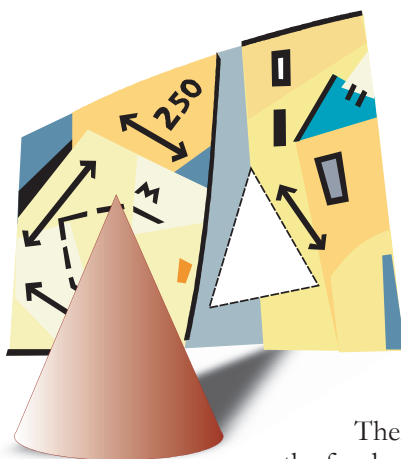


Model Mutual Fund and ETF Portfolios: Waiting for Value and Small-Cap to Improve

By James B. Cloonan

We continue to cover both the Model Mutual Fund Portfolio and the Model Exchange-Traded Fund (ETF) Portfolio on a quarterly basis.

They both will be covered each March, May, August and November in the *AAIL Journal*. Of course any changes will also be reported at AAIL.com.



500 Index fund (VFINX). These returns are about 15% lower than those of three months ago. These and longer-term results can be seen in Tables 1 and 2 as well as Figure 1. As Figure 1 indicates, the recovery has stopped, and we have a significant leg down.

There are no portfolio changes at this time. All of the funds except FMIMX remain open for new investors. FMIMX should continue to be held by those who already have it.

How the Portfolios Differ

In the August *AAIL Journal*, we detailed the difference between the selection approach of the Model Mutual Fund Portfolio and that of the Model ETF Portfolio.

Basically, the mutual fund portfolio looks for funds within the equity category that are believed to be most likely to outperform the general stock market, regardless of their exact category. Only secondarily does it try to balance the categories (large cap vs. small cap, value vs. growth, etc.)

In the Model ETF Portfolio, the emphasis is on choosing the areas of investment that seem most likely to outperform and then choosing the best ETF in that category. In both cases, the long term is emphasized.

In August, we provided the detailed selection rules for the Model Mutual Fund Portfolio. This issue we show the rationale for the Model ETF Portfolio. The rules and rationales for both portfolios are always provided at AAIL.com.

Model Mutual Fund Portfolio

What a difference three months makes. The Model Mutual Fund Portfolio is down 12.6% year-to-date. This compares with -8.8 % for the S&P 500 as measured by the Vanguard

Model ETF Portfolio

The Model ETF Portfolio is down 14.8% year-to-date, as opposed to -10.0% for our benchmark, which is 80% SPDR S&P 500 (SPY) and 20% iShares MSCI EAFE Index (EFA). Longer-term results can be seen in Figure 2 and Tables 3 and 4.

There are no portfolio changes at this time.

Looking Ahead

The third year of the election cycle has not been a down market year since 1939. To preserve that record, the market is going to need a strong performance in the last quarter. To attain the 16.6% average return for a pre-election year, we would need one of the strongest quarters in history.

Over the longer term, smaller-cap stocks and value stocks easily outperform larger-cap and non-value (growth) stocks. However, every so often the growth and large-cap equities have a period of better performance. We are in such a period now, and it has affected the relative performance of our portfolios. This is especially true of the Model ETF Portfolio. I believe a return to the normal superiority of value

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Model ETF Portfolio: Selection Rationale

The rationale used in building the Model ETF Portfolio is to achieve diversification across the asset 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 do not intend to use foreign bonds for risk reduction.

In U.S. investments:

- We will diversify across equities, real estate, master limited partnerships, 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. 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.

ETF Descriptions

Domestic Stock ETF Holdings

- **PowerShares FTSE RAFI US 1000 (PRF):** Tracks a fundamentally weighted index that holds the 1,000 largest domestic stocks based on four factors—book value, cash flow, sales, and dividends. Stocks in the portfolio are weighted by their fundamental scores.
- **Rydex S&P MidCap 400 Pure Value (RFV):** Tracks the “pure value” segment of S&P MidCap 400 index, which holds approximately one third of the index ranked on price-to-book-value, price-earnings, and price-to-sales ratios.
- **Rydex S&P SmallCap 600 Pure Value (RZV):** Tracks the “pure value” segment of the S&P SmallCap 600 index, which holds approximately one third of the index ranked on price-to-book-value, price-earnings, and price-to-sales ratios.
- **First Trust Dow Jones Select MicroCap Index (FDM):** Tracks an index constructed from micro-

cap stocks based on a combination of value and growth factors. The weighting of each stock is based on a modified market capitalization determined using float rather than total shares.

