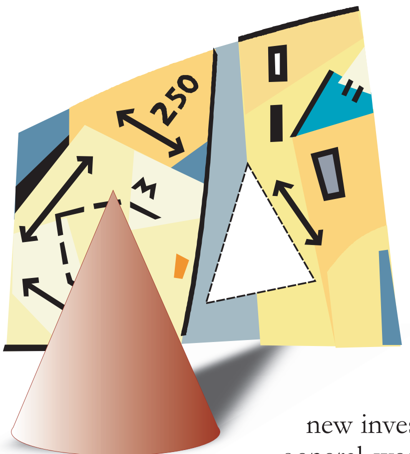
Model Fund Portfolio: Diversification Offsets Weak Performers

By James B. Cloonan



The Model Fund Portfolio fell behind the S&P 500 index, as measured by the Vanguard 500 Index fund (VFINX), 1.1% versus 1.2% year-to-date as of June 30.

They were both victims of a weak stock market that can't seem to decide what to do this year.

We get an upward movement for a short time but then a pullback, also for a very short time. Everyone seems to feel we are due for a long run, but the predictors are split on which direction it will take.

Despite this volatility and lack of significant movement, the indexes are staying close to their all-time highs. The results for the portfolio over long and short periods can be seen in the chart and tables.

Figure 1 shows the cumulative performance of the Model Fund Portfolio compared to the Vanguard 500 Index fund since the portfolio was started at the end of June 2003. Table 1 breaks out performance and other figures for each holding in the portfolio, an optional Treasury bond ETF and the comparison index fund. Table 2 reports the portfolio's average annual return for each year, along with what $10,000 would have grown to, compared to the index fund. And for those who are only interested in the exchange-traded funds (ETFs) in the portfolio, Table 3 gives performance figures for an alternative All-ETF Portfolio.

No Changes

There are no changes to the Model Fund Portfolio at this time.

I was afraid that Aston/Fairpointe Mid Cap fund (CHTTX) would experience a negative impact from closing its doors to new investors. But I think it has also been hurt by the general weakness of value stocks this year after a very long bullish run following the 2008 collapse.

Real estate turned down rapidly after a very favorable period, and Vanguard REIT Index ETF (VNQ) is the worst-performing holding in the Model Fund Portfolio year-to-date. Real estate is often out of step with the rest of the

Figure 1. Model Fund Portfolio vs. Comparison (through 6/30/2015)

