

Revised Model Fund Portfolio: Combining Mutual Funds and ETFs

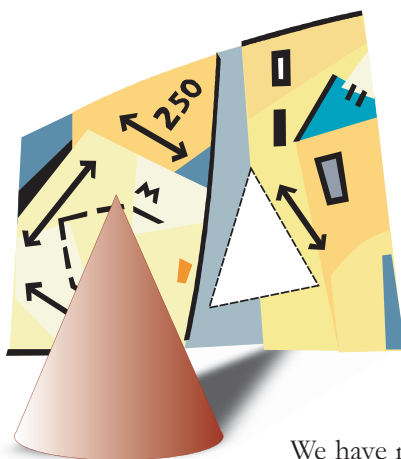
By James B. Cloonan

In the August 2006 *AII Journal*, we began a Model ETF Portfolio.

We indicated that it was an experimental portfolio meant for the examination of exchange-traded funds (ETF), which were quite new at the time. While ETFs are still relatively new—few have a 10-year history—we feel we can make some judgments and integrate ETFs into an overall fund portfolio.

While it is handy to keep traditional mutual funds, ETFs and closed-end funds separate when listing them or reporting on them, an effective fund portfolio should combine them to take advantage of the strengths of each. That is exactly what we have done by making major changes to our Model Fund Portfolio.

Closed-end funds are mutual funds with a fixed number of shares that can only be purchased or sold through exchanges. The share price may deviate from the net asset value (NAV). With a traditional mutual fund, investors buy and sell an unlimited or open number of shares once per day, directly through the fund at the NAV. Exchange-traded funds trade on exchanges like closed-end funds, but the fund also buys and sells shares directly with authorized participants to help keep the ETF market price close to the NAV.



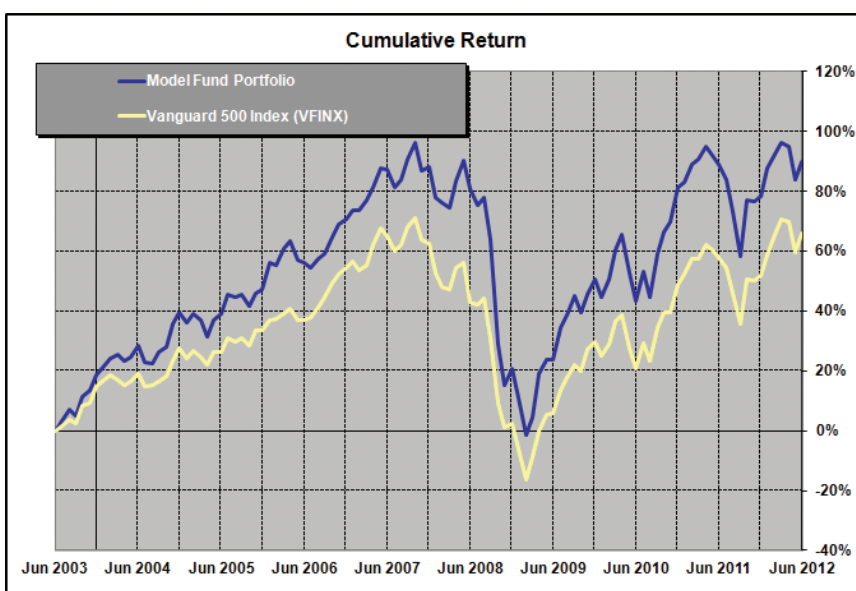
ETFs and Funds

The following is my opinion of the relative strengths and weaknesses of ETFs and traditional mutual funds. Closed-end funds seem more applicable to bond investing.

We have not found any closed-end funds that seem appropriate for a stock portfolio, except perhaps to speculate in a specific area that does not yet have an ETF.