Domestic Stock Sector ETF Holdings

- **iShares Cohen & Steers Realty Majors Index Fund (ICF):** Tracks a modified capitalization-weighted index of large, liquid domestic real estate investment trusts (REITs) that is diversified across property sectors in an attempt to represent the current market.
- **Alerian MLP ETF (AMLPL):** Tracks the modified capitalization-weighted Alerian MLP Infrastructure Index, which consists of master limited partnerships (MLP) and limited liability companies (LLC) that earn the majority of their cash flow from energy commodities, but are not directly exposed to changes

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Table 1. Model Mutual Fund Portfolio

Fund (Ticker)	Style	Market-Cap Size	YTD Return (%)	Annual Return (%)			Fund Assets (\$ Mil)	Exp Ratio (%)	Std Dev (36 Mo Ann'l) (%)	Worst 3-Yr Calendar-Period Return (%)
				1-Yr	5-Yr	10-Yr				
Aston/Optimum Mid Cap N (CHTTX)	Moderate Value	Mid-Cap	(20.3)	(10.1)	3.4	8.4	1,289	1.15	28.8	(7.9)
CGM Realty (CGMRX)	Very Low Value	Large-Cap	(13.8)	(3.0)	3.3	17.4	1,353	0.89	40.0	(2.7)
Fidelity Capital & Income (FAGIX)	na*	na*	(6.5)	(0.5)	7.0	9.9	9,209	0.76	18.0	(7.2)
FMI Common Stock (FMIMX)**	Low Value	Mid-Cap	(9.8)	2.0	4.4	8.8	946	1.24	24.0	(3.0)
Madison Mosaic Mid-Cap (GTSGX)	Low Value	Mid-Cap	(7.5)	2.9	0.4	5.6	135	1.25	21.5	(7.1)
Manning & Napier Pro-Blend Ext S (MNBAX)	Low Value	Giant-Cap	(7.3)	(1.5)	1.9	5.8	664	1.08	15.5	(2.2)
Meridian Value (MVALX)	Low Value	Mid-Cap	(12.7)	(1.7)	(0.1)	5.8	667	1.09	21.5	(4.5)
Northern Small Cap Value (NOSGX)	High Value	Small-Cap	(15.0)	(2.1)	(1.2)	8.0	1,357	1.00	26.8	(6.3)
Royce PA Mutual Invest (PENNX)	Low Value	Small-Cap	(15.5)	(2.8)	0.8	8.3	3,895	0.90	27.0	(8.4)
Yacktman Focused (YAFFX)	Very Low Value	Giant-Cap	(1.2)	5.2	8.3	12.4	3,346	1.25	24.0	(2.8)
Avg of Funds in Model Fund Portfolio[†]			(11.0)	(1.2)	2.8	9.1	2,286	1.06	24.7	(5.2)
Model Fund Portfolio Performance^{††}			(12.6)	(0.5)	(0.1)	na	—	—	24.2	(6.4)
Vanguard 500 Index (VFINX)	Low Value	Giant-Cap	(8.8)	1.0	(1.3)	2.7	25,318	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 September 30, 2011.

Go to the Model Mutual Fund Portfolio area of AAIL.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**	(12.6)	(8.8)
Since Incep**	5.7	3.8

*June 30 to December 31, 2003.

**Through September 30, 2011.

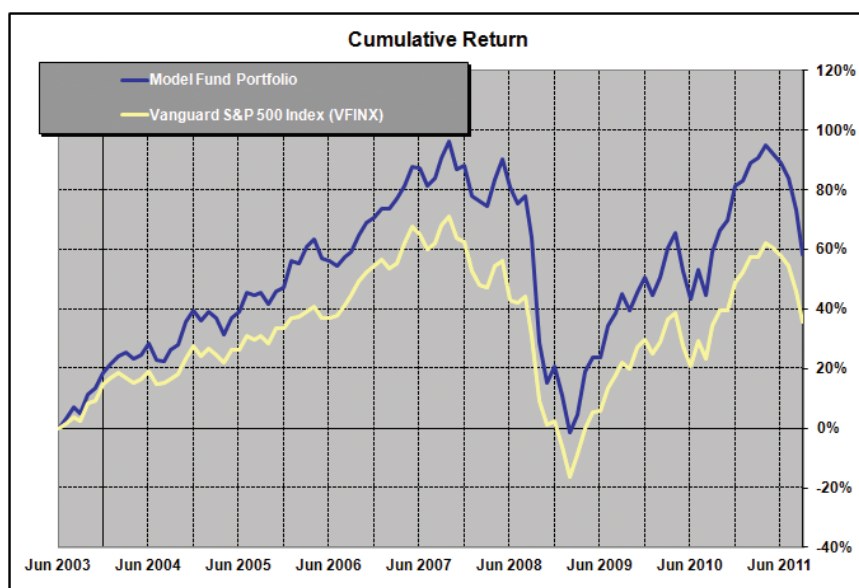
Figure 1. Model Mutual Fund Portfolio Vs. Benchmark (Through 9/30/11)