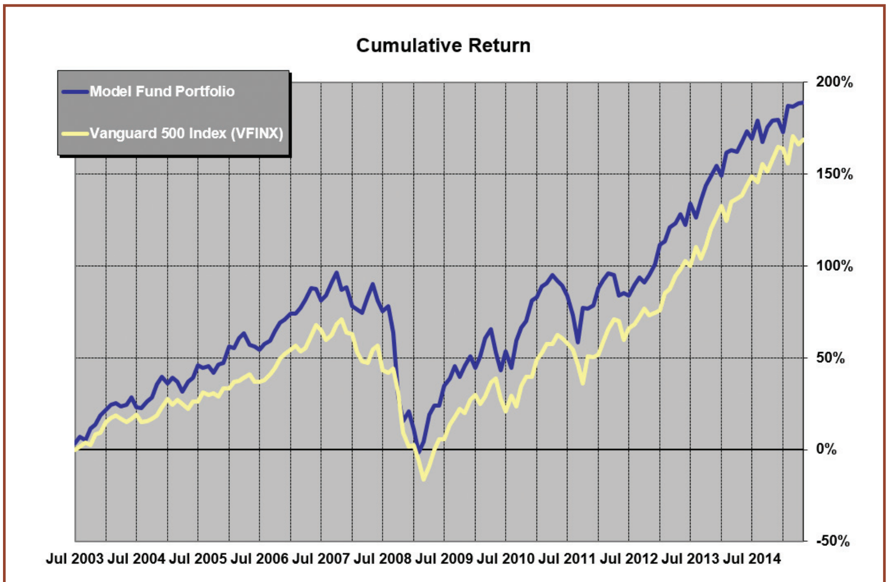


Table 1. Model Fund Portfolio

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	(0.1)	(0.6)	17.1	11.3	11.8	2,229.8	1.11	12.3	(7.9)
MF	Fidelity Capital & Income (FAGIX)	na**	4.2	3.0	9.7	8.7	9.3	11,156.4	0.72	4.8	(7.2)
MF	Fidelity OTC (FOCPX)	Large-Cap	4.6	14.1	20.8	12.3	nmf	9,281.5	0.77	12.6	(8.3)
ETF	First Trust US IPO (FPX)	Large-Cap	8.6	14.0	24.9	nmf	nmf	774.3	0.60	11.3	(13.7)
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	0.5	5.7	17.9	9.0	10.6	11,067.0	0.40	9.2	(11.4)
ETF	Guggenheim S&P MidCap 400 Pure Value (RFV)	Mid-Cap	1.1	2.9	16.7	nmf	nmf	119.9	0.37	12.4	(4.3)
ETF	Guggenheim S&P SmCap 600 Pure Value (RZV)	Small-Cap	1.6	1.5	17.0	nmf	nmf	176.1	0.36	15.6	(7.9)
ETF	iShares MSCI Frontier 100 (FM)	Large-Cap	(3.5)	(10.7)	nmf	nmf	nmf	577.3	0.79	12.6	nmf
ETF	Vanguard REIT Index (VNQ)***	Large-Cap	(6.2)	3.8	14.2	7.2	nmf	23,802.0	0.12	13.7	(11.9)
Avg of Funds in Actual Model Fund Portfolio†			**1.2**	**3.8**	**17.3**	**9.7**	**10.6**	**6,576.0**	**0.58**	**11.6**	**(9.1)**
Actual Fund Portfolio Performance††			**1.1**	**3.4**	**14.6**	**7.3**	**9.0**	**—**	**—**	**8.5**	**(6.4)**
Optional Investment:											
ETF	iShares Barclays 1-3 Year Treasury Bond (SHY)	Bonds	0.6	0.8	0.7	2.4	2.9	8,917.2	0.15	0.5	1.3
Comparison:											
MF	Vanguard 500 Index (VFINX)	Giant-Cap	1.2	7.3	17.2	7.8	8.6	27,173.1	0.17	8.3	(8.4)

**CHTTX is 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.*
*** Distressed securities - stock and bond.*
****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 6/30/2015.

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	12.6	15.8	20,075	17,589
2013	26.7	32.2	25,436	23,250
2014	9.9	13.5	27,962	26,390
2015 YTD**	1.1	1.2	28,278	26,701
Since Incep**	9.0	8.6	28,278	26,701

**June 30 to December 31, 2003.*
***Through June 30, 2015. Portfolio was started on June 30, 2003.*

market. This makes it an excellent diversifier in a portfolio, while still providing a long-term return that is equal to the overall market.

Our aggressive iShares MSCI Frontier 100 ETF (FM) continues to be weak because of its perceived correlation to the price of oil. Over the long term, I feel these pre-emerging countries' stocks will grow at an above-average rate. But I am not sure how to measure how related they really are to the price of oil.

In addition to the three situations above, our portfolio has a significant value bias. This year has not been a good year for value, at least so far.

On the brighter side, First Trust US IPO ETF (FPX) continues to outpace the market. I believe First Trust has uncovered an effective anomaly. We continue to hope that there will not be too many copycats.

The All-ETF Portfolio did somewhat better than the Model Fund Portfolio and the S&P 500, with a 1.4% year-to-date return. This was mainly due to the lesser weight (10%) on the two losers, iShares MSCI Frontier 100 and Vanguard REIT Index, and a higher weight (20%) on the largest gainer, First Trust US IPO.

Outlook

The market just continues on, sort

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.

Table 3. Alternative All-ETF Portfolio

Fund (Ticker)	Weight*	YTD Return (%)	Annual Return (%) 1-Yr	Annual Return (%) Since 12/31/12
First Trust US IPO ETF (FPX)	20%	8.6	14.0	79.1
Guggenheim S&P 500 Equal Weight (RSP)	20%	0.5	5.7	49.4
Guggenheim S&P MidCap 400 Pure Value (RFV)	20%	1.1	2.9	51.4
Guggenheim S&P SmCap 600 Pure Value (RZV)	20%	1.6	1.5	51.3
iShares MSCI Frontier 100 (FM)	10%	(3.5)	(10.7)	22.7
Vanguard REIT Index (VNQ)	10%	(6.2)	3.8	26.4
Avg of ETF Funds in Portfolio†		**0.4**	**2.9**	**46.7**
Actual ETF Portfolio††		**1.4**	**4.1**	**49.4**
Comparison: Spider S&P 500 (SPY)		1.2	7.3	51.0

** Weights were adjusted at the close of 9/30/2014.*
†An average of the ETFs in the current Model Fund Portfolio.
††Performance of actual ETF Portfolio, including reinvested dividends.
Source: Morningstar, Inc. Data as of 6/30/2015.

of drifting. I personally have a bullish bias, but it lacks strong conviction. So far, this year is not like the typical very bullish pre-election year.

Perhaps in three months when the next Model Fund Portfolio update appears in the *AAII Journal*, we will know who the real presidential candidates are for the Republican Party. In the meantime you can follow the performance of the Model Fund Portfolio each month at AAII.com. ▲

James B. Cloonan is founder and chairman of AAII.