

Revised Model Fund Portfolio: Benchmark Impacted by Cap Weighting

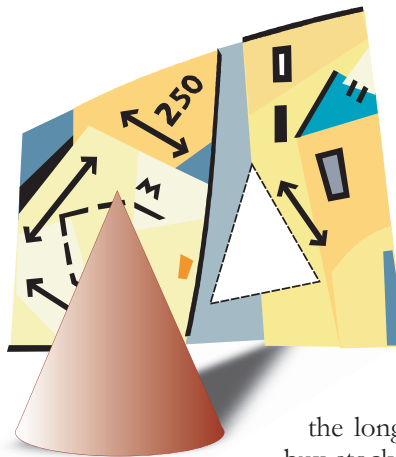
By James B. Cloonan

The Model Fund Portfolio increased nicely over the past three months and is now up 11.5% year-to-date as of September 30, 2012.

However, the S&P 500 index, as measured by the Vanguard 500 Index fund (VFINX), is up 16.3% over the same period, outpacing every one of the funds in the portfolio. VFINX is even ahead of Guggenheim S&P 500 Equal Weight fund (RSP), which is rather unusual since the equally weighted RSP exchange-traded fund consistently outperforms the capitalization-weighted VFINX mutual fund, as you can see by comparing their three-, five- and nine-year results in Table 1.

The one time that the cap-weighted model is sure to work best is when the heaviest weighted holding [Apple Inc. (AAPL), 4.4% of VFINX] goes up over 60%. Apple had a fantastic run and Google Inc. (GOOG) also helped. Unlike the tech bust of the early 1990s, AAPL and GOOG are not high price earnings ratio stocks, and both could go to \$1,000 per share without high price-earnings ratios, but not without risk.

There was an amazing consistency in the returns of the funds in the Model Fund Portfolio. We had no super-performing fund, and only FMI Common Stock fund (FMIMX) was significantly lower. When new money is added to a fund, research shows that

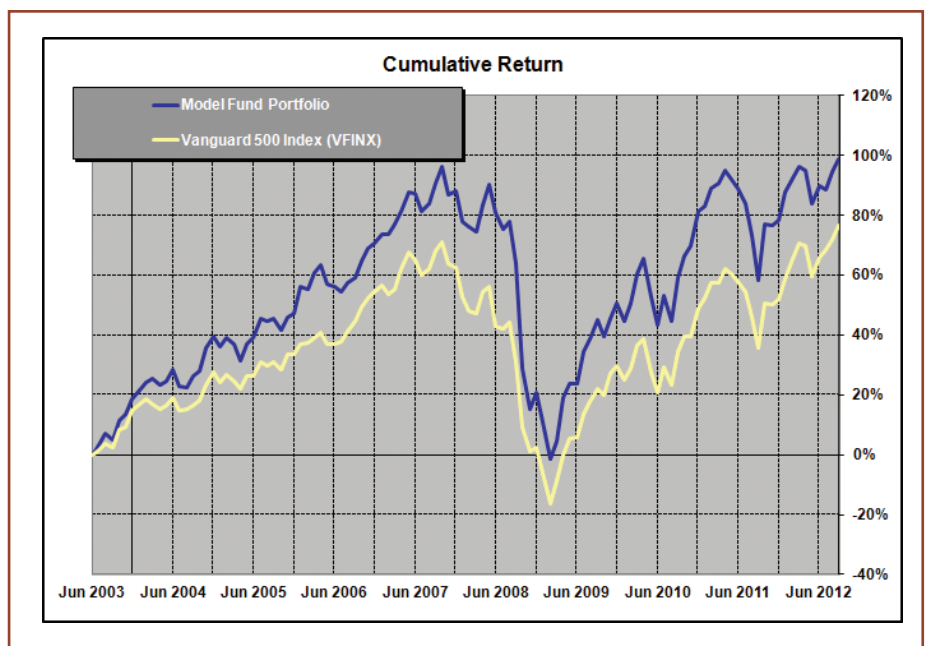


the stocks purchased with those inflows outperform stocks bought later on to replace them. This would suggest that funds with new money flowing in will perform better. This is a problem when funds close to new investors, as FMIMX has. However, over

the long term there is an advantage in not having to buy stocks when you have already bought all the stocks that fit your criteria.

We will watch the future performance of FMIMX. I have another slight grievance with the fund as well as with Yacktman Focused fund (YAFFX). While they both have

Figure 1. Model Fund Portfolio vs. Benchmark (through 9/30/12)



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.

expense ratios that just make it inside our limit, there is no reason for funds of their size to have costs over 1%. They of course want to maximize profit, but fund investors should consider fees.