Table 3. Model ETF Portfolio

ETF (Ticker)	Weight in Port (%)	YTD Return (%)	Annual Return (%)				Fund Assets (\$ Mil)	Exp Ratio (%)	Std Dev (36 mo. Ann'l) (%)
			1- Yr	3- Yr	5- Yr	Since 4/1/06			
PowerShares FTSE RAFI US 1000 (PRF)	13.33	(11.2)	(0.8)	4.4	(0.3)	0.7	1,007.9	0.39	25.9
Rydex S&P MidCap 400 Pure Value (RFV)	13.33	(18.5)	(7.1)	1.2	(0.7)	(0.4)	32.9	0.35	37.5
Rydex S&P SmallCap 600 Pure Value (RZV)	13.33	(21.7)	(5.5)	1.6	(2.8)	(3.3)	55.2	0.35	48.4
First Trust DJ Select MicroCap Index (FDM)	13.33	(22.6)	(6.9)	(3.9)	(4.0)	(4.7)	54.0	0.60	29.8
iShares Cohen & Steers Realty Majors (ICF)	13.33	(4.6)	2.1	(3.1)	(3.8)	(2.0)	2,084.9	0.35	42.1
Alerian MLP ETF (AMLP)	13.33	(0.8)	4.7	nmf	nmf	nmf	1,357.0	0.85	nmf
Vanguard FTSE All-World Ex-U.S. (VEU)	5.00	(17.9)	(11.9)	(0.2)	nmf	nmf	5,772.4	0.22	27.7
SPDR S&P International Small Cap (GWX)	5.00	(15.5)	(5.6)	5.2	nmf	nmf	862.5	0.59	26.6
Vanguard Emerging Markets (VWO)	5.00	(23.4)	(17.6)	5.0	4.3	3.8	39,777.0	0.22	31.5
SPDR Dow Jones Int'l Real Estate (RWX)	5.00	(13.5)	(6.5)	1.1	nmf	nmf	1,996.1	0.59	28.3
Portfolio Average*		(14.8)	(4.2)	0.5	(2.3)	(1.9)	3,032.5	0.47	31.1
Optional Investment:									
iShares Barclays 1-3 Year Treasury Bond (SHY)		1.2	1.1	2.2	3.7	3.9	9,465.4	0.15	1.3
Benchmarks:									
SPDR S&P 500 Index (SPY)		(8.7)	1.0	1.2	(1.2)	(0.4)	81,232.9	0.09	20.8
iShares MSCI EAFE Index (EFA)		(14.9)	(9.4)	(1.2)	(3.5)	(2.4)	35,034.8	0.35	25.0
ETF Benchmark (80% SPY/20% EFA)		(10.0)	(1.0)	0.7	(1.7)	(0.8)	71,993.3	0.14	21.4

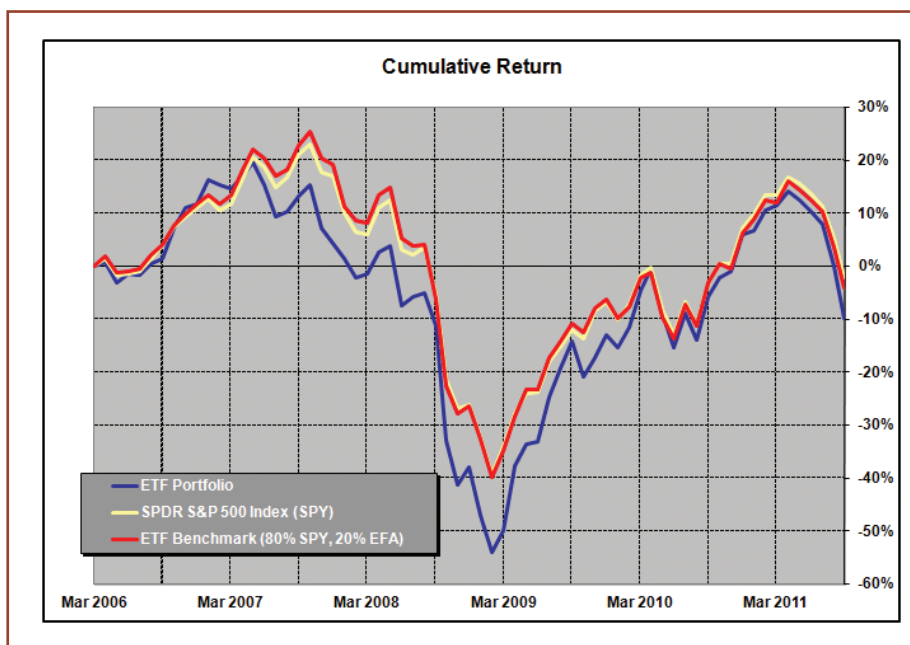
*Performance of actual portfolio including reinvested dividends. Other figures are weighted averages.
Source: Morningstar, Inc. Data as of September 30, 2011.

