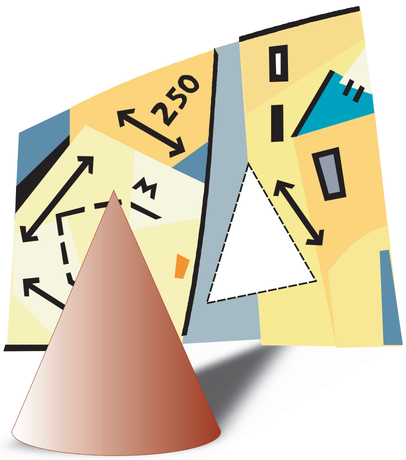
Model Fund Portfolio Holding Opens to New Investors

By James B. Cloonan



The Model Fund Portfolio is up 1.5% year-to-date. This compares to 1.3% for the S&P 500 index, as measured by the Vanguard 500 Index fund (VFINX).

The All-ETF Portfolio, a subset that contains only the exchange-traded funds in the Model Fund Portfolio, is up 3.1% year-to-date compared to 1.3% for the SPDR S&P 500 ETF (SPY).

These results and longer-term performance can be seen in Figure 1 and Tables 1, 2, and 3.

The Portfolios

We are still in a weak period for small and value stocks but they have started to rebound a bit, as can be seen in the exchange-traded funds Guggenheim S&P MidCap 400 Pure Value (RFV) and Guggenheim S&P SmallCap 600 Pure Value (RZV). Over the past year Vanguard REIT Index ETF (VNQ) has been the best performer in the portfolio.

The very oil-dependent frontier markets, represented in the model portfolio by iShares MSCI Frontier 100 ETF (FM), have started to bounce back. I feel these funds have been overpunished and will get stronger.

Aston/Fairpointe Mid Cap N fund (CHTTX) reopened to new investors. I hope this will permit a return to their excellent stock-picking. Those of you who were not able to purchase this mutual fund previously can do so now. I feel that their year of underperformance was greatly influenced by its closing to new investors and not having inflows to fund new stock purchases.

Portfolio Changes

There are no changes in either the Model Fund Portfolio or the alternative All-ETF Portfolio at this time, but please see the box on page 36 for changes to come.

Looking Forward

I still have no great insight on the short-term market.

Figure 1. Model Fund Portfolio vs. Comparison (through 3/31/2016)

