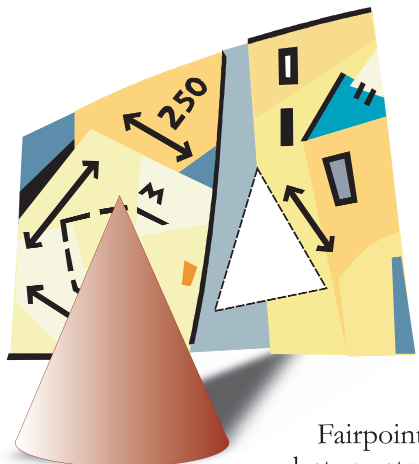
Model Fund Portfolio: Replacing a Closed Fund

By James B. Cloonan



The stock market, as well as the Model Fund Portfolio and its variations, finished out 2013 on a continued bullish note to complete a very strong up year.

There was a slight pullback in January: The year-to-date return for the Model Fund Portfolio was –2.0%, as of January 31. The S&P 500 index pullback in January, as measured by the Vanguard 500 Index fund (VFINX), was –3.5%. January is usually a strong up month, but at least part of the pullback can be attributed to the strong up market and investors waiting until after the year end to sell and realize profits.

Figure 1 charts the cumulative return. Returns for various time periods are shown in Table 1, and Table 2 gives the year-by-year performance figures and growth of $10,000.

Portfolio Changes

We have sold Yacktman Focused fund (YAFFX) and replaced it with Fidelity OTC fund (FOCPX).

We felt that Yacktman Focused fund was reaching the size where it would become a closet index fund, and the 1.25% expense ratio was just too high. Fidelity OTC fund is one of the few funds that currently meets our criteria, and it provides a broadening of our holdings. There is no rush to sell the Yacktman fund if you are just short of the one-year capital gains holding period.

Closed Funds

The Yacktman fund was one of three holdings in the Model Fund Portfolio closed to new investors. The other two are Aston/Fairpointe Mid Cap N fund (CHTTX), which closed last quarter, and FMI Common Stock fund (FMIMX), which closed at the end of 2009.

For those using the Model Fund Portfolio as a guide for their investments, these two funds should continue to be held by those who currently own them. Anyone not owning them

Figure 1. Model Fund Portfolio vs. Comparison (through 1/31/14)

