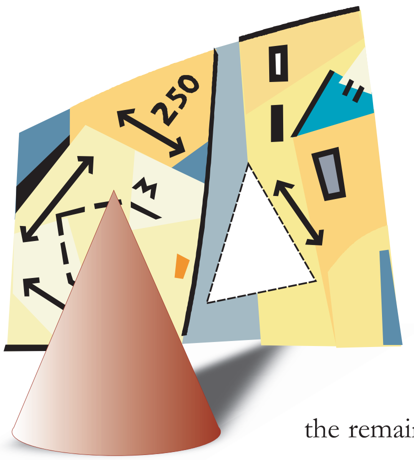
Model Fund Portfolio: Adjust Risk Based on Personal Factors

By James B. Cloonan



The stock market continues its upward movement despite anticipation of a pullback.

The Model Fund Portfolio is up 7.5% and the All-ETF Portfolio is up 7.7% year-to-date. This compares to 7.0% for the S&P 500 index as represented by the Vanguard S&P Index fund (VFINX).

Results for the Model Fund Portfolio over longer periods can be viewed in Figure 1 and Tables 1 and 2. Performance for the All-ETF Portfolio is shown in Table 3. The Vanguard REIT Index (VNQ) exchange-traded fund continues to lead the pack and is making up for the weak period a year ago. The iShares MSCI Frontier 100 (FM) exchange-traded fund, up 9.9% year-to-date, is still outperforming the Vanguard Emerging Markets Stock Index (VWO) exchange-traded fund, which is up 7.1% year-to-date.

The All-ETF portfolio continues to outperform the Model Fund Portfolio, but not by a significant amount. It's about equal to the difference in expenses.

Small- and mid-cap value stocks continue to lag. They had been the big winners over the past several years, but slowed somewhat earlier this year.

Portfolio Changes

There are no changes to the Model Fund Portfolio.

Aston/Fairpointe Mid Cap N (CHTTX) and FMI Common Stock (FMIMX) continue to be closed to new investors. Current shareholders should continue to hold these funds, but those investors who do not own them can build a portfolio from the remaining seven funds.

Presentation Change

We are no longer running performance figures for the Conservative Portfolio, which we had defined as a portfolio

Figure 1. Model Fund Portfolio vs. Comparison (Through 6/30/2014)

