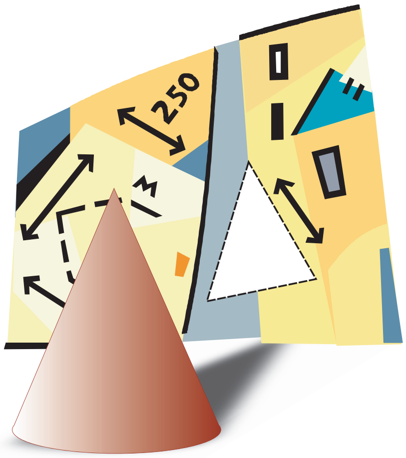
Model Fund Portfolio: Introducing the Level3 Passive Portfolio

By James B. Cloonan



The market continued to stay positive in the second quarter, but has yet to show any indication of a superior year.

The Model Fund Portfolio is up 2.9% year-to-date, as compared to 3.8% for the S&P 500 index as represented by the exchange-traded fund SPDR S&P 500 ETF (SPY). Longer-term results can be seen in Figure 1 and Tables 1 and 2.

Portfolio Changes

There are no changes in the holdings of the Model Fund Portfolio this month. However, there are changes in the rationale, which will likely bring about changes in the holdings in the near future. I discuss this after I introduce a new portfolio that is replacing the alternative All-ETF Portfolio.

The Level3 Passive Portfolio

This new portfolio, which is called the Level3 Passive Portfolio, is based on research carried out for the writing of my forthcoming book "Investing at Level3" (www.level3investing.com). It is an ETF portfolio of index funds meant to be:

- The complete equity portfolio for investors who wish to maintain their own portfolio, but do not choose to be involved in individual stock selection or non-index mutual fund selection, or
- A semi-permanent portion of an overall portfolio where some assets are in individual equities or more aggressive funds.

The characteristics of the Level3 Passive Portfolio are:

- The holdings are all index funds;
- The holdings should have, based on their approach, returns above that of the S&P 500 index over the long run;
- It is more diversified as a group than the S&P 500 and should temper portfolio downturns that could result from problems with one or a few market sectors; and
- It is meant for the long run, and changes will only occur if other funds with similar objectives seem to perform better.

Figure 1. Model Fund Portfolio vs. Comparison (Through 6/30/2016)

