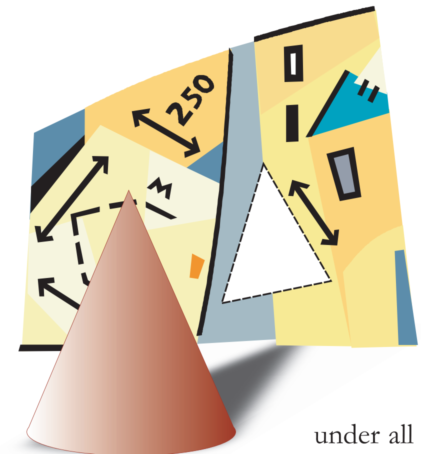
Model Mutual Fund and ETF Portfolios: Combined Update, Different Strategies

By James B. Cloonan

As promised in my May column, both the Model Mutual Fund Portfolio and the Model Exchange-Traded Fund (ETF) Portfolio will be covered four times a year from now on. They both will be covered each March, May, August and November. Of course any changes will also be reported on AAII.com.



The two portfolios will be treated separately—not combined into one overall portfolio—although members can certainly choose investments from either or both. It seems an excellent time to emphasize the difference between the approach taken in the Model ETF Portfolio and that taken in the Model Mutual Fund Portfolio.

Comparing the Two Portfolios

In the Mutual Fund Portfolio, the emphasis has been finding funds that meet the criteria, regardless of what specific area of investment they are in. The portfolio only invests in U.S. general equity funds, although a slight exception is made this month. Diversification across different sub-areas is only a secondary consideration, such as value versus growth or capitalization size.

I feel this is the appropriate approach because mutual fund managers have a great deal of discretion, and mutual funds are not always defined by the classification given to them by analysts. To some degree managers are free to time the market and vary their strategy over time. The objective is not to try to select the funds that have had the best performance over recent years (the hot funds), since the highest short-term performance usually comes from an approach that will not be best in future market scenarios, but to select funds that are likely to do better over the long run than the market, absolutely and relative to the level of risk, under all market conditions.

In the Model ETF Portfolio, the approach has been to select investment areas that have been the most rewarding over the long term, with enough different areas to provide diversification, and then to search for the best ETFs in each of those areas. I have included some foreign ETFs in the portfolio. This approach is taken because ETFs are usually constrained to a rather narrow investment approach and, in addition, not many have long-term histories.

The selection rules for the Model Mutual Fund Portfolio are shown on page 33 with the changes. In my November column, I will provide the rationale for the Model ETF Portfolio. The rules and rationale for both portfolios are always available at AAII.com.

The Model Mutual Fund Portfolio

The Model Mutual Fund Portfolio is up 4.2% year-to-date. This compares with 6.0% for the S&P 500, as measured by the Vanguard 500 Index fund (VFINX). These and longer-term results can be seen in Tables 1 and 2 as well as Figure 1. As Figure 1 indicates, while the portfolio has recovered significantly from the recession low, it has not reached its previous high. This is also true of the general market.

Portfolio Changes

Two changes were made in the Model Mutual Fund Portfolio. CGM Focus (CGMFX) was sold. This has always

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) **In its worst three-year period (based on calendar years) either it must not have had a loss or, in the case of a really bad stock market, its loss must have been substantially less than that of the S&P 500 and its recovery quicker.** I feel that individuals should have at least a three-year investment horizon when investing in equities. So this rule seeks to find funds that will minimize the losses an investor might face in bear markets.

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 four times a year.

