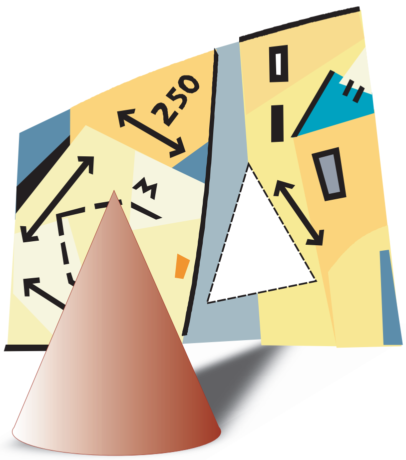
A More Aggressive Allocation for the Model Fund Portfolio

By James B. Cloonan



The year 2017 has started out with a bullish tone.

While it is only one month old as of this writing, it is nice to see market gains despite a number of uncertainties. In my last column, the uncertainty was: Who will be president? Now it is: What will he do? That is being answered day by day.

The Model Fund Portfolio is up 2.4% year-to-date as of January 31, which is somewhat better than the 1.9% