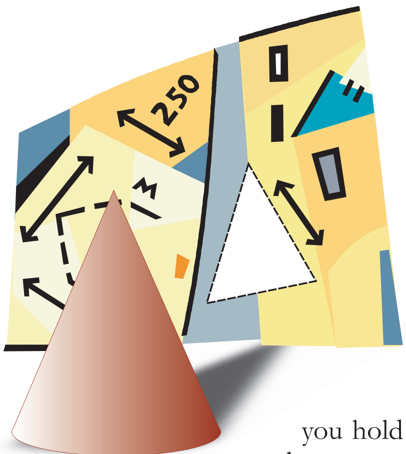
Model Mutual Fund and ETF Portfolios: Value and Small Stocks Impact Returns

By James B. Cloonan



Once again, the past quarter saw the market change direction dramatically. This time, happily, the change was strongly to the upside.

As can be seen in Tables 1 and 3 on pages 30 and 31, both the Model Mutual Fund Portfolio and the Model ETF Portfolio outperformed their benchmarks year-to-date as of January 31, 2012.

However, the turn to the upside was not strong enough to overcome the weak third quarter of last year. Both model portfolios underperformed for 2011, as shown in Tables 2 and 4.

Figures 1 and 2 give a graphical representation of the portfolios' performances compared to their benchmarks.

Performance Determinants

The underperformance of both portfolios is largely due to the inferior short-term performance of value stocks and small-cap stocks. Since small-cap and value stocks have always proved superior in the long run, they are emphasized in the model portfolios. As a result, the model portfolios pay a price during the occasional periods when small caps and value stocks underperform. With the recent turnaround in the market, smaller-cap and value stocks have led the way up, and we expect to see that continue.

With an apparent solution, at least short term, to the eurozone problems, foreign equities should be recovering. Emerging markets, which were a top-performing sector for years, were hit the hardest in the 2011 pullback but seem to have regained upward strength.

No Portfolio Changes

There are no changes in either of the portfolios.

FMI Common Stock fund (FMIMX) continues to be closed to new investors. If you hold FMIMX, continue to hold it. If you do not, then create your portfolio from the remaining funds. The selection rules for the Model Mutual Fund Portfolio are shown on page 29. The May 2012 *AAII Journal* Model Portfolios column will give the selection rationale for the Model ETF Portfolio.

Looking Ahead

Most of the news is positive, and the stock market appears to be in a bullish mode.

There are of course a number of political and economic vulnerabilities, mostly foreign, that could impact the market. I remain somewhat bullish, and my main concern is that more and more advisers are turning bullish.

The average return (since 1932) for the fourth year in the election cycle (which is the actual election year) is 10.3% for the S&P 500, and the index is getting close to that already. Of course there is a lot to make up for from 2011, since the third year in the cycle has averaged 20.7% but 2011 was up only 2%. However last year did escape being the only pre-election year to have a negative return since 1931—but not by much. Congress has been acting a little differently lately, so the usual cyclical influence of government spending is a bit distorted.

We will discuss the Model Mutual Fund and ETF Portfolios again in the May *AAII Journal*. In the meantime you may follow them at AAII.com. ▲