Let me emphasize that we are concerned here only with the equity portion of an investment portfolio and a long-term

Figure 1. Model Fund Portfolio vs. Benchmark (through 6/30/12)



Model Fund Portfolio: Selection Rationale

First Methodology

The fund selection rationale consists of two distinct approaches. The first approach is to select actively managed funds where the managers have shown a long-term ability to outperform the market after allowing for additional portfolio risk, regardless of the sector invested in. A fund must have the following characteristics to be considered for the Model Fund Portfolio:

1. It must be a pure no-load fund. Short-term holding penalties are allowed if paid to the fund and not the manager.
2. It must have been active for 10 years. However, exceptions are possible.
3. It must have outperformed the S&P 500 index over the past five-year and 10-year periods.
4. In its worst three-year (calendar) period, it must not have had a loss; or, in particularly difficult market periods, its loss must have been substantially less than that of the S&P 500 index.
5. Its expense ratio must not be above 1.25%. Lower ratios will increase desirability.
6. Fund assets must not be over \$10 billion. Some exceptions are permitted, depending on fund objectives.
7. It must currently be open to individual investors, with a minimum investment of \$25,000 or less.

The above rules apply to new fund selections. Funds will not automatically be eliminated if they later violate the rules without considering other factors.

Second Methodology

The second methodology selects investment approaches that have provided excess returns or reduced

portfolio risk to investors over the long term and then searches for the best traditional fund or exchange-traded fund (ETF) in that area. Factors to be considered are:

1. The liquidity of the fund.
2. The resources of the management company, in the case of ETFs.
3. The investment returns and risk over as long a term as possible, given the newness of so many ETFs.
4. Selection of areas with demonstrated long-term excess returns: value stocks, small-cap stocks, real estate, and special areas where individuals cannot easily invest. An example of a fund in a special area would be Fidelity Capital & Income fund (FAGIX), which invests in distressed securities.

Portfolio Management Notes

- The Model Fund Portfolio is meant to be a portfolio, and we suggest you invest in the entire portfolio on an equal investment basis—that is, invest equal dollar amounts in each fund initially.
- If a fund is closed, create your portfolio from the remaining funds.
- You may make adjustments based on your non-fund holdings. For example, if you have partnership or individual holdings in investment real estate (not personal housing), you may reduce or eliminate any REIT funds.
- There is no need to rebalance on a regular basis. Rebalancing can be accomplished when there are portfolio changes or if one holding gets way out of line. We will notify you of any rebalancing in the Model Fund Portfolio.

investment horizon. There is no attempt to switch funds based on short-term prognostications about which sector or subcategory will do best in the short run.

Exchange-Traded Funds

The major advantages I find for exchange-traded funds are their generally lower expenses, the ability to buy and sell them at anytime the market is open, and the ability to tax-manage them according to individual requirements. In coming articles, I will expand on each of these advantages. If an investor believes in the efficient market of modern portfolio

theory, then ETFs can be a complete answer to effective investing.

If an investor believes, as we do, that there are significant inefficiencies that can be exploited, then index funds cannot be the only approach. ETFs are limited to portfolios that are, or can be, indexed. There has been discussion of more actively managed ETFs, but if there is no comparable index, or if a created index cannot easily be purchased in the marketplace, then there is no ability for arbitrage and the ETF's share price in the marketplace can deviate from the market value of the securities held.

As in the case of closed-end funds, the deviation can be quite wide, particularly in a less-active market segment.

Some of the more well-known anomalies, such as market capitalization and measures of value, can be at least partially accomplished in an ETF portfolio, and our new Model Fund Portfolio uses them for that purpose as well as for diversification.

Traditional Mutual Funds

These funds have value only if the investment approach used provides a return, net of expenses, that exceeds

