

Building an All-ETF Subset From the Model Fund Portfolio

By James B. Cloonan

Over the past three months the stock market has continued its upward climb despite the dangers on the horizon.

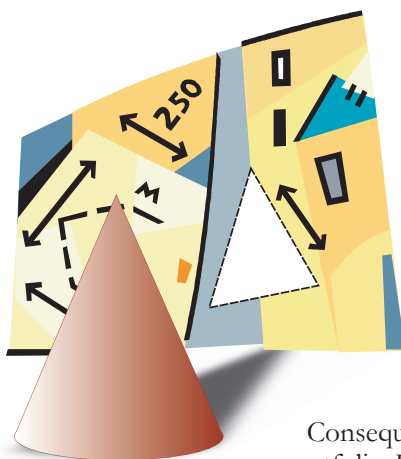
The Model Fund Portfolio is up 17.4% year-to-date but lags the S&P 500 index as measured by Vanguard 500 Index fund (VFINX), which is up 19.7%. As we mentioned previously, the lower return is largely due to our two holdings that provide diversification—Fidelity Capital & Income fund (FAGIX) and Vanguard REIT Index ETF (VNQ).

Figure 1 and Table 2 show performance figures over the long term for the portfolio, the index comparison and the Conservative Portfolio, which is 75% Model Fund Portfolio and 25% iShares Barclays 1-3 Year Treasury ETF (SHY).

No Portfolio Changes

Table 1 shows the current holdings for the Model Fund Portfolio. There are no portfolio changes at this time.

Our change from WisdomTree Emerging Markets SmallCap Dividend ETF (DGS) to iShares MSCI Frontier 100 ETF (FM) proved timely but the area of frontier markets is still new. We will feel more confident when there are longer-term results. We particularly would like to see how frontier markets perform in a down market.



The ETF Quandary

I continue to believe that traditional mutual funds can invest in certain ways that exchange-traded funds cannot, and some of these areas have been profitable in the past.

Consequently, I believe that they have a place in a fund portfolio. However, many of our members feel that ETFs are easier to trade, have lower costs, and are far superior for tax planning. They would prefer an all-ETF approach.

Depending on individual circumstances, the advantages of ETFs may outweigh any potential gain from maintaining

Figure 1. Model Fund Portfolio vs. Benchmark (through 9/30/13)