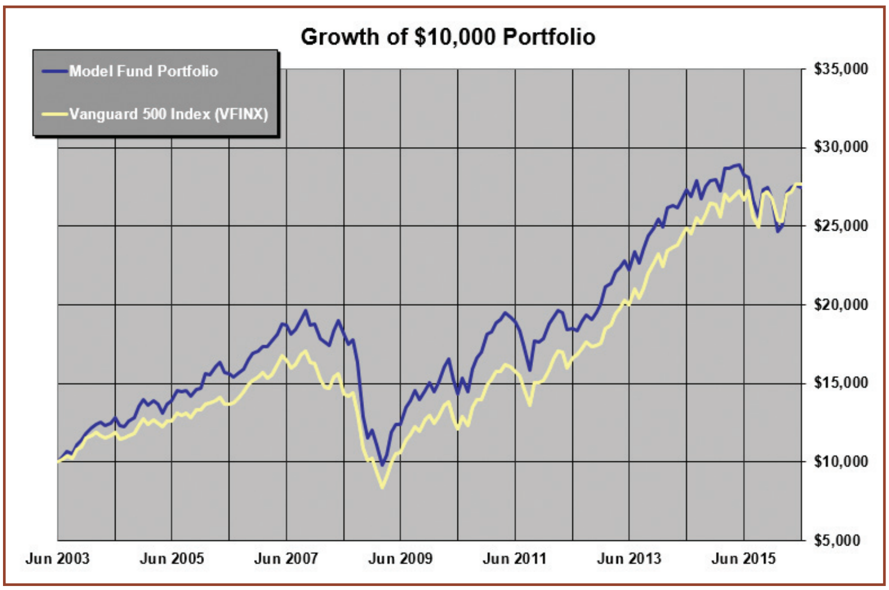


Table 1. Model Fund Portfolio

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	0.5	(9.9)	8.4	9.1	10.1	1,418.6	1.11	15.1	(7.9)
MF Fidelity Capital & Income (FAGIX)	**	2.9	(2.1)	5.3	7.8	8.3	10,105.4	0.75	6.1	(7.2)
MF Fidelity OTC (FOCPX)	Large-Cap	(6.7)	(1.0)	12.5	11.5	11.4	9,087.9	0.83	16.5	(9.3)
ETF First Trust US IPO (FPX)	Large-Cap	(0.7)	(6.6)	15.4	11.0	nmf	561.0	0.60	14.0	(2.3)
ETF Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	5.6	2.3	11.4	8.1	10.0	9,598.7	0.40	11.5	(11.4)
ETF Guggenheim S&P MidCap 400 Pure Value (RFV)	Mid-Cap	8.6	(4.2)	9.5	6.9	nmf	118.3	0.35	16.0	(4.3)
ETF Guggenheim S&P SmCap 600 Pure Value (RZV)	Small-Cap	4.2	(10.2)	8.4	5.3	nmf	165.5	0.35	18.6	(8.0)
ETF iShares MSCI Frontier 100 (FM)	Large-Cap	(0.7)	(12.9)	nmf	nmf	nmf	401.6	0.79	13.1	3.4
ETF Vanguard REIT Index (VNQ)***	Large-Cap	13.5	23.9	12.4	7.6	11.3	34,379.1	0.12	15.1	(11.9)
Avg of Funds in Actual Model Fund Portfolio†		**3.0**	**(2.3)**	**10.4**	**8.4**	**10.2**	**7,315.1**	**0.59**	**11.4**	**(6.5)**
Actual Fund Portfolio Performance††		**2.9**	**(2.8)**	**7.8**	**5.8**	**8.1**	**—**	**—**	**11.7**	**(6.4)**
Optional Investment:										
ETF iShares Barclays 1-3 Year Treasury Bond (SHY)	Bonds	1.3	1.1	0.7	2.3	2.7	10,039.3	0.15	0.7	0.3
Comparison:										
MF Vanguard 500 Index (VFINX)	Giant-Cap	3.8	3.8	11.9	7.3	8.2	26,161.6	0.16	11.1	(8.4)

nmf= no meaningful figure
**Reopened 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 6/30/2016.

Table 2. Model Fund Portfolio Annual Performance

	Average Annual Return (%)		Cumulative Growth of $10,000 ($)	
	Model Fund Portfolio	Vanguard 500 Index (VFINX)	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**	2.9	3.8	27,485	27,722
Since Incep**	**8.2**	**8.2**	**27,485**	**27,722**

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

The ETFs that make up the Level3 Passive Portfolio are described in the Investment Rationale and Processes section on the next page. I have appended "passive" to the portfolio name because my book also describes "active" Level3 portfolios that involve individual stock selection.

Table 3 shows the funds and their performance over the very short term since this portfolio's inception on June 1, 2016.

Impact on the Model Fund Portfolio

Because the Level3 Passive Portfolio provides an approach for investors who do not wish to spend the time or effort to select individual stocks or non-index mutual funds based on factors that change over time, the Model Fund Portfolio will take a more aggressive approach. Funds and ETFs selected will be based on their manager's skill in adapting to markets and whether they are investing in areas of strength in the intermediate term.

This may require more frequent changing of holdings than occurred in the previous approach.

Looking Forward

I think we now know who will be our candidates for the presidency. However, as of this writing just before the conventions, there are still some theories about possible changes.

Both candidates have been fairly clear on income tax issues, but political party platforms and the make-up of the House and Senate would have significant impact on any president's plans for changing the tax code. There probably won't be much change unless the Democrats should win the presidency and both houses. In that case, we would probably see higher tax rates, but only for the wealthy. We would also likely see higher estate and gift taxes. If the Republicans win both houses and the presidency, we would see corporate taxes go down and fewer brackets for individual taxes with slightly lower rates. Within each party, there are wide differences of opinion.

Personally, I still think this is likely to be an above-average year in the equity market. However, there are vulnerabilities with domestic and international terrorism. In addition, if Mother Nature continues the way she is going, the economic impact could be significant. Please keep up with the model portfolios at AAII.com until my next column in the November *AAII Journal*.

Investment Rationale and Processes

Level3 Passive Portfolio

This portfolio is intended to be either the complete equity portfolio for those investors who wish to manage their own portfolio but do not choose to be involved in individual stock selection or one portion of a whole portfolio for those who may wish to select individual equities and actively managed funds on a limited basis but keep the majority of their portfolio in index funds.

The portfolio consists of index ETFs that should have, based on their approach, returns above that of the S&P 500 index. As a portfolio, it is more diversified than the S&P 500, which should reduce portfolio downturns that are based on the impact of a few sectors.

Portfolio changes should be relatively rare and will occur only when a new or different ETF is felt to be more effective at accomplishing a similar objective than one of the current holdings. There are some new index ETFs with promising approaches, but there will be at least a year of observation before they can be considered.

Level3 Portfolio Holdings

Four ETFs make up the Level3 Passive Portfolio. The weights of the holdings in the portfolio are very likely to change over time based on experience.

A more thorough discussion of the ETFs in the Level3 Passive Portfolio and other new funds that might qualify when they have sufficient volume and history are discussed in my book "Investing at Level3."