Table 1. Model Mutual Fund Portfolio

Fund (Ticker)	Style	Market-Cap Size	YTD Return (%)	Annual Return (%) 1-Yr	5-Yr	10-Yr	Fund Assets ($ Mil)	Exp Ratio (%)	Std Dev (36 Mo Ann'l) (%)	Worst 3-Yr Calendar-Period Return (%)
Aston/Optimum Mid Cap N (CHTTX)	Low Value	Mid-Cap	3.9	32.8	9.9	9.5	1,767	1.15	28.5	(7.9)
CGM Realty (CGMRX)	Very Low Value	Large-Cap	8.9	41.2	9.0	19.4	1,785	0.89	39.3	(2.7)
Fidelity Capital & Income (FAGIX)	na*	na*	4.9	20.5	10.3	10.2	10,762	0.76	18.1	(7.2)
FMI Common Stock (FMIMX)**	Low Value	Mid-Cap	7.8	32.0	9.2	9.6	1,141	1.24	23.6	(3.0)
Madison Mosaic Mid-Cap (GTSGX)	Very Low Value	Large-Cap	10.3	38.2	5.2	6.7	160	1.25	21.2	(7.1)
Manning & Napier Pro-Blend Ext S (MNBAX)	Low Value	Giant-Cap	4.7	21.5	5.5	6.2	790	1.08	15.2	(2.2)
Meridian Value (MVALX)	Very Low Value	Mid-Cap	2.4	30.1	4.1	6.3	871	1.09	21.2	(4.5)
Northern Small Cap Value (NOSGX)	High Value	Small-Cap	5.0	33.9	3.4	8.1	1,670	1.00	25.9	(6.3)
Royce PA Mutual Invest (PENNX)	Low Value	Small-Cap	7.1	36.1	5.6	9.1	5,092	0.90	26.2	(8.4)
Yacktman Focused (YAFFX)	Very Low Value	Giant-Cap	8.1	27.0	11.7	13.0	3,200	1.25	23.7	(2.8)
Avg of Funds in Model Fund Portfolio†			**6.3**	**31.3**	**7.4**	**9.8**	**2,724**	**1.06**	**24.3**	**(5.2)**
Model Fund Portfolio Performance††			**4.2**	**31.9**	**3.9**	**na**	**—**	**—**	**23.9**	**(6.4)**
Vanguard 500 Index (VFINX)	Low Value	Giant-Cap	6.0	30.5	2.9	2.6	30,462	0.17	20.9	(8.4)

**Distressed securities—stock and bond.*
***FMIMX is closed to new investors. Current shareholders can continue to invest in the fund. Other investors should simply use the other nine funds to form their portfolio.*
†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 6/30/2011.

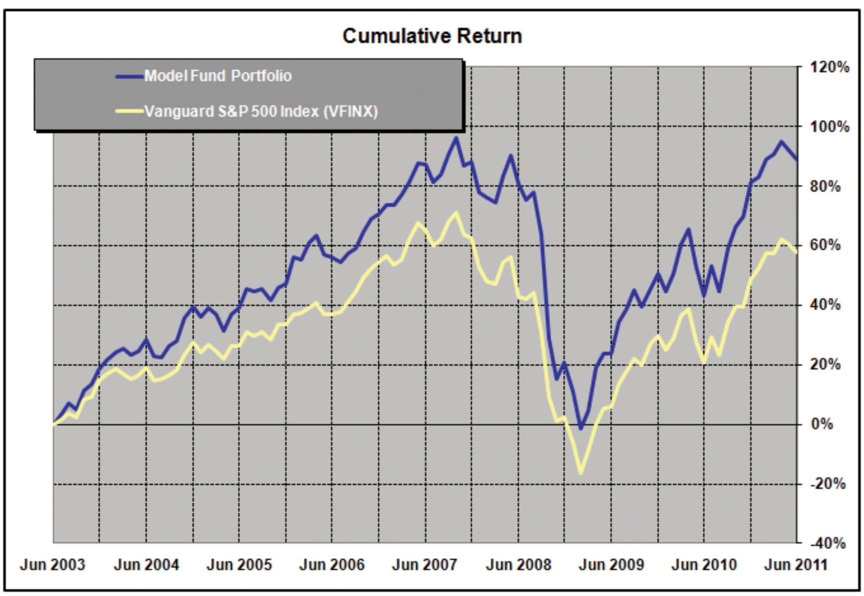
Go to the Model Mutual Fund Portfolio area of AAII.com for the definitions of style and market-cap size.

Table 2. Model Mutual Fund Portfolio: Annual Performance Since Inception

	Average Annual Return (%) Model Mutual Fund Portfolio	Vanguard S&P 500 Index (VFINX)
2003*	18.6	15.0
2004	17.7	10.8
2005	5.4	4.8
2006	16.1	15.6
2007	10.2	5.4
2008	(35.9)	(37.0)
2009	24.9	26.5
2010	20.3	14.9
YTD**	4.2	6.0
Since Incep**	8.3	5.9