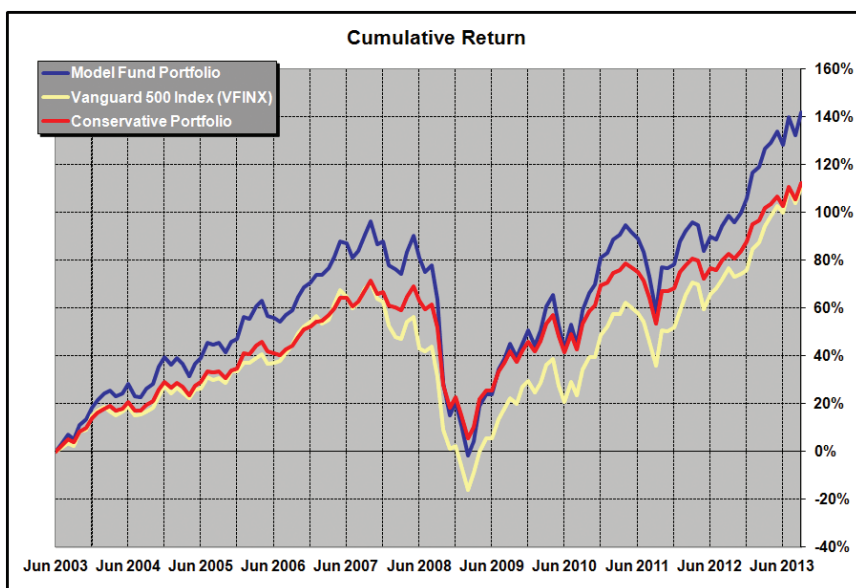


Table 1. Model Fund Portfolio

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	5-Yr	10-Yr	Since 6/30/03				
MF	Aston/Fairpointe Mid Cap N (CHTTX)	Large-Cap	32.3	36.0	15.6	12.0	12.2	2,303.4	1.11	18.5	(7.9)
MF	Fidelity Capital & Income (FAGIX)	na*	4.3	7.9	13.1	9.3	9.3	9,464.4	0.73	8.5	(7.2)
MF	FMI Common Stock (FMIMX)**	Mid-Cap	21.4	26.6	12.9	11.7	11.7	1,260.2	1.20	12.8	(3.0)
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	23.6	26.9	13.1	9.8	10.1	5,210.7	0.40	14.1	(11.4)
ETF	Guggenheim S&P MidCap 400 Pure Val (RFV)	Mid-Cap	26.5	35.2	12.6	na	na	72.1	0.40	16.5	(4.3)
ETF	Guggenheim S&P SmallCap 600 Pure Val (RZV)	Small-Cap	29.4	35.3	14.1	na	na	116.7	0.38	19.9	(7.9)
ETF	iShares MSCI Frontier 100 (FM)	Large-Cap	17.9	21.1	na	na	na	305.2	0.79	na	na
ETF	Vanguard REIT Index (VNQ)	Large-Cap	1.5	4.1	6.0	na	na	17,171.3	0.10	16.5	(11.9)
MF	Yacktman Focused (YAFFX)	Giant-Cap	18.8	18.4	15.8	11.1	11.2	7,987.6	1.25	9.0	(2.8)
Avg of Funds in Actual Model Fund Portfolio†			19.5	23.5	12.9	10.8	10.9	4,876.8	0.71	15.0	(7.1)
Actual Fund Portfolio Performance††			17.4	21.7	8.1	8.7	9.0	—	—	13.0	(6.4)
Optional Investment:											
ETF	iShares Barclays 1-3 Year Treasury (SHY)		0.2	0.2	1.5	2.5	3.4	8,300.6	0.15	0.5	1.3
	Conservative Portfolio		13.0	16.1	6.9	7.4	7.6	—	—	9.7	(2.6)
Comparison:											
MF	Vanguard 500 Index (VFINX)	Giant-Cap	19.7	19.2	9.9	7.5	7.5	26,502.5	0.17	12.2	(8.4)

*Distressed securities - stock and bond.
 **Closed to new investors. Current shareholders can continue to invest in the fund. Other investors should simply use the other eight 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 9/30/2013.

traditional mutual funds in the portfolio. This makes sense, so we are going to track an all-ETF portfolio, called the Pure ETF Portfolio. It can be used as a guide, and it will provide insight into how the approaches differ over the long run.

Setting Up the All-ETF Portfolio

I feel that our five current exchange-traded funds are diversified enough to make up a balanced portfolio that zeros in on investment areas that have outperformed the market in the past. iShares MSCI Frontier 100 ETF does not have such a history, but it is in keeping with a micro-cap stock philosophy.

The reduction in the number of holdings requires an unequal weighting of each of the holdings. Table 3 shows the new Pure ETF Portfolio and the weights given each of the holdings. We only look at the results for this year-to-date and will have to wait for longer-term results to be meaningful.

Table 2. Model Fund Portfolio Annual Performance

	Average Annual Return (%)			Cumulative Return of \$10,000 (\$)		
	Model Fund Portfolio	Conser-Vative Portfolio	Vanguard 500 Index (VFINX)	Model Fund Portfolio	Conser-Vative 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**	17.4	13.0	19.7	24,191	21,221	21,048
Since Incep**	9.0	7.6	7.5	24,191	21,221	21,048

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

If you wish to mimic this portfolio, simply determine the total dollars you wish to invest and multiply this by the

fraction assigned to each exchange-traded fund as indicated in Table 3. (RSP, 0.40; RFV, 0.20; RZV, 0.20; VNQ, 0.10;

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.

Table 3. Pure ETF Portfolio

Fund (Ticker)	Weight (%)	YTD Return (%)
Guggenheim S&P 500 Equal Weight (RSP)	40	23.6
Guggenheim S&P MidCap 400 Pure Value (RFV)	20	26.5
Guggenheim S&P SmallCap 600 Pure Value (RZV)	20	29.4
iShares MSCI Frontier 100 (FM)	10	17.9
Vanguard REIT Index (VNQ)	10	1.5
Portfolio Weighted Performance	100	22.5
Comparison: Spider S&P 500 (SPY)		19.7

As of 9/30/2013.

and FM, 0.10). Don't be tempted to bypass the Vanguard REIT Index ETF just because real estate is performing poorly so far this year. Over the long term, it

add money to it, add the funds so as to help restore original weightings. The same applies if you are withdrawing funds.

Switching to an all-ETF portfolio

has done well and it is likely a bargain now.

We will rebalance this portfolio, but not frequently and only when a holding gets far out of line. We will let you know when we rebalance. If you have this portfolio and

means that the second methodology in our selection rationale will dominate the portfolio. We gain something and we lose something; only time (five to 10 years) and your personal experience with tax considerations will tell us which approach is best. New ETFs may provide additional opportunities for better portfolio performance.

Outlook

With all the uncertainty in Washington, I don't feel competent to comment about an outlook. I hope much is resolved by the next discussion of the Model Fund Portfolio in the March 2014 *AAIL Journal*. In the meantime, you can follow performance at AAIL.com. ▲

James B. Cloonan is founder and chairman of AAIL.