Note: The Vanguard Mid-Cap Value ETF is being held in the Level3 Passive Portfolio, but the Guggenheim S&P MidCap 400 Pure Value ETF (RFV) is being retained in the Model Fund Portfolio. The difference between the two funds is slight. Since the Model Fund Portfolio may be experiencing other changes soon, the decision was made to leave it as is for now.

Guggenheim S&P 500 Equal Weight ETF (RSP)

This exchange-traded fund has outperformed the cap-weighted S&P 500 index over the 13 years of its existence. Other indexes also indicate that equal weighting provides higher returns. Equal weighting gives more weight to value stocks and smaller-cap stocks in an index, which leads to superior performance over the long run.

This fund, because of its size and history, is given a portfolio weight of 40%.

PowerShares Russell 1000 Equal Weight ETF (EQAL)

This ETF includes the top 1,000 stocks by capitalization size and gives some exposure to mid-cap stocks. Mid-cap stocks historically have had higher returns than large caps. It is a new fund, however, and uses an innovative approach that needs some observation before comparing it to Guggenheim S&P 500 Equal Weight ETF.

For now, it is weighted at 20% of the portfolio.

Vanguard Mid-Cap Value ETF (VOE)

Mid-cap value has had higher returns than large stocks or mid-cap growth stocks.

It is weighted at 20% of the portfolio.

Vanguard REIT Index (VNQ)

The returns of real estate investment trusts (REITs) have exceeded the returns of the S&P 500 over the long run and provide diversification as well.

This ETF is weighted at 20%.

The Model Fund Portfolio

The new approach to the Model Fund Portfolio will be more aggressive than in the past, including switching some holdings over those with an intermediate-term focus. The portfolio will focus on:

- Actively managed funds that seem able to adjust to the market and outperform the S&P 500 over the intermediate and long term,
- Actively managed funds in investment areas that have proven to outperform in the intermediate

Table 3. Level3 Passive Portfolio

Fund (Ticker)	Weight	Return (%) Since 5/31/16
Guggenheim S&P 500 Equal Weight (RSP)	40%	(0.09)
PowerShares Russell 1000 Equal Weight (EQAL)	20%	0.56
Vanguard Mid-Cap Value (VOE)	20%	0.29
Vanguard REIT Index (VNQ)	20%	6.89
Weighted Avg of ETFs in Portfolio*		**1.51**
Actual ETF Portfolio**		**1.39**
Comparison: SPDR S&P 500 (SPY)		0.25

**A weighted average return of the ETFs in the current Level3 Passive Portfolio.*

***Performance of actual Level3 Passive Portfolio, including reinvested dividends.*

Source: Morningstar, Inc. Portfolio inception date 6/1/2016. Data as of 6/30/2016.

and long term,

- Some index funds in investment areas that have been long-term winners.

Portfolio changes will only be made every three months, as in the past, but changes will be posted the evening of the change at the Model Portfolios section of AAII.com.

Portfolio Management Notes

For the Model Fund Portfolio, the initial holdings are equally weighted. For the Level3 Passive Portfolio, the initial weightings are as previously indicated and as shown in Table 3. The approach to rebalancing in both cases is to keep it to a minimum. While momentum is less of a factor with funds than it might be with stocks, and transaction costs for funds are much less than for stocks, rebalancing frequently is a distraction and can make taxes a significant consideration.

You should be able to achieve almost all the rebalancing necessary when you add and withdraw funds or when changes are made in the holdings. In the 12 years of the Model Fund Portfolio, no rebalancing has been thought as necessary to do. If over time a holding gets significantly out of line, adjustments can be made.

Decisions will have to be made by the individual since every investor will have added assets at a different time, so everyone's weights will be different. But the following are general guidelines:

- Don't rebalance any holding unless you have held it for over a year.
- If a holding is 25% below where it should be with the planned weight, bring it back to the appropriate level by selling some overweighted holdings to provide funds.
- If a holding is 33% above where it should be with the planned weight, bring it back to the appropriate level by selling the excess and using the funds to buy underweighted holdings. ▲

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companies are not beholden to a schedule of when they must repurchase stock. As such, a big buyback in one quarter may not be repeated in future quarters, leading to volatility in the buyback yield.

Which Method Is Best?

All of the aforementioned strategies have their advantages and their disadvantages. They are useful guides for narrowing down the universe of stocks, but additional analysis must still be conducted. Particularly, a company's ability to continue paying (and growing) a dividend and its ability to repurchase more shares must checked. Similarly, business trends and financial soundness should also be analyzed to ensure the stock is not merely cheap, but truly a bargain.

Keep in mind the impact of market conditions. A strong bull market will create downward pressure on dividend yields, while a bad bear market will greatly increase them. Furthermore, buybacks and dividend payments will be influenced by prevailing economic, industry and business conditions. Share repurchases are more discretionary than dividends are, and there isn't a penalty when buyback programs are not completed. Thus, like any valuation measure, yields are just one trait making a stock attractive or unattractive. ▲

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