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)	Moderate Value	Mid-Cap	7.4	(0.7)	5.2	8.4	1,573	1.15	25.7	(7.9)
CGM Realty (CGMRX)	Low Value	Mid-Cap	8.4	7.3	4.5	18.7	1,638	0.89	30.9	(2.7)
Fidelity Capital & Income (FAGIX)	na*	na*	4.2	(0.8)	7.6	10.4	9,336	0.76	14.3	(7.2)
FMI Common Stock (FMIMX)**	Moderate Value	Mid-Cap	5.0	7.5	6.4	9.5	1,149	1.24	20.8	(3.0)
Madison Mosaic Mid-Cap (GTSGX)	Low Value	Mid-Cap	4.8	6.3	2.3	6.0	174	1.25	18.0	(7.1)
Manning & Napier Pro-Blend Ext S (MNBAX)	Moderate Value	Giant-Cap	3.9	1.2	2.7	6.0	732	1.08	13.3	(2.2)
Meridian Value (MVALX)	Moderate Value	Mid-Cap	5.5	4.1	1.7	6.3	746	1.09	20.4	(4.5)
Northern Small Cap Value (NOSGX)	High Value	Small-Cap	6.1	5.6	1.3	8.4	1,699	1.00	24.3	(6.3)
Royce PA Mutual Investment (PENNX)	Moderate Value	Small-Cap	7.1	1.6	2.7	8.5	4,557	0.90	24.1	(8.4)
Yacktman Focused (YAFFX)	Low Value	Giant-Cap	2.8	8.7	9.3	11.4	4,946	1.25	20.5	(2.8)
Avg of Funds in Model Fund Portfolio†			**5.5**	**4.1**	**4.4**	**9.3**	**2,655**	**1.06**	**21.2**	**(5.2)**
Actual Fund Portfolio Performance††			**5.4**	**2.6**	**1.6**	**na**	**—**	**—**	**20.6**	**(6.4)**
Vanguard 500 Index (VFINX)	Moderate Value	Giant-Cap	4.5	4.1	0.2	3.4	26,661	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 January 31, 2012.

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
2011	(1.7)	2.0
YTD**	5.4	4.5
Since Incep**	7.6	5.5

**June 30 to December 31, 2003.*
***Through January 31, 2012.*

Figure 1. Model Mutual Fund Portfolio Vs. Benchmark (Through 1/31/12)