Table 1. Model Fund Portfolio

Type	Fund (Ticker)	Market Cap Size	YTD Return (%)	Annual Return (%)				Fund Assets (\$ Mil)	Exp Ratio (%)	Std Dev (36 Mo. Ann'l) (%)	Worst 3-Yr Cal Period (%)
				1- Yr	3- Yr	5- Yr	Since 6/30/03				
MF	Aston/Fairpointe Mid Cap N (CHTTX)	Mid-Cap	6.5	(4.2)	20.6	3.1	9.4	1,517.6	1.14	22.4	(7.9)
MF	CGM Realty (CGMRX)	Large-Cap	11.7	3.6	28.2	4.1	17.2	1,631.3	0.88	24.4	(2.7)
MF	Fidelity Capital & Income (FAGIX)	na*	7.6	0.6	17.3	7.3	9.1	9,407.0	0.77	11.5	(7.2)
MF	FMI Common Stock (FMIMX)**	Mid-Cap	4.4	1.2	17.4	4.5	10.3	1,109.5	1.21	16.8	(3.0)
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Giant-Cap	6.2	12.6	12.9	12.7	12.8	2,819.4	0.40	18.2	(11.4)
ETF	Guggenheim S&P MidCap 400 Pure Value (RFV)	Mid-Cap	6.2	(3.3)	21.4	(0.1)	3.0	33.4	0.36	24.0	(4.3)
ETF	Guggenheim S&P SmallCap 600 Pure Value (RZV)	Small-Cap	5.4	(4.2)	16.1	(1.5)	0.5	64.4	0.36	28.9	(7.9)
ETF	WisdomTree Emerging Markets SmallCap Div (DGS)	Small-Cap	6.2	12.8	12.9	nmf	nmf	907.9	0.64	21.9	8.3
MF	Yacktman Focused (YAFFX)	Giant-Cap	6.5	5.7	17.3	9.8	10.2	6,312.5	1.25	12.1	(2.8)
Avg of Funds in Model Fund Portfolio†			7.3	2.8	19.3	6.4	11.8	3,297.0	0.9	18.7	(6.4)
Actual Fund Portfolio Performance††			6.6	0.5	15.3	0.3	7.4	—	—	17.2	(6.4)
	Vanguard 500 Index (VFINX)	Giant-Cap	9.4	5.3	16.3	0.1	5.8	26,173.4	0.17	15.9	(8.4)

*Distressed securities—stock and bond.

**Closed to new investors. If you are not a current shareholder, simply use the other eight funds to form your 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 June 30, 2012.

what can be obtained from an index fund or similar ETF, or if investing in areas that are not available to the individual investor through other approaches and those approaches provide excess returns or reduced risk for the portfolio.

It is my opinion that there are traditional mutual funds that meet these criteria over the long run, and choices from these are included in the revised Model Fund Portfolio.

Individual Equities

There are several areas of investment, very important areas, where funds of any type seem unable to operate efficiently. One is the area of MLPs (master limited partnerships). I feel that MLPs are very effective in a portfolio for providing a good return while reducing portfolio risk. While there are several mutual funds that aggregate these—we previously recommended ALPS Alerian MLP ETF (AMLP)—we feel that over the long term they cannot make up the penalty of double taxation. It may be worthwhile for those with the time and interest to study this area and select individual MLPs as part of their portfolio.

Far more important from my point of view is the area of micro-cap stocks. Historically these stocks have outperformed the market significantly (our Model Shadow Stock Portfolio of micro-cap value stocks has returned 15.8% a year on average over 19 years, versus 7.8% for the S&P 500 index, which gives us four times as much wealth). There are various explanations for this anomaly, but a major reason is that the companies are too small to attract institutional buyers, hedge funds, and high-speed traders and are more likely to be mispriced.

While a few funds have attempted to operate in this area, there are several significant problems. First, it is difficult to create large positions in true micro-cap stocks (market capitalization under \$400 million), and there is little incentive to run a fund with less than \$200 million. Second, the bid/ask spread on these stocks is wider than average so turnover becomes expensive. Both ETFs and open-end mutual funds get hit when stockholders sell in a down market, and fund managers must liquidate against a widening bid/ask spread at a time

when they would like to be buying. I feel micro-caps is the rare area where individual investors have a tremendous advantage. But if you want to be in micro-cap stocks, you will have to do it with individual stocks. Small-cap stocks (market capitalization under \$1.6 billion) are covered by funds and obtain some of the same excess returns.

The Modified Portfolio

The modified Model Fund Portfolio takes two different approaches. The first is the approach we have taken in the past: to find funds that provide higher returns and/or lower risk than the general market regardless of investment area. These will primarily be traditional open-end mutual funds. The Selection Rationale box on page 34 describes this approach in more detail.