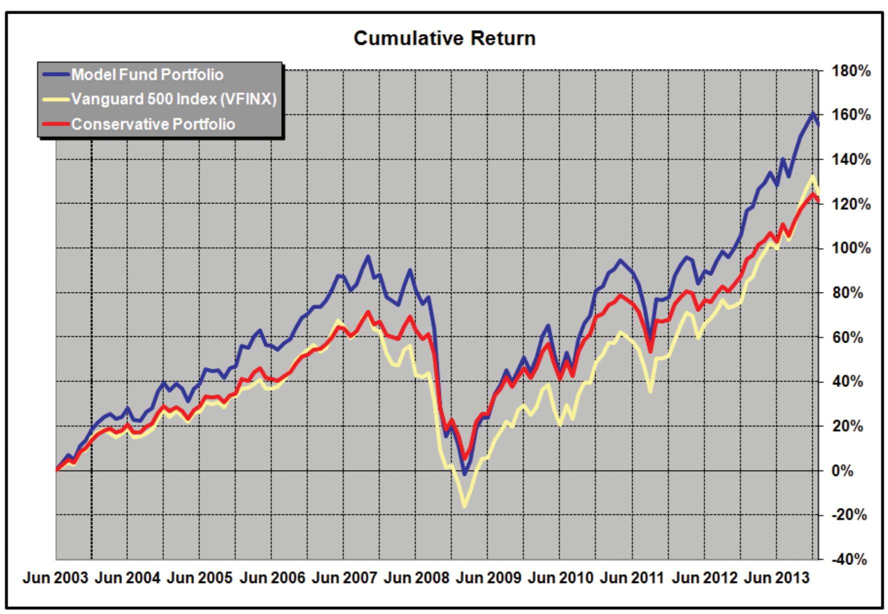


Table 1. Model Fund Portfolio

Type	Fund (Ticker)	Market Cap Size	YTD Return (%)	Annual Return (%) 1-Yr	5-Yr	10-Yr	Since 6/30/03	Fund Assets ($ Mil)	Exp Ratio (%)	Std Dev (36 Mo. Ann'l) (%)	Worst 3-Yr Cal Period (%)
MF	Aston/Fairpointe Mid Cap N (CHTTX)*	Large-Cap	(1.8)	30.7	27.7	10.9	12.5	2,460.3	1.11	18.4	(7.9)
MF	Fidelity Capital & Income (FAGIX)	na**	0.1	7.8	19.7	8.9	9.5	9,971.2	0.73	8.1	(7.2)
MF	Fidelity OTC (FOCPX)	Large-Cap	1.4	43.3	27.0	10.5	nmf	7,800.0	0.76	16.1	(8.3)
MF	FMI Common Stock (FMIMX)*	Mid-Cap	(3.4)	21.4	21.2	10.8	11.8	1,302.6	1.20	12.7	(3.0)
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	(3.0)	23.5	24.0	8.7	10.4	6,391.0	0.40	14.0	(11.4)
ETF	Guggenheim S&P MidCap 400 Pure Va (RFV)	Mid-Cap	(3.6)	23.9	28.2	nmf	nmf	90.5	0.40	16.5	(4.3)
ETF	Guggenheim S&P SmallCap 600 Pure Val (RZV)	Small-Cap	(4.7)	30.6	32.9	nmf	nmf	166.1	0.38	19.5	(7.9)
ETF	iShares MSCI Frontier 100 (FM)	Large-Cap	0.4	17.6	nmf	nmf	nmf	482.3	0.79	nmf	nmf
ETF	Vanguard REIT Index (VNQ)***	Large-Cap	4.2	2.9	22.1	8.3	nmf	18,527.6	0.10	16.7	(11.9)
Avg of Funds in Actual Model Fund Portfolio†			**(1.2)**	**22.4**	**25.3**	**9.7**	**11.0**	**5,243.5**	**0.65**	**13.4**	**(7.7)**
Actual Fund Portfolio Performance††			**(2.0)**	**17.9**	**18.2**	**7.7**	**9.3**	**—**	**—**	**12.7**	**(6.4)**
Optional Investment											
ETF	iShares Barclays 1-3 Year Treasury Bond (SHY)		0.1	0.4	1.0	2.4	3.2	8,163.5	0.15	0.5	1.3
Conservative Portfolio†††			**(1.5)**	**13.3**	**13.9**	**6.7**	**7.8**	**—**	**—**	**9.5**	**(2.6)**
Comparison											
MF	Vanguard 500 Index (VFINX)	Giant-Cap	(3.5)	21.3	19.1	6.7	7.9	26,539.6	0.17	12.2	(8.4)

**CHTTX and FMIMX are closed to new investors. Current shareholders can continue to invest in both funds. Other investors should simply use the other seven funds to form their portfolio.*
***Distressed securities - stock and bond.*
****Vanguard REIT Index Investors mutual fund (VGSIX) returns used prior to October 2004.*
†A simple average of the funds in the current Model Fund Portfolio.
††Performance of actual portfolio since inception (June 2003) including reinvested dividends.
†††75% Model Fund Portfolio/25% SHY.
Source: Morningstar, Inc. Data as of 1/31/2014.

Table 2. Model Fund Portfolio Annual Performance

	Average Annual Return (%) Model Fund Portfolio	Conser-Vative Portfolio*	Vanguard 500 Index (VFINX)	Cumulative Return of $10,000 ($) 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	26.7	19.6	32.2	26,097	22,470	23,250
2014 YTD***	(2.0)	(1.5)	(3.5)	25,572	22,139	22,444
Since Incep***	9.3	7.8	7.9	26,097	22,470	23,250

**75% Model Fund Portfolio/25% SHY.*
***June 30 to December 31, 2003.*
****Through January 31, 2014. Portfolio was started on June 30, 2003.*

and unable to buy them now should simply use the remaining seven funds. They provide ample diversification.

I have a personal belief that successful fund managers are constantly looking for stocks with real potential for their portfolios and are able to find them. To take advantage of such discoveries, new cash is required or old holdings need to be sold. When a fund closes to new investors, cash inflows are reduced (there still are some inflows from existing shareholders), and history shows that managers are not good at selecting which stocks to sell. So I believe there is a negative effect.

There may also be a positive effect in that managers are not forced to invest more than they are comfortable investing, but I feel this advantage would only be significant for small-cap funds. It is hard to understand why Yacktman Focused, which invests in giant-cap stocks,

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.

would need to close. Since Aston/Fairpointe Mid Cap just closed, we can't look for any impact. But FMI Common Stock is showing some weakness, and I believe it is a result of the fund closing.