**June 30 to December 31, 2003.*
***Through 6/30/2011.*

Figure 1. Model Mutual Fund Portfolio Vs. Benchmark (Through 6/30/11)



been a volatile fund, but it has managed a good return over the very long run. I feel that the volatility is just too high, however, and the five-year return fails on a risk-adjusted basis. RBC Microcap Value S (TMVSX) was also sold. While its very-long-term (10 years and longer) return is excellent, its five-year and shorter-term returns don't justify

Table 3. Model ETF Portfolio

ETF (Ticker)	Weight in Port (%)	YTD Return (%)	Annual Return (%) 1-Yr	3-Yr	5-Yr	Since 4/1/06	Fund Assets ($ Mil)	Exp Ratio (%)	Std Dev (36 Mo Ann'l) (%)
PowerShares FTSE RAFI US 1000 (PRF)	13.33	5.5	30.9	8.2	4.3	4.1	1,218.9	0.39	25.6
Rydex S&P MidCap 400 Pure Value (RFV)	13.33	3.7	31.6	10.2	4.3	4.2	52.5	0.35	36.6
Rydex S&P SmallCap 600 Pure Value (RZV)	13.33	1.2	30.8	13.7	2.3	1.4	79.4	0.35	47.4
First Trust DJ Select MicroCap Index (FDM)	13.33	3.4	33.7	6.1	1.5	0.5	132.7	0.60	28.3
iShares Cohen & Steers Realty Majors (ICF)	13.33	11.9	36.1	3.4	1.3	0.9	2,652.6	0.35	41.4
ALPS Alerian MLP ETF (AMLP)	13.33	2.6	nmf	nmf	nmf	nmf	1,197.3	0.85	nmf
Vanguard FTSE All-World Ex-U.S. (VEU)	5.00	4.1	31.6	0.2	nmf	nmf	7,296.4	0.22	27.5
SPDR S&P International Small Cap (GWX)	5.00	3.0	33.5	3.0	nmf	nmf	962.2	0.59	27.2
Vanguard Emerging Markets (VWO)	5.00	0.8	28.7	4.1	11.1	9.5	49,339.2	0.22	31.5
SPDR Dow Jones Int'l Real Estate (RWX)	5.00	4.8	38.8	0.5	nmf	nmf	2,276.2	0.59	28.6
Portfolio Average*		**4.1**	**30.4**	**6.0**	**2.3**	**1.9**	**3,704.6**	**0.47**	**30.4**
Optional Investment:									
iShares Barclays 1-3 Yr Treasury Bond (SHY)		0.8	1.2	2.7	4.0	4.0	8,464.7	0.15	1.3
Benchmarks:									
SPDR S&P 500 Index (SPY)		6.0	30.4	3.3	2.9	2.5	92,092.6	0.09	20.8
iShares MSCI EAFE Index (EFA)		5.0	30.1	(1.8)	1.4	1.5	39,403.4	0.35	25.4
ETF Benchmark (80% SPY/20% EFA)		5.8	30.4	2.3	2.7	2.3	81,554.8	0.14	21.4

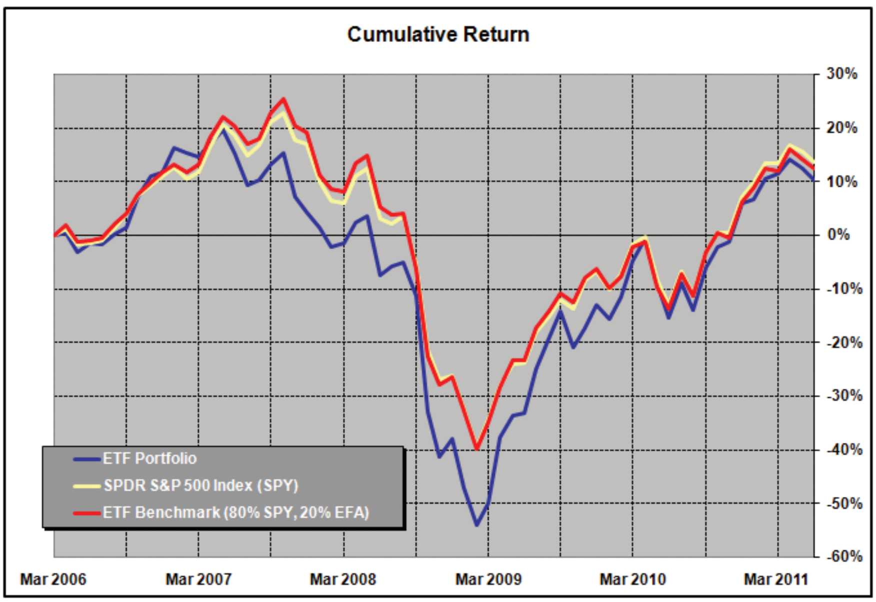
**Performance of actual portfolio including reinvested dividends. Other figures are weighted averages.*
Source: Morningstar Inc. Data as of 6/30/2011.

