holdings at the end of January. The ETF has $8.7 billion in total assets. The expense ratio is 0.07%.

## Vanguard Real Estate ETF (VNQ)

This fund is given a portfolio weight of 10% in the Level3 Passive Portfolio.

This ETF tracks the return of the MSCI U.S. Investable Market Real Estate 25/50 Index that measures the performance of publicly traded equity real estate investment trusts (REITs), companies that purchase office buildings, hotels and other real property. Historically, the returns of REITs have exceeded the returns of the S&P 500 over the long run and provide diversification as well.

The Vanguard Real Estate ETF has a dividend yield of 4.2%, reflecting the higher payouts common with this sector. The higher yield also makes the group more sensitive to interest rates—falling in price when interest rates rise and moving up in price when interest rates decline.

The average price-to-book ratio for the holdings in the Vanguard Real Estate ETF is 2.22, compared to 3.04 for the S&P 500 fund. The top 10 holdings account for 41.6% of the portfolio holdings, but it is worth noting that the measure is boosted in this ETF, as it holds 11.3% of its assets in the Vanguard Real Estate II Index Fund (VRTPX), which also tracks the MSCI U.S. Investable Market Real Estate 25/50 Index. The fund's expense ratio is 0.12% it has $30.7 billion in assets.

## Portfolio Management Notes

For the Level3 Passive Portfolio, the initial weightings are as previously indicated and shown in Table 1. The approach to rebalancing 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 can be much less than they are 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 changes are made in the holdings.

Rebalancing decisions will have to be made by the individual since every investor will add or has 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 in relation to 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 in relation to the planned weight, bring it back to the appropriate level by selling the excess and using the funds to buy underweighted holdings.

The next review of the Level3 Passive Portfolio will be in the June 2019 *AAII Journal*.

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