

Equal-Weighted ETF Helps Boost Model Fund Portfolio Return

By James B. Cloonan

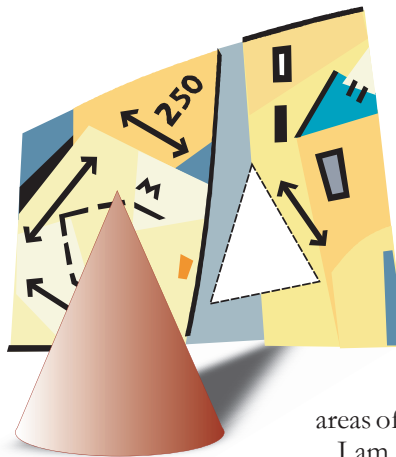
The Model Fund Portfolio, which three months ago was trailing the Vanguard 500 Index fund (VFINX) by 5%, just about caught up to the broad market for the year, finishing 2012 up 15.5% compared to a 15.8% return for the index fund.

Year-to-date through January 31, 2013, the Model Fund Portfolio has pulled ahead again by a bit, with a return of 5.3% compared to 5.2% for the Vanguard 500 Index fund. Much of this is due to the run up and run down of Apple Inc (AAPL). With Apple at more typical growth levels, our portfolio's S&P 500 exchange-traded fund holding, the Guggenheim S&P 500 Equal Weight fund (RSP), reestablished dominance over the Vanguard 500 Index fund over both the long and short term, as can be seen in Table 1.

Figure 1 shows the cumulative return of the Model Fund Portfolio since its inception in June 2003 compared to the Vanguard 500 Index fund. Table 2 gives year-by-year return figures.

Portfolio Composition

There are no changes in the portfolio this month. I have had a number of emails indicating that investors prefer exchange-traded funds (ETFs) because



of the flexibility, the low expense ratios and, above all, the better control of tax liability. I believe our Model Fund Portfolio will gradually move toward holding more ETFs as we get more portfolio history, but unless the rules change, there will always be some areas of profit opportunity that don't fit the ETF model.

I am hoping that the movement by investors toward ETFs will encourage traditional mutual funds to cut their expenses. There is no reason for an established fund to have an expense ratio over 1.00%, and the larger funds could be well below that. I understand that fund management is a busi-

Figure 1. Model Fund Portfolio vs. Benchmark (through 1/31/13)