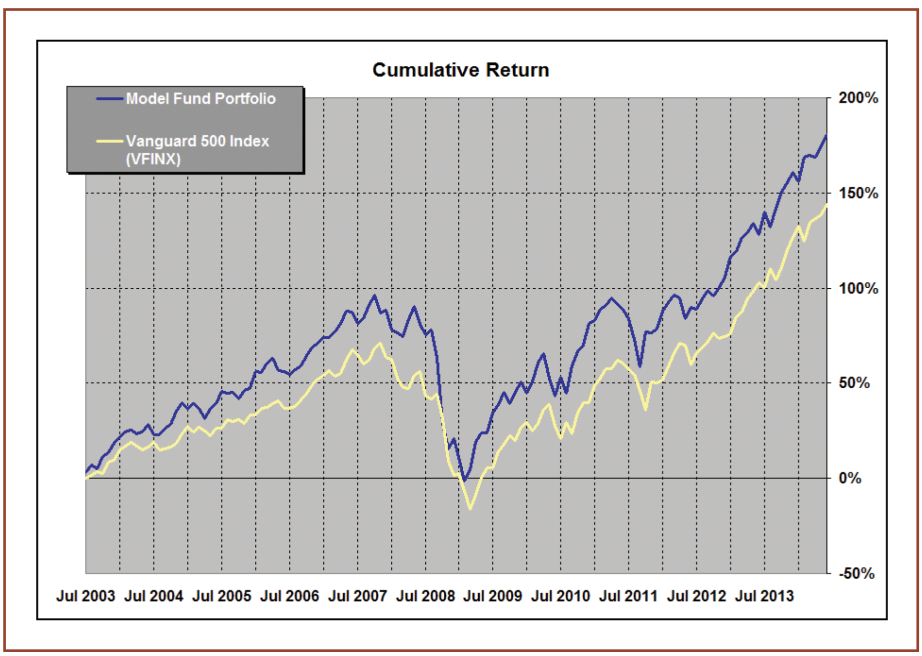


Table 1. Model Fund Portfolio

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	10.3	30.3	25.1	11.4	13.2	2,481.5	1.12	18.4	(7.9)
MF	Fidelity Capital & Income (FAGIX)	na**	7.3	15.0	15.5	9.8	9.8	10,548.9	0.73	8.0	(7.2)
MF	Fidelity OTC (FOCPX)	Large-Cap	6.8	34.4	21.3	11.1	nmf	7,786.2	0.76	16.9	(8.3)
MF	FMI Common Stock (FMIMX)*	Mid-Cap	6.8	27.5	19.2	11.2	12.3	1,408.4	1.19	12.8	(3.0)
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	8.4	26.8	21.8	9.5	11.1	7,794.1	0.40	14.0	(11.4)
ETF	Guggenheim S&P MidCap 400 Pure Val (RFV)	Mid-Cap	6.5	25.6	24.2	nmf	nmf	98.7	0.38	16.3	(4.3)
ETF	Guggenheim S&P SmallCap 600 Pure Val (RZV)	Small-Cap	2.9	26.7	21.9	nmf	nmf	178.2	0.35	19.5	(7.9)
ETF	iShares MSCI Frontier 100 (FM)	Large-Cap	9.9	24.6	nmf	nmf	nmf	803.3	0.79	nmf	nmf
ETF	Vanguard REIT Index (VNQ)***	Large-Cap	17.7	13.4	23.8	9.6	nmf	23,050.0	0.10	16.2	(11.9)
Avg of Funds in Actual Model Fund Portfolio†			**8.5**	**25.0**	**15.3**	**10.4**	**11.6**	**6,016.6**	**0.65**	**15.3**	**(7.7)**
Actual Fund Portfolio Performance††			**7.5**	**22.9**	**14.1**	**8.1**	**9.8**	**—**	**—**	**12.8**	**(6.4)**
Optional Investment:											
ETF	iShares Barclays 1-3 Year Treasury Bond (SHY)		0.4	0.6	1.0	2.5	3.1	7,785.9	0.15	0.4	1.3
Comparison:											
MF	Vanguard 500 Index (VFINX)	Giant-Cap	7.0	24.4	18.7	7.7	8.6	28,077.9	0.17	12.1	(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 before 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.
nmf = no meaningful figure
Source: Morningstar, Inc. Data as of 6/30/2014.

Table 2. Model Fund Portfolio Annual Performance

	Average Annual Return (%) Model Fund Portfolio	Average Annual Return (%) Vanguard 500 Index (VFINX)	Cumulative Return of $10,000 ($) Model Fund Portfolio	Cumulative Return of $10,000 ($) 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	26.7	32.2	26,097	23,250
YTD**	7.5	7.0	28,054	24,885
Since Inception**	9.8	8.6	26,097	23,250

**June 30 to December 31, 2003*
***Through June 30, 2014. Portfolio was started on June 30, 2003.*

invested 75% in the Model Fund Portfolio and 25% invested in the iShares Barclays 1-3 Treasury Bond (SHY) exchange-traded fund. While I believe that many investors need to be more conservative than being 100% in the Model Fund Portfolio or All-ETF portfolio, I think the appropriate level of risk is unique to each investor. I don't want the tracking of a sample conservative portfolio to be taken as a suggestion that a particular level of risk is appropriate for many investors, so I have decided it is best to drop calculation of the Conservative Portfolio.

My personal feeling is that investors who are far from retirement—or have another need to withdraw funds—should be almost entirely in equities. On the other hand, for those near retirement (or with another need to withdraw funds) the level of very safe investments should be based on the time that will elapse before the funds need to be withdrawn, not on some percentage of wealth. Since this is unique to each investor, I don't want to favor a particular level.

We will continue to show the performance of the optional iShares Barclays 1-3 Treasury Bond (SHY) exchange-traded fund investment so that you can calculate the impact it might have on your portfolio given any particular portfolio percentage invested.

Outlook

Over the past two years, more and

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 you are building an All-ETF Portfolio, see the recommended weightings shown in Table 3.
- 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.

more pundits have been predicting a major pullback, but the market continues to move up at more than an average rate. I have no idea when there might be a pullback. There are multiple factors that cause concern—from an election and uncertainty about the economy domestically to the most simultaneous conflicts abroad that I can remember. We may see some increase in market volatility, but it would be prudent to maintain your long-term investment posture.

We will review the Model Fund Portfolio and the All-ETF Portfolio again in the November *AAII Journal*. In the meantime, you can keep up with the portfolios at AAII.com. ➤

James B. Cloonan is founder and chairman of AAII.

Table 3. Alternative All-ETF Portfolio

		Annual Return (%)	
Fund (Ticker)	Weight	YTD	2013
Guggenheim S&P 500 Equal Weight (RSP)	40%	8.4	35.6
Guggenheim S&P MidCap 400 Pure Value (RFV)	20%	6.5	38.3
Guggenheim S&P SmallCap 600 Pure Value (RZV)	20%	2.9	45.1
iShares MSCI Frontier 100 (FM)	10%	9.9	25.6
Vanguard REIT Index (VNQ)	10%	17.7	2.4
Portfolio Weighted Performance	**100%**	**7.7**	**33.7**
Comparison: SPDR S&P 500 (SPY)		7.1	32.2

	Annual Return (%)		Cumulative Return of $10,000 ($)	
	YTD	2013	YTD	2013
ETF Alternative Portfolio	7.7	33.7	$14,399	$13,372
Comparison: Spider S&P 500 (SPY)	7.1	32.2	$14,153	$13,221

Source: Morningstar, Inc. Data as of 6/30/2014.