We added a second approach that is similar to the approach taken by our experimental Model ETF Portfolio: that is, to select areas of investment that have proven to be successful for individuals over the long term and then to search for the best fund in that area. These

Table 2. Model Fund Portfolio: Annual Performance

	Average Annual Return (%)		Cumulative Return of \$10,000 (\$)	
	Model Fund Portfolio	Vanguard 500 Index (VFIX)	Model Fund Portfolio	Vanguard 500 Index (VFIX)
2003*	18.6	15.0	11,858	11,503
2004	17.7	10.8	13,955	12,742
2005	5.4	4.8	14,711	13,350
2006	16.1	15.6	17,086	15,436
2007	10.2	5.4	18,820	16,267
2008	(35.9)	(37.0)	12,071	10,245
2009	24.9	26.5	15,080	12,959
2010	20.3	14.9	18,136	14,892
2011	(1.7)	2.0	17,827	15,186
2012 YTD**	6.6	9.4	19,001	16,614
Since Incep**	7.4	5.8	19,001	16,614

*June 30 to December 31, 2003

**Through June 30, 2012. Portfolio was started on June 30, 2003.

funds may be traditional funds or ETFs.

In both cases, we are looking at the impact of each fund on the portfolio, rather than each fund's individual characteristics. We feel that combining two different approaches will provide risk-reducing diversification to the portfolio.

Please note that the portfolio orientation is long term. We make no effort to switch holdings based on short-term prognostications of which sectors are best now or where the stock market as a whole is going. Each individual, of course, is free to determine their own asset allocation at any time.

No International Diversification

I was never a fan of international diversification, but because of the popularity of the approach, I did add international stocks to the experimental Model ETF Portfolio in 2007. But given a three- to five-year investment horizon, I believe there is no significant diversification benefit and international investments do not provide higher returns. In fact, if you eliminate 1985–1988, international returns are inferior and

most of the 1985–1988 advantage came from Pacific stocks.

The long-term trend is for foreign stock indexes to be more closely correlated with U.S. indexes, and this will likely continue because of the ongoing internationalization of corporations. I will expand on this in a future column.

While we will not include foreign funds simply to diversify, we will include them on an individual basis, just like U.S. funds. For example, we include WisdomTree Emerging Markets SmallCap Dividend ETF (DGS) in our Model Fund

Portfolio because we feel long-term emerging markets are like small-cap stocks—they have more room to grow and the international community has shown commitment to more economic equalization among countries.

Components of the New Model Fund Portfolio

Table 1 shows the nine funds in the new Model Fund Portfolio. Five were previously held in this portfolio: Aston/Fairpointe Mid Cap N fund (CHITX), CGM Realty fund (CGMRX), Fidelity Capital & Income fund (FAGIX), FMI Common Stock fund (FMIMX) and Yacktman Focused fund (YAFFX). Two were in the experimental Model ETF Portfolio: Guggenheim (Rydex) S&P MidCap 400 Pure Value ETF (RFV) and Guggenheim (Rydex) S&P SmallCap 600 Pure Value ETF (RZV). And two are new: Guggenheim S&P 500 Equal Weight ETF (RSP) and WisdomTree Emerging Markets SmallCap Dividend ETF (DGS).

FMI Common Stock fund continues to be closed to new investors. Keep it if

you have it. If you do not own it, make up your portfolio from the remaining eight funds. Please see the Selection Rationale box on page 34 for more information on portfolio construction. We took the opportunity to rebalance, and the holdings are now approximately equal.

For risk reduction using fixed-income securities, I still suggest iShares Barclays 1-3 Year Treasuries ETF (SHY). I will discuss the impact of SHY on the Model Fund Portfolio in my November column.

As I mentioned, the orientation of the portfolio is long term. Figure 1, Table 1 and Table 2 show that the portfolio has outperformed the market over the past nine years without additional risk. We feel that including ETFs and combining the two approaches will add to the Model Fund Portfolio's advantage.

Funds Sold

None of the funds we sold were removed for negative reasons, but rather because we thought there were better opportunities and that we could create a better overall portfolio.

If you are following the Model Fund Portfolio in your investing, there is no need to rush to make any changes. If you are near a critical date for capital gains, you can wait for the tax advantage.

The Market Ahead

Volatility continues, but the market has an upward bias and at this juncture seems headed for an average or somewhat better year, even in the face of foreign and domestic uncertainty.

We have a bitter election campaign ahead and an uncertain tax situation confusing us all. Major issues will probably be deferred, particularly if they provide ammunition in the political wars.

The next article on the Model Fund Portfolio will be in the November 2012 *AAIL Journal* and will be available about the same time as the election results. In the meantime, please keep up to date at AAIL.com. ▲

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