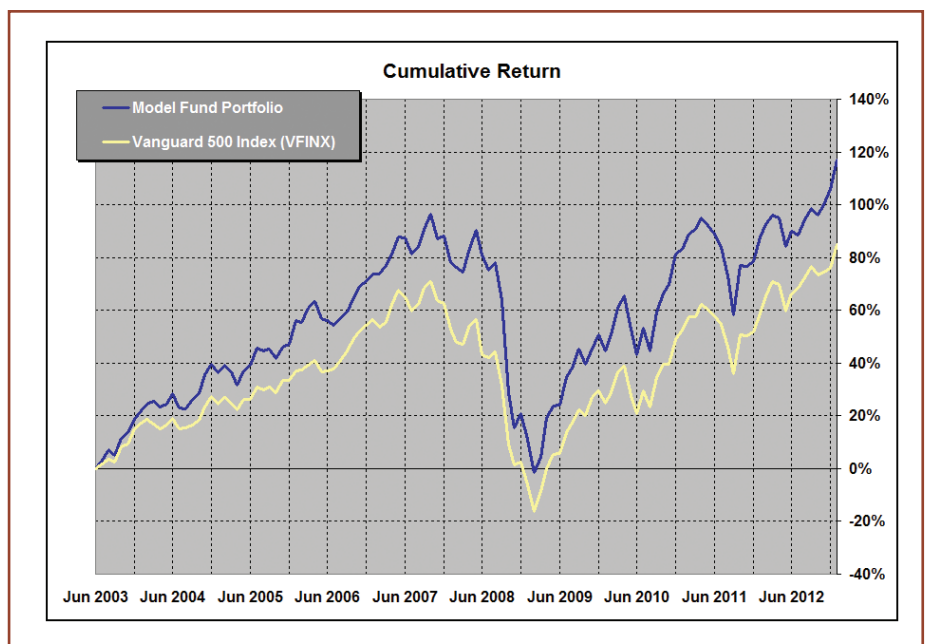


Table 1. Model Fund Portfolio

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	8.5	17.6	14.1	7.9	10.8	1,746.3	1.14	20.8	(7.9)
MF	CGM Realty (CGMRX)	Large-Cap	4.7	6.8	17.7	2.6	16.5	1,451.9	0.88	21.3	(2.7)
MF	Fidelity Capital & Income (FAGIX)	na*	1.7	13.6	10.8	10.5	9.7	9,807.0	0.77	9.5	(7.2)
MF	FMI Common Stock (FMIMX)**	Mid-Cap	5.0	10.1	14.5	10.0	10.8	1,134.8	1.20	15.4	(3.0)
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	6.5	18.1	15.8	6.4	9.1	3,855.1	0.40	17.0	(11.4)
ETF	Guggenheim S&P MidCap 400 Pure Value (RFV)	Mid-Cap	7.6	18.6	14.5	5.8	nmf	41.8	0.36	20.3	(4.3)
ETF	Guggenheim S&P SmallCap 600 Pure Value (RZV)	Small-Cap	5.8	17.1	14.6	6.8	nmf	80.1	0.36	24.6	(7.9)
ETF	WisdomTree Emerging Markets SmallCap Div (DGS)	Small-Cap	2.6	13.7	9.9	7.5	nmf	1,306.6	0.64	20.3	7.8
MF	Yacktman Focused (YAFFX)	Giant-Cap	6.2	14.3	12.8	12.7	10.7	6,598.5	1.25	11.5	(2.8)
Average of Funds in Actual Model Fund Portfolio†			5.4	14.4	13.9	7.8	11.3	2,891.3	0.78	16.8	(5.9)
Actual Fund Portfolio Performance††			5.3	15.5	14.5	4.0	8.4	—	—	16.1	(6.4)
Optional Investment:											
ETF	iShares Barclays 1-3 Year Treasury Bond (SHY)		0.0	0.2	1.1	1.8	3.7	7,496.6	0.15	0.7	1.3
Comparison:											
MF	Vanguard 500 Index (VFINX)	Giant-Cap	5.2	16.6	14.0	3.9	6.6	26,036.1	0.17	15.1	(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 January 31, 2013.

ness, and managers want to maximize profit. Only if investors become more sensitive to costs and vote with their feet will profit maximization and lower fees come together.

Outlook

We have at least a temporary decision on taxation rates. Dividends, for now, remain taxed at a reduced rate, and only interest income faces the full earned income tax rate. In general, it will remain better to have stocks in non-deferred accounts and debt instruments sheltered in deferred accounts.

I continue to have a bullish bias on the Model Fund Portfolio and probably will until the market reaches its historical highs, whenever that may occur. It may occur before you read this, but historically February has not been a great month. While the economy looks a bit better both here and abroad, there are still many concerns. One cannot help but wonder what will happen when the

Federal Reserve slows down its easing and interest rates start to rise. Over the long term, the T-bill rate has matched inflation, which it is not doing now.

In my Shadow Stock Portfolio column in the January 2013 issue of the *AAll Journal*, I mentioned that post-election years have, on average, been the weakest with a 6.7% average since the 1930s. However, 2009 was a notable exception, with the Vanguard S&P 500 index fund up 26.5% and the Model Fund Portfolio up 24.9%, the best year in its 10-year history.

Also, with Baltimore and San Francisco

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	15.5	15.8	20,597	17,589
2013 YTD**	5.3	5.2	21,691	18,500
Since Incep**	8.4	6.6	21,691	18,500

*June 30 to December 31, 2003.
 **Through January 31, 2013. Portfolio was started on June 30, 2003.

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.

both being old NFL football teams, the NFL indicator was up no matter which team won the Super Bowl this year. I

am not much of a believer in historical indicators and will wait and see.

The next Model Fund Portfolio

column will be in the June *AAIL Journal*. In the meantime, you can keep abreast at AAII.com in the Model Portfolios area. ▲

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