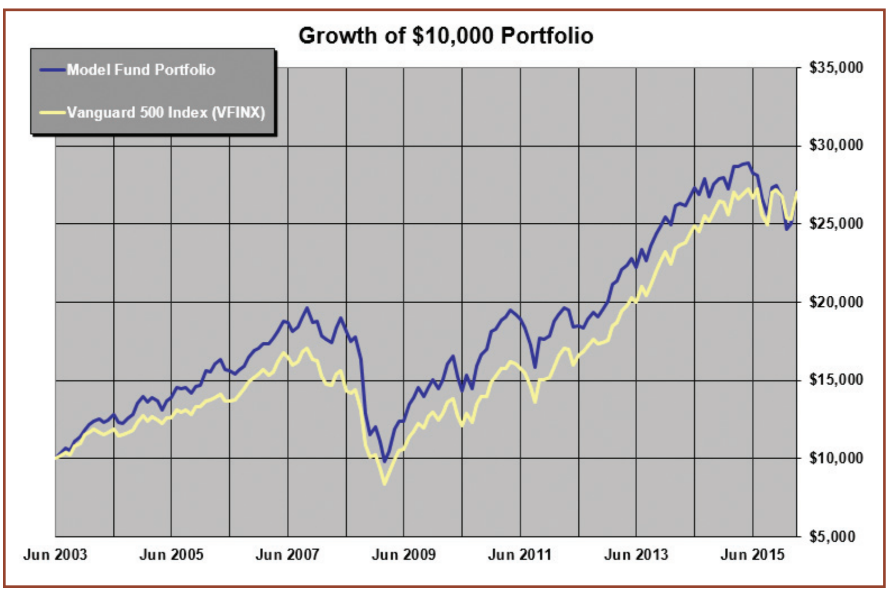


Table 1. Model Fund Portfolio

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	3.6	(9.2)	8.4	9.2	10.6	1,618.1	1.11	15.3	(7.9)
MF	Fidelity Capital & Income (FAGIX)	**	0.6	(4.2)	4.8	7.5	8.3	10,014.4	0.72	6.3	(7.2)
MF	Fidelity OTC (FOCPX)	Large-Cap	(8.7)	(3.4)	11.8	10.2	11.4	9,124.5	0.83	16.3	(9.3)
ETF	First Trust US IPO (FPX)	Large-Cap	(1.9)	(6.3)	15.6	nmf	nmf	579.1	0.60	14.0	(2.3)
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	2.9	(1.4)	11.0	7.6	9.9	8,968.6	0.40	11.6	(11.4)
ETF	Guggenheim S&P MidCap 400 Pure Value (RFV)	Mid-Cap	7.5	(5.2)	8.58	6.8	nmf	91.8	0.35	16.0	(4.3)
ETF	Guggenheim S&P SmCap 600 Pure Value (RZV)	Small-Cap	5.0	(9.0)	8.02	5.0	nmf	164.2	0.35	18.8	(8.0)
ETF	iShares MSCI Frontier 100 (FM)	Large-Cap	(1.3)	(14.7)	nmf	nmf	nmf	420.1	0.79	13.5	3.4
ETF	Vanguard REIT Index (VNQ)***	Large-Cap	6.3	3.9	11.7	6.66	11.0	30,149.6	0.12	15.6	(11.9)
Avg of Funds in Actual Model Fund Portfolio†			**1.6**	**(5.5)**	**10.0**	**7.6**	**10.3**	**6,792.3**	**0.59**	**11.5**	**(6.5)**
Actual Fund Portfolio Performance††			**1.5**	**(5.5)**	**7.3**	**5.4**	**8.1**	**—**	**—**	**11.8**	**(6.4)**
Optional Investment:											
ETF	iShares Barclays 1-3 Year Treasury Bond (SHY)	Bonds	0.9	0.8	0.7	2.4	2.7	11,437.4	0.15	0.7	0.3
Comparison:											
MF	Vanguard 500 Index (VFINX)	Giant-Cap	1.3	1.7	11.4	6.9	8.1	26,317.0	0.17	11.2	(8.4)

nmf= no meaningful figure
**CHTTX re-opened to new investors on 2/29/2016.*
***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.

Source: Morningstar, Inc. Data as of 3/31/2016.

Table 2. Model Fund Portfolio Annual Performance

	Average Annual Return (%) Model Fund Portfolio	Vanguard 500 Index (VFINX)	Cumulative Growth of $10,000 ($) Model Fund Portfolio	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	26,388
2015	(4.5)	1.3	26,711	26,719
2016 YTD**	1.5	1.3	27,103	27,069
Since Incep**	**8.1**	**8.1**	**27,103**	**27,069**

**June 30 to December 31, 2003.*
***Through March 31, 2016. Portfolio was started on June 30, 2003.*

The large number of pundits saying "take some money off the table" and/or "the recent move upward is a slight recovery in a bear market" makes me a bit hopeful about the short and intermediate term.

In the long term, I am always bullish.

We still have a long time before the election and months before we even know who is in the final running.

We will be discussing the Model Fund Portfolio and the All-ETF Portfolio again in the August *AAII Journal*, and you can follow their progress at AAII.com in the meantime.

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;

Special Note

As I planned for at least semi-retirement, I couldn't help but think about the 37 years since I started AAII, and what has happened to the stock market and to the approaches and methods of investing during that time. Lower commissions, tighter bid/ask spreads, no-load funds, exchange-traded funds, index funds, and other new products have all changed the shape of the investment landscape. While our investing has been improved by these advances, I believe that investment strategy—which I feel is even more important—has not advanced as far as it could have and should have.

I am proud of the contribution AAII has made toward helping over a million individual investors move from an unstructured approach to investing, which I call Level 1 investing, to a more structured approach that incorporates contemporary portfolio theory and practice, which I call Level 2 investing.

Looking back over past progress and based on real-world experience, I feel that we can move forward to a new level of investing strategy and I have written a book in that vein called "Investing at Level3." It departs quite a bit from conventional wisdom, but I believe it could lead to twice the assets at retirement over an investment lifetime as compared to current best practice.

More information about the book can be found inside the back cover of this issue of the *AAII Journal,* but I mention it here because the All-ETF Portfolio will be changed over the coming months to reflect the basic passive portfolio approach I describe in "Investing at Level3."

—*Jim Cloonan*

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

- 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.

Table 3. Alternative All-ETF Portfolio

Fund (Ticker)	Weight*	YTD Return (%)	Annual Return (%) 1-Yr	3-Yr	Since 12/31/12
First Trust US IPO ETF (FPX)	20%	(1.9)	(6.3)	13.3	16.9
Guggenheim S&P 500 Equal Weight (RSP)	20%	2.9	(1.4)	11.3	14.4
Guggenheim S&P MidCap 400 Pure Val (RFV)	20%	7.5	(5.2)	7.5	11.8
Guggenheim S&P SmCap 600 Pure Val (RZV)	20%	5.0	(9.0)	7.5	10.2
iShares MSCI Frontier 100 (FM)	10%	(1.3)	(14.7)	0.4	2.8
Vanguard REIT Index (VNQ)	10%	6.3	3.9	10.3	12.2
Weighted Avg of ETFs in Portfolio†		**3.2**	**(5.5)**	**9.0**	**12.1**
Actual ETF Portfolio††		**3.1**	**(5.4)**	**8.6**	**11.7**
Comparison: SPDR S&P 500 (SPY)		1.3	1.7	11.7	14.2

** Weights were adjusted at the close of 9/30/2014.*
†A weighted average return of the ETFs in the current All-ETF Portfolio.
††Performance of actual All-ETF Portfolio, including reinvested dividends.
Source: Morningstar, Inc. Data as of 3/31/2016.

James B. Cloonan is founder and chairman of AAII.