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**	(14.8)	(10.0)
Since Incep**	(1.8)	(0.8)

*April 1 to December 31, 2006.
**Through September 30, 2011.

Figure 2. Model ETF Portfolio Vs. Benchmarks (Through 9/30/2011)



(Continued from page 33)

in commodity prices. AMLP issues Form-1099 like a regular corporation, and the net asset value (NAV) of fund shares will be reduced by the accrual of any deferred tax liabilities. Therefore, the fund's NAV performance could differ from the index.

Foreign Stock ETF Holdings

- **Vanguard FTSE All-World ex-US (VEU):** Tracks the float-adjusted capitalization-weighted FTSE All-World ex US Index, which includes approximately 2,220 non-U.S. large- and mid-cap stocks from both the developed and emerging markets.
- **SPDR S&P International Small Cap (GWX):** Tracks the float-adjusted capitalization-weighted S&P Developed Ex-U.S. Under USD2 Billion Index, which is constructed of small-cap, publicly traded companies domiciled in developed countries outside the U.S.
- **Vanguard Emerging Markets (VWO):** Tracks the float-

adjusted capitalization-weighted MSCI Emerging Markets Index, which is designed to provide broad exposure to the equity markets of emerging countries in Europe, Asia, Africa, and Latin America.

Foreign Stock Sector ETF Holding

- **SPDR Dow Jones International Real Estate (RWX):** Tracks the float-adjusted capitalization-weighted Dow Jones Global ex-U.S. Real Estate Securities Index, which holds publicly traded real estate securities in developed and emerging countries.

Optional ETF Holding

- **iShares Barclays 1-3 Year Treasury Bond (SHY):** Use of this ETF should be considered as a way of controlling portfolio risk. The index tracked is capitalization-weighted and includes U.S. Treasury bonds and notes that have a remaining maturity of between one and three years.

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and smaller capitalization will be the first sign of bull market resumption. It may require that technology stocks, which are mostly large-growth stocks, have a bit of a run first, since they are lagging the rest of the market. I will discuss this possibility again when we cover the Model Shadow Stock Portfolio in the January 2012 *AAIL Journal*.

In August I said that I hoped we would see some progress on the Greek situation and a resolution to the U.S. Congress stalemate on the debt limit before I wrote this column. The situation in Greece seems far from settled, and while we have survived one deadline for the debt limit increase, Congress looks to be headed for a series of deadlocks. No matter how the situation in Greece

is resolved, the impact on Europe will be significant and there will be some impact on the U.S. as well.

The wall of worry keeps getting higher. Will the stock market climb it? We will be covering both the Model Fund Portfolio and the Model ETF Portfolio again in the March 2012 *AAIL Journal*; in the meantime, you can follow any updates at AAIL.com. ▲

James B. Cloonan is founder and chairman of AAIL.

Retired Investor

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to interest and dividends, while preserving and growing capital, you are ahead of the game. Bad or volatile markets will have less affect on you.

5. Think of your retirement assets not as individual stocks and bonds but as a portfolio that is the sum of its parts. In other words, think in terms of the big-picture. How is each element of the portfolio working to help you meet your retirement goals?
6. Define how much risk you want to take. Do you want to assume general market risk, as measured by the S&P 500 index, or a higher or lower level of risk? The measure will help you put things in context when it comes to reviewing your portfolio.
7. Once reasonable objectives are determined, decisions can be implemented. Then, start paying close attention to the results of your decisions.

No System?

Without a system—or with an ineffective system such as the ones discussed above—it is all too easy to be compelled to action by outside events. In bubble markets, which you will likely see again during your lifetime, many otherwise conservative investors can be drawn into highly speculative investments. During bear markets, normally cautious investors can be spooked into pulling out of the market at the worst time, often without realizing that they are engaging in the risky practice of market timing.

—Julie Jason, Jackson, Grant Investment Advisers Inc., Stamford, Conn., author, *Managing Retirement Wealth: An Expert Guide to Personal Portfolio Management in Good Times and Bad* (Sterling, 2011).