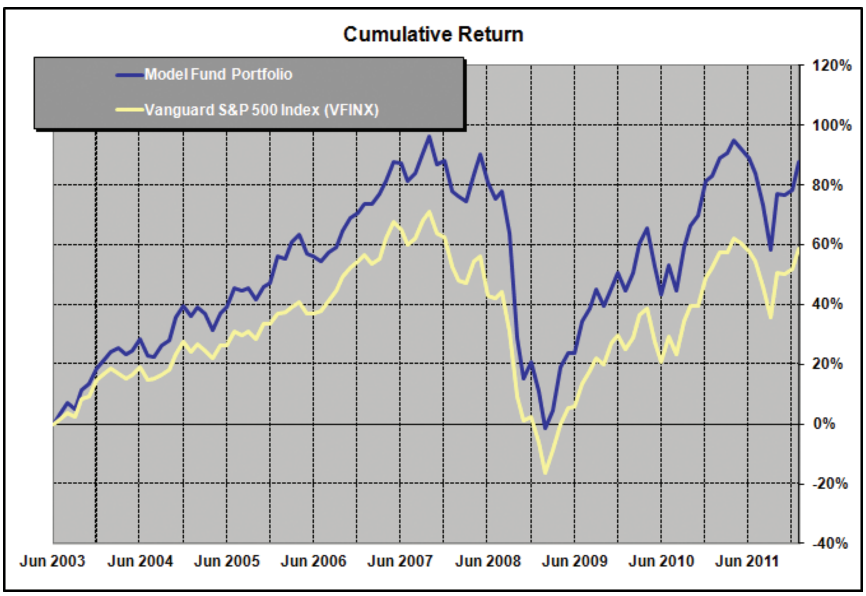


Table 3. Model ETF Portfolio

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	4.1	1.4	25.2	1.0	3.4	1,243.9	0.39	23.2
Rydex S&P MidCap 400 Pure Value (RFV)	13.33	8.2	(0.2)	33.1	1.1	3.5	42.8	0.35	33.1
Rydex S&P SmallCap 600 Pure Value (RZV)	13.33	9.6	3.3	39.3	(0.4)	1.2	69.3	0.35	45.4
First Trust DJ Select MicroCap Index (FDM)	13.33	7.2	(1.5)	20.7	(1.6)	(0.5)	56.1	0.60	27.5
iShares Cohen & Steers Realty Majors (ICF)	13.33	6.0	12.0	32.6	(3.7)	1.6	2,632.8	0.35	32.4
ALPS Alerian MLP ETF (AMLP)	13.33	1.4	9.9	nmf	nmf	nmf	2,382.4	0.85	nmf
Vanguard FTSE All-World Ex-U.S. (VEU)	5.00	7.3	(8.7)	17.4	nmf	nmf	6,295.9	0.22	24.3
SPDR S&P International Small Cap (GWX)	5.00	8.5	(11.6)	19.0	nmf	nmf	712.6	0.59	23.0
Vanguard Emerging Markets (VWO)	5.00	11.1	(7.2)	27.3	4.5	6.5	49,811.7	0.22	28.0
SPDR Dow Jones Int'l Real Estate (RWX)	5.00	8.2	(8.1)	19.4	(7.1)	nmf	2,224.1	0.59	24.5
Portfolio Average*		**6.4**	**1.7**	**27.0**	**(1.4)**	**1.4**	**3,809.0**	**0.47**	**26.4**
Optional Investment:									
iShares Barclays 1-3 Yr Treas Bond (SHY)		0.1	1.4	1.6	3.6	3.7	11,197.0	0.15	1.0
Benchmarks:									
SPDR S&P 500 Index (SPY)		4.4	4.0	19.0	0.3	2.3	99,010.5	0.10	18.5
iShares MSCI EAFE Index (EFA)		5.3	(9.6)	13.2	(3.9)	(0.9)	38,923.9	0.34	22.4
ETF Benchmark (80% SPY/20% EFA)		4.6	1.3	17.9	(0.6)	1.7	86,993.2	0.14	19.0

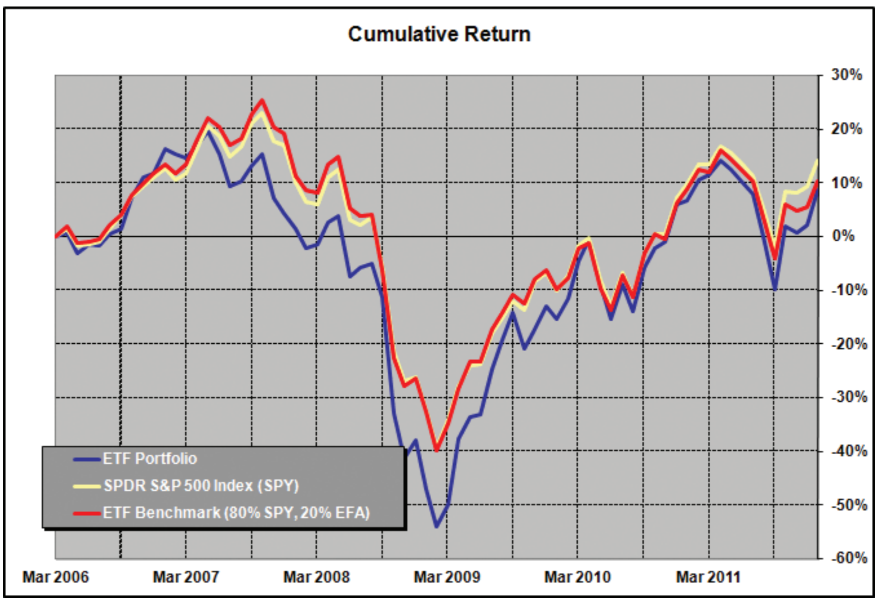
**Performance of actual portfolio including reinvested dividends. Other figures are weighted averages.*
Source: Morningstar, Inc. Data as of January 31, 2012.

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
2011	(3.7)	(0.9)
YTD**	6.4	4.6
Since Incep**	1.4	1.7

**April 1 to December 31, 2006.*
***Through January 31, 2011.*

Figure 2. Model ETF Portfolio Vs. Benchmark (Through 1/31/2012)



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