The All-ETF Portfolio

As explained in my November 2013 column, we are now tracking a portfolio made up of only the exchange-traded funds (ETFs) in the Model Fund Portfolio. Comparing the performance of these two portfolios (Tables 2 and 3), the All-ETF Portfolio outperformed the Model Fund Portfolio in 2013. The holding of Fidelity Capital & Income fund (FAGIX) makes the Model Fund portfolio more conservative, and the downside of being conservative is un-

Table 3. Pure ETF Alternative Portfolio

Fund (Ticker)	Weight (%)	Annual Return (%) YTD	Annual Return (%) 2013
Guggenheim S&P 500 Equal Weight (RSP)	40%	(3.0)	35.6
Guggenheim S&P MidCap 400 Pure Val (RFV)	20%	(3.6)	38.3
Guggenheim S&P SmallCap 600 Pure Val (RZV)	20%	(4.7)	45.1
iShares MSCI Frontier 100 (FM)	10%	0.4	25.6
Vanguard REIT Index (VNQ)	10%	4.2	2.4
Portfolio Weighted Performance	**100%**	**(2.4)**	**33.7**
Comparison: Spider S&P 500 (SPY)		(3.5)	32.2

	Annual Return (%) YTD	Annual Return (%) 2013	Cumulative Return of $10,000 YTD	Cumulative Return of $10,000 2013
ETF Alternative Portfolio	(2.4)	33.7	$13,052	$13,372
Comparison: Spider S&P 500 (SPY)	(3.5)	32.2	$12,764	$13,221

derperformance in up markets. The fund was up during a generally down January.

It is also interesting to note that our real estate holding, Vanguard REIT Index fund (VNQ), had a weak 2013 but has started to move up, as we felt it might. This exchange-traded fund is the best performer year-to-date as of January 31 in the Model Fund Portfolio, although one month does not offset a long weak spell.

The debate continues as to whether the extra return a great fund manager can produce is enough to overcome the higher expense ratio and more frequent transactions with higher transaction costs. There is also the rather significant factor of tax management, for investments outside of a retirement plan. Exchange-traded funds have significant advantage there. We will be observing and comparing the Model Fund Portfolio and the All-ETF Portfolio through the months and years to come.

Outlook

January was down, but after a very strong up year investors who wished to take profits could have deferred the tax obligations by waiting until January to sell. The stock market never goes up every day, week, month, or year, so there will be some pullback during 2014 even if it is an up year.

There is also the possibility that the economy could stagnate and 2014 could be a down year. But as of this writing in early February, things look pretty good for the economy and corporate profits are above expectations. The consensus is that it will be a modest up year with volatility along the way. But we are all long-term investors, so it doesn't matter, right?

The next Model Fund Portfolio column will be in the May *AAII Journal*. You can keep up with the portfolio at AAII.com. ➤

James B. Cloonan is founder and chairman of AAII.

Briefly Noted

Panel Advises Against Mandated Spreads for Small-Cap Stocks

Mandating wider bid-ask spreads for small-cap stocks may unfairly hurt individual investors. This was the opinion issued by the U.S. Securities and Exchange Commission's (SEC) Investor Advisory Committee on January 31, 2014. The SEC has been looking into instituting a pilot program to test the effect of wider bid-ask spreads to improve the liquidity of small-cap stocks. The program would potentially involve mandating spreads of five or 10 cents.

The bid-ask spread is the difference between what buyers are willing to pay (the "bid") and what sellers are willing to accept (the "ask"). Highly liquid stocks trade with bid-ask spreads of a penny. Stocks with lower levels of trading volume tend to have wider spreads. Though low-price and small-cap stocks are most often perceived as having wider spreads, stocks with high share prices can also have wider spreads.

A shift in 2000 to quoting stock prices in penny increments (called decimalization) instead of fractional increments narrowed the spreads. While this has generally resulted in significant cost savings for investors, it has also reduced the revenues realized by market-making firms. This fact is often cited as a reason why efforts need to be made to entice market makers to improve the liquidity of small-cap stocks.

The committee took issue with this stance, citing what they describe as a "chicken and egg" problem. Specifically, committee members questioned whether investor interest in small-cap companies is reduced because there is less information about those stocks available, leading market makers to focus on other sectors. Alternatively, they asked if less market-maker support leads to less information being available. The committee further pointed out that the valuation premium of small-cap companies has increased since decimalization was implemented. At the same time, the committee said no evidence exists showing that market-making firms would provide more research on small-cap stocks if wider spreads were mandated.

Most importantly, the committee raised concerns about the higher transaction costs created by mandating a five- or 10-cent bid-ask spread. They warned, "A government-mandated increase in tick size would subsidize profits for the most sophisticated financial participants at the expense of retail investors."

At press time, it is uncertain as to what the SEC will or won't do in light of the committee's recommendations. Some industry groups are pushing for the implementation of the pilot program, though the SEC could alter it before launch.

Source: "Recommendation of the Market Structure Subcommittee: Decimalization and Tick Sizes," U.S. Securities and Exchange Commission, January 31, 2014.

For more Briefly Noted, go to the March 2014 issue at www.aaii.com/journal.