Using Two Methodologies

I feel comfortable with mixing various kinds of funds and focusing on diversified long-term results in terms of both return and risk. We are more concerned with real long-term financial risk as individual investors perceive it, rather than short-term volatility. We will continue to look for the best component funds based on our two methodologies.

The two separate approaches that we take are explained in the “Selection Rationale” box above. We anticipate additional diversification and risk reduction because of the separate methodologies.

Table 2 shows the year-by-year and long-term returns for the Model Fund Portfolio compared to the VFINX.

Closed & Optional Funds

There were no changes in the Model Fund Portfolio this period.

As mentioned, FMIMX continues to be closed to new investors, so anyone new to the model portfolio will have to use the other eight funds. This wouldn't

have hurt over the past year.

We have reinstated iShares Barclays 1-3 Year Treasury Bond fund (SHY) as an optional exchange-traded fund investment for those who wish to reduce risk below the level of the portfolio. Next year, we will show what different percentages of SHY in the model portfolio would do to its risk/reward profile as a whole.

The Market Ahead

Despite the myriad risks, domestic and foreign, the stock market is having a better than average year. Of course the year is not over and the election is

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)	Large-Cap	13.3	32.7	13.3	4.4	9.9	1,604.1	1.14	21.9	(7.9)
MF	CGM Realty (CGMRX)	Large-Cap	9.7	28.5	15.1	1.6	16.5	1,529.5	0.88	22.9	(2.7)
MF	Fidelity Capital & Income (FAGIX)	na*	12.5	18.0	11.8	8.4	9.4	9,834.3	0.77	10.6	(7.2)
MF	FMI Common Stock (FMIMX)**	Mid-Cap	5.6	22.4	10.9	6.1	10.1	1,118.2	1.21	15.7	(3.0)
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	14.0	28.0	13.5	2.5	8.4	2,836.5	0.40	17.5	(11.4)
ETF	Guggenheim S&P MidCap 400 Pure Value (RFV)	Mid-Cap	11.4	29.2	10.9	2.0	nmf	33.2	0.36	21.5	(4.3)
ETF	Guggenheim S&P SmallCap 600 Pure Value (RZV)	Small-Cap	16.0	36.4	7.1	3.1	nmf	75.0	0.36	26.9	(7.9)
ETF	WisdomTree Emerging Markets SmallCap Div (DGS)	Small-Cap	13.3	17.3	8.0	nmf	nmf	1,035.8	0.64	20.8	8.3
MF	Yacktman Focused (YAFFX)	Giant-Cap	10.9	20.6	12.8	10.6	10.4	6,847.6	1.25	11.5	(2.8)
Avg of Funds in Model Fund Portfolio[†]			11.0	25.9	12.9	4.6	10.9	3,384.5	0.90	17.7	(6.4)
Actual Fund Portfolio Performance^{††}			11.5	25.4	11.0	0.8	7.7	—	—	16.7	(6.4)
Optional Investment:											
	iShares Barclays 1-3 Year Treasury Bond (SHY)		0.3	0.5	1.3	2.7	3.9	8,590.7	0.15	1.0	0.0
Benchmark Comparison:											
	Vanguard 500 Index (VFINX)	Giant-Cap	16.3	30.0	13.1	1.0	6.3	26,417.1	0.17	15.4	(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 September 30, 2012.

still ahead of us as of this writing, but I cannot help but feel that whoever wins will remove uncertainty, and that should have a positive effect in the short term. Over the long term, the policies of the administration will certainly be a factor. The post-election year historically is the worst year for stocks in the four-year election cycle; the market has been up an average of 6.7% in post-election years since the depression. But there have been exceptions, as in 2009 when the market was up 26.5%.

The election will be over when we next discuss the fund portfolio in the March 2013 issue of the *AAIL Journal*. Gone too, I hope, will be the mystery about our tax rates. I have had questions from readers regarding whether the funds are better in IRAs and other tax-deferred accounts or in regular taxable accounts. Generally, stock funds

are better in taxable accounts with the deferred accounts being reserved for interest-bearing investments. But we will review this subject as soon as we find out the new tax rates for capital gains, dividends and interest. We hope to know before next year because some of the proposals are quite different and would make the choices different for different income groups.

In the meantime, you can follow the Model Fund Portfolio at AAIL.com. ▲

Table 2. Model Fund Portfolio Annual Performance

	Average Annual Return (%)		Cumulative Return of \$10,000 (\$)	
	Model Fund Portfolio	Vanguard 500 Index (VFINX)	Model Fund Portfolio	Vanguard 500 Index (VFINX)
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**	11.5	16.3	19,872	17,663
Since Incep**	7.7	6.3	19,872	17,663

*June 30 to December 31, 2003.

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

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