

Frontier Markets Exposure Added to the Model Fund Portfolio

By James B. Cloonan

The strong up market has continued into summer and the Model Fund Portfolio is up 10.8% year-to-date.

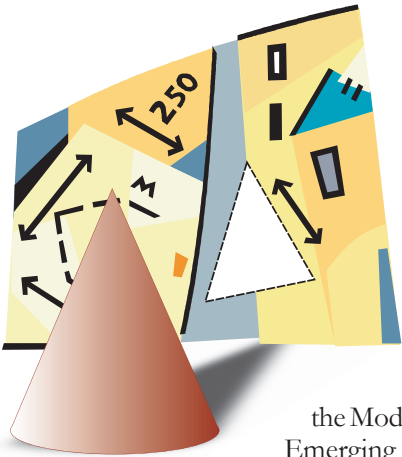
However this lags the performance of the S&P 500 index, as measured by the Vanguard 500 Index fund (VFINX), which is up 13.8% year-to-date.

Over the long term, the Model Fund Portfolio is still ahead, as can be seen in Figure 1 and Table 3.

10-Year Anniversary

The Model Fund Portfolio has now been in existence for 10 years. During that time it has seen some very difficult markets, but has provided an annualized return of 8.6%. Ten thousand dollars invested in the Model Fund Portfolio 10 years ago would now be worth \$22,828, as opposed to \$20,008 for the S&P 500, as shown in Table 3.

During that time we have also seen the arrival of exchange-traded funds (ETFs), and they currently represent over half of our portfolio. ETFs must track a defined index, so there are strategies that can't be carried out. But ultimately we should see ETFs dominate as inferior funds (the majority) close. This will take some time because so many investors are very slow to make changes. I can't help but wonder what



the “fund space” will look like 10 years from now.

Portfolio Changes

Table 1 shows the current holdings for the Model Fund Portfolio. We are replacing WisdomTree Emerging Markets SmallCap Dividend ETF (DGS) with iShares MSCI Frontier 100 ETF (FM), as shown in Table 2.

The new addition is a fund of pre-emerging market stocks. I feel that most emerging markets have emerged or are maybe over-emerged and the opportunity, though risky,

Figure 1. Model Fund Portfolio vs. Benchmark (through 6/30/13)