Table 4. Model ETF Portfolio: Annual Performance Since Inception

	Average Annual Return (%) Model ETF Portfolio	ETF Benchmark (80% SPY/ 20% EFA)
2006*	11.7	11.9
2007	(6.6)	6.5
2008	(40.5)	(38.1)
2009	40.0	27.4
2010	21.9	13.4
YTD**	4.1	5.8
Since Incep**	1.9	2.3

**April 1 to Dec. 31, 2006.*
***Through 6/30/2011.*

Figure 2. Model ETF Portfolio Vs. Benchmarks (Through 6/30/2011)



the risk.

Yacktman Focused (YAFFX) and Fidelity Capital & Income (FAGIX) funds have been added. In both cases these funds were chosen over other qualifying funds because of their relatively good performance during the "great recession." They easily meet the new requirement that even in their worst three-year period they substantially beat the market.

Fidelity Capital & Income fund may seem like a strange selection. It is usually listed under high-yield bond funds, even though it holds both stocks and bonds. High-yield (junk) bond analysis is closer to the kind of analysis used for stocks as opposed to bond analysis. Nomenclature is often confusing. In an investment sense, a preferred stock is more like a bond than a stock, and a convertible bond more closely resembles a stock. What's in a name?

I like the added diversification that Fidelity Capital & Income brings and the consistency of its returns. Distressed securities are one of the areas where I believe the market is not efficient, thus providing opportunities for excess profits. It is also an area that is difficult for an individual to approach, and that is where mutual funds are most valuable.

When more than one fund is sold, the total proceeds are split equally between the new funds.

Rule Change

As I have discussed previously, the old rule requiring that the fund never have a three-year period with negative earnings had to be adjusted since virtually all general stock funds had such a period surrounding the 2008 recession. I have modified that selection rule to make it relative to the general market rather than absolute. Consequently, Rule 4 has been changed to require that a fund's worst three-year period (on a calendar basis) must either be positive or have negative earnings significantly better than the market's (the S&P 500).

The current rules are shown on page 33. I had hoped that management fees would start to come down with competition from ETFs and index funds; however, this has not been realized. I remain concerned about fees over 1%, except for small funds, not just because of the reduced return, but because of what it says about management.

Model ETF Portfolio

The Model ETF Portfolio is up 4.1% year-to-date compared to 5.8% for our ETF benchmark, which is 80% SPDR S&P 500 (SPY) and 20% iShares MSCI EAFE Index (EFA). Longer-term results can be seen in Tables 3 and 4 and Figure 2.

Real estate, which has hurt portfolio performance from 2008 through 2010, has become a strong performer in 2011 both domestically and overseas, as shown by iShares Cohen & Steers Realty Majors (ICF) and SPDR Dow Jones International Real Estate (RWX). Emerging markets have seen their growth slow this year, but in the long term, I believe, the odds favor continued growth.

There are no portfolio changes at this time. The cash dividends received over the period were reinvested. While the Mutual Fund Portfolio has automatic reinvestment of dividends and capital gains, those from the Model ETF Portfolio must be reinvested after receipt. The procedure is to invest dividend proceeds in the holding that has the most below-average dollar value, thereby obtaining some degree of rebalancing without any active selling.

Looking Ahead

Surprisingly, at the year's halfway point the maket is almost exactly halfway to an overall average year, which has a return of 12.6% (since 1935), as measured by the S&P 500 index. It is behind schedule to attain the 21.7% of the average pre-election year.

I will be glad to see some settlement of the Greek crisis and an agreement on the conditions surrounding an expansion of the debt limit. Hopefully these dramas will have played out by the time you receive this issue of the *AAII Journal*. I, personally, have average expectations for the stock market at this time and don't see interest rate increases coming for a while. So I think it remains a time for holding the long-term allocations that are appropriate for each of us.

I will be covering both the Model Fund Portfolio and the Model ETF Portfolio again in the November *Journal*. In the meantime, you can follow any updates at AAII.com. ➤

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