LEVEL3 PASSIVE PORTFOLIO

The Level3 Approach: Seeking Higher Returns by Going Beyond the S&P 500

The portfolio outperformed the S&P 500 for the first four months of 2019 largely due to the slightly stronger performance of the equally weighted ETFs overcoming the outperformance of growth-focused stocks this year.

BY JOHN BAJKOWSKI

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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."

Cloonan envisioned the use of the Level3 Passive Portfolio as a complete equity portfolio for individual investors who wish to manage their own portfolio but do not have the desire to get involved in individual stock selection. It can be used as an equity portion of a whole portfolio for investors interested in selecting some individual stocks and actively managed funds, but with a desire to keep the majority of their portfolio in index funds. 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 on long-term observations and research on market segments and strategies that 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.

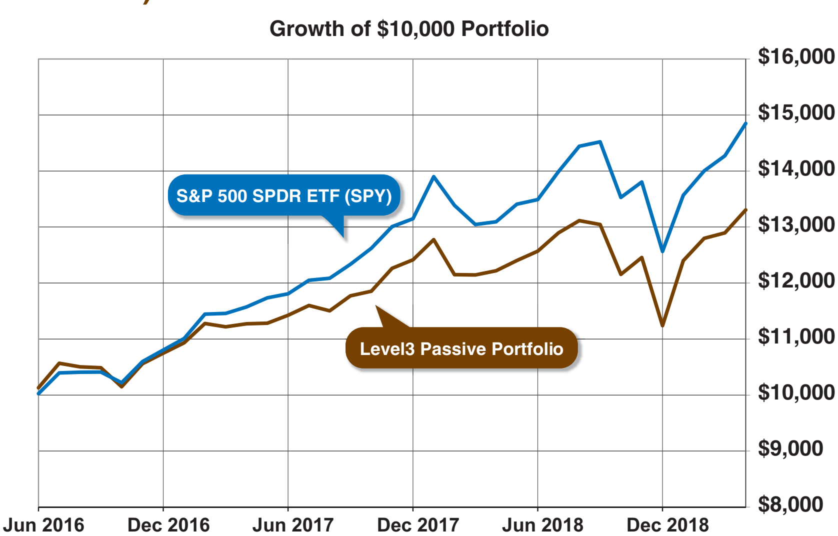
Changes to the Level3 Passive Portfolio should be relatively rare and will occur only when a new or different ETF is felt to be more effective at accomplishing a similar objective than one of the current holdings. Many of these ETFs are called smart beta indexes because they vary the weighting of stocks 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 shorter time periods will probably diverge (for better or worse) from the S&P 500.

Looking at the recent performance in Table 1, the Level3 Passive Portfolio outperformed the S&P 500 for the first four months of 2019 but is underperforming the index since its formation. The Level3 Passive Portfolio gained 18.4% year-to-date compared to a gain of 18.2% for the SPDR S&P 500 ETF (SPY). This is largely due to the slightly stronger performance of the equally weighted funds—Invesco S&P 500 Equal Weight Portfolio ETF (RSP) and Invesco Russell 1000 Equal Weight ETF (EQAL)—overcoming the outperformance of growth-focused stocks this year. Stock prices of growth-oriented companies have outpaced those of

FIGURE 1

Level3 Passive Portfolio vs. Comparison (Through 4/30/2019)



value stocks in 2019 across all market size segments. The technology, industrial and consumer discretionary sectors have led the market for the first four months of the year, while health care and biotech sectors have lagged.

Table 2 provides the target weights, recent 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 2.6% of total assets versus 22.0% of the market-cap-weighted SPDR 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%, equal to the 1.8% 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 3.25 compared to 2.65 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 $16.1 billion in total assets.

TABLE 1

Level3 Passive Portfolio Annual Performance

	Average Annual Return (%)		Cumulative Growth of $10,000 ($)	
	Level3 Passive Portfolio	S&P 500 SPDR ETF (SPY)	Level3 Passive Portfolio	S&P 500 SPDR ETF (SPY)
2016*	7.5	8.0	10,749	10,805
2017	15.5	21.7	12,414	13,148
2018	(9.5)	(4.4)	9,732	10,325
2019**	18.4	18.2	14,695	15,539
Since Inception**	**10.3**	**14.5**	**14,695**	**15,539**

**May 31 to December 31, 2016.*
***Through Apr 30, 2019. Portfolio was started on May 31, 2016.*

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 exchange-traded fund 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 the Invesco S&P 500 Equal Weight ETF.

The dividend yield of the Invesco Russell 1000 Equal Weight ETF is 1.4%, 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 1.2% 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 2.28 compared to 3.25 for the SPDR S&P 500 ETF. The top 10 holdings constitute 2.9% of the portfolio holdings. The ETF has $586 million in total assets, the lowest in the Level3 Passive Portfolio. The SPDR S&P 500 ETF

TABLE 2

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%	40.7	18.9	(7.8)	18.5	8.2	1.8	2.65	0.20	2.6	16,144
Invesco Russell 1000 Equal Weight (EQAL)	30%	36.9	18.9	(8.9)	17.2	7.9	1.4	2.28	0.20	2.9	586
Vanguard Mid-Cap Value (VOE)	30%	34.0	18.1	(12.4)	17.1	10.7	2.3	1.90	0.07	10.7	9,281
Vanguard Real Estate (VNQ)	10%	18.2	17.2	(5.9)	4.9	2.2	4.0	2.58	0.12	41.4	33,868
Weighted Avg of ETFs in Portfolio**		**35.3**	**18.5**	**(9.3)**	**16.3**	**8.3**	**2.0**	**2.31**	**0.15**	**9.0**	**11,190**
Actual Level3 Passive Portfolio***		**33.0**	**18.4**	**(9.5)**	**15.5**	**7.5**	—	—	—	—	—
Comparison:											
SPDR S&P 500 (SPY)		48.5	18.2	(4.4)	21.7	8.0	1.8	3.25	0.10	22.0	278,461

**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 4/30/2019.

has $278 billion in total assets. The expense ratio for the Invesco Russell 1000 Equal Weight ETF is 0.20%.

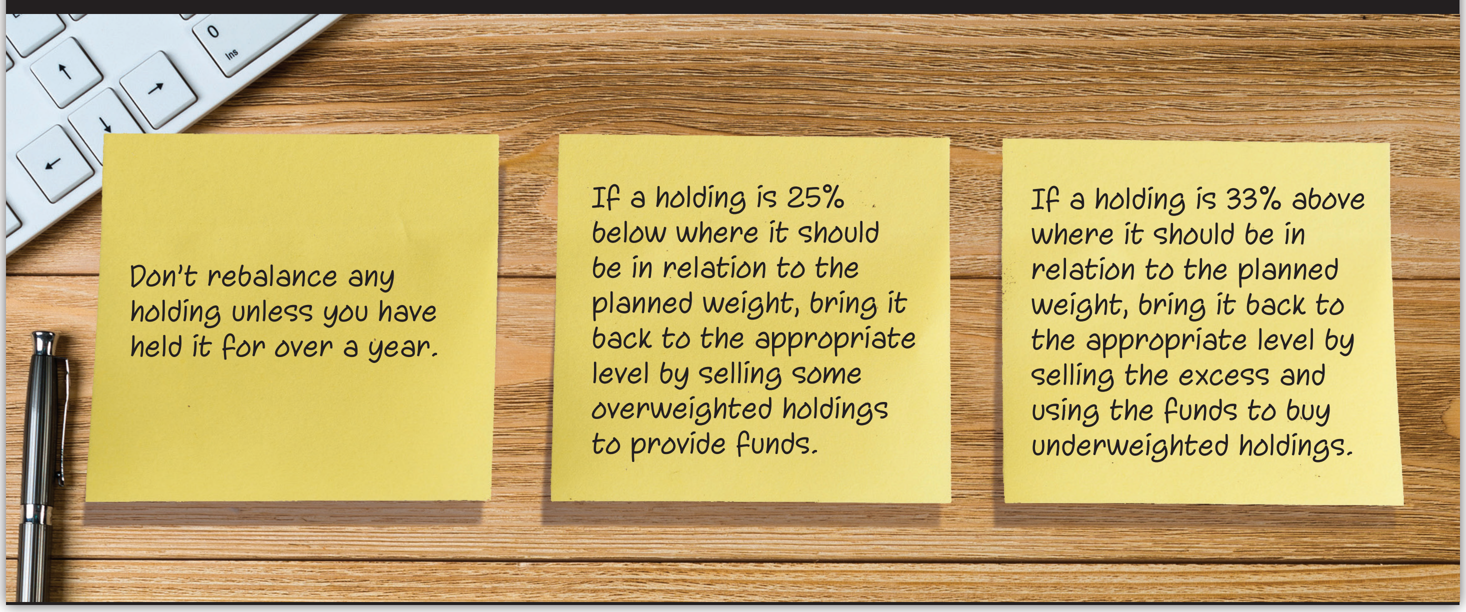
Vanguard Mid-Cap Value ETF (VOE)

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

The Vanguard Mid-Cap Value 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 2.3% compared to the SPDR S&P 500 ETF yield of 1.8%. The average dividend yield of mid-cap funds as a whole is 0.8%, while the average dividend yield for mid-cap value funds is 1.3%. The Vanguard Mid-Cap Value ETF has the lowest price-to-book ratio in the Level3 Passive

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:



Portfolio. At 1.90, its price-to-book ratio is well below the 3.25 ratio for the SPDR S&P 500 ETF.

The top 10 holdings in the ETF make up 10.7% of the portfolio holdings. The ETF had 206 holdings at the end of March. It has $9.3 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, which 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 4.0%, 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 2.58, compared to 3.25 for the SPDR S&P 500 ETF. The top 10 holdings account for 41.4% of the portfolio holdings, but it is worth noting that the measure is boosted in this ETF, as it holds 11.0% 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 $33.8 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.

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 November 2019 *AAII Journal*.

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Why a New Allocation Approach Is Needed an interview with James B. Cloonan, June 2016
The Level3 Withdrawal Strategy to Maximize Your Long-Term Wealth by John Bajkowski and James B. Cloonan, November 2017
Tracking the S&P 500 With Mutual Funds and ETFs by Charles Rotblut, CFA, March 2017