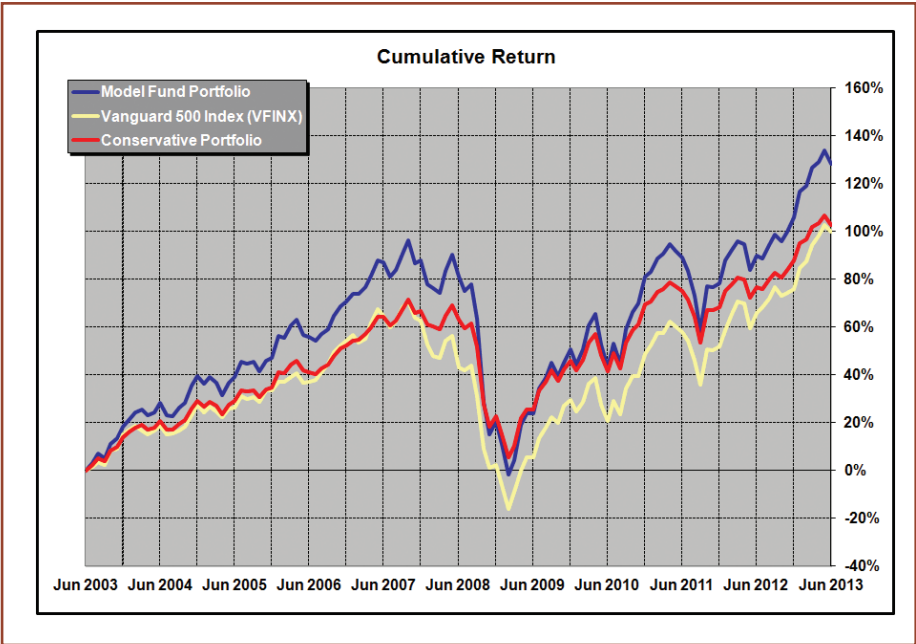


Table 1. Model Fund Portfolio

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	22.4	33.8	19.4	9.8	11.6	2,042.9	1.11	19.7	(7.9)
MF	Fidelity Capital & Income (FAGIX)	na*	2.2	10.5	10.3	10.1	9.3	9,525.5	0.73	8.9	(7.2)
MF	FMI Common Stock (FMIMX)**	Mid-Cap	10.6	16.7	16.0	11.8	10.9	1,212.7	1.20	13.9	(3.0)
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	15.9	25.9	19.3	9.8	9.6	4,098.4	0.40	15.3	(11.4)
ETF	Guggenheim S&P MidCap 400 Pure Val (RFV)	Mid-Cap	17.3	31.7	18.8	11.3	nmf	60.6	0.40	17.7	(4.3)
ETF	Guggenheim S&P SmallCap 600 Pure Val (RZV)	Small-Cap	17.8	35.6	19.3	13.8	nmf	88.6	0.38	21.5	(7.9)
ETF	iShares MSCI Frontier 100 (FM)	Large-Cap	10.8	nmf	nmf	nmf	nmf	207.9	0.79	nmf	nmf
ETF	Vanguard REIT Index (VNQ)	Large-Cap	4.7	7.2	17.6	7.8	nmf	17,763.8	0.10	16.7	(11.9)
MF	Yacktman Focused (YAFFX)	Giant-Cap	16.6	21.1	17.6	16.8	11.3	7,425.6	1.25	9.9	(2.8)
Average of Funds in Actual Model Fund Portfolio†			13.1	22.8	17.3	11.4	10.6	4,714.0	0.71	15.0	(7.1)
Actual Fund Portfolio Performance††			10.8	20.1	16.8	4.7	8.6	—	—	14.4	(6.4)
Optional Investment:											
ETF	iShares Barclays 1-3 Year Treasury Bond (SHY)		(0.1)	0.2	0.7	1.8	3.5	8,234.0	0.15	0.5	1.3
Conservative Portfolio (75% Fund Portfolio/25% SHY)			8.1	14.9	12.8	4.4	7.3			10.8	(2.6)
Comparison:											
MF	Vanguard 500 Index (VFINX)	Giant-Cap	13.8	20.4	18.3	6.9	7.2	26,834.6	0.17	13.4	(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 6/30/2013.

Table 2. Portfolio Transactions

Fund	Reason
Buy	
iShares MSCI Frontier 100 (FM)	more upside potential
Sell	
WisdomTree Emerging Markets SmallCap Div (DGS)	less opportunity than FM

Table 3. Model Fund Portfolio Annual Performance

	Average Annual Return (%)			Cumulative Return of \$10,000 (\$)		
	Model Fund Portfolio	Conservative Portfolio*	Vanguard 500 Index (VFINX)	Model Fund Portfolio	Conservative Portfolio*	Vanguard 500 Index (VFINX)
2003**	18.6	13.9	15.0	11,858	11,388	11,503
2004	17.7	13.3	10.8	13,955	12,905	12,742
2005	5.4	4.5	4.8	14,711	13,486	13,350
2006	16.1	13.0	15.6	17,086	15,243	15,436
2007	10.2	9.5	5.4	18,820	16,696	16,267
2008	(35.9)	(26.4)	(37.0)	12,071	12,281	10,245
2009	24.9	19.0	26.5	15,080	14,609	12,959
2010	20.3	16.0	14.9	18,136	16,941	14,892
2011	(1.7)	(0.7)	2.0	17,827	16,825	15,186
2012	15.5	11.6	15.8	20,597	18,783	17,589
2013 YTD	10.8	8.1	13.8	22,828	20,296	20,008
Since Incep***	8.6	7.3	7.2	22,828	20,296	20,008

*Seventy-five percent Model Fund Portfolio and 25% Barclays 1-3 Year Treasury fund (SHY).

**June 30 to December 31, 2003.

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

Source: Morningstar, Inc. Data as of 6/30/2013.

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.

is in the even smaller economies.

As far as the risk goes, the iShares MSCI Frontier 100 ETF is only a fraction of the Model Fund Portfolio, and the fund manager sticks with solid companies. It also occupies a smaller niche and will not attract the larger institutions until the companies start to grow significantly.

Recent Performance

In looking for a reason that the portfolio is underperforming the S&P 500 in the last few months, it is appar-

ent that Fidelity Capital & Income fund (FAGIX) and Vanguard REIT Index ETF (VNQ) are the culprits. These are our main diversification funds. [Formerly, our REIT fund was CGM Realty fund (CGMRX).]

It is often the case that the stocks that may help you in difficult markets lag in very bullish markets. We believe in the areas represented by these funds in the long run. And, just as we sat and watched our value funds go through a tough period early last year, we will hang in for the longer term with both of these funds.

Outlook

Selling in May (or June) and going away would not have been a very good idea this year. The market is still strong, but there is more volatility. There will likely be a pause in the upward trend, but the stock market could go much higher before a rest. Since we are long-term investors, we shouldn't be concerned about short-term adjustments, anyway.

The next coverage of the Model Fund Portfolio will be in the November *AAIL Journal*, but in the meantime you can follow performance at AAIL.com. ▲

James B. Cloonan is founder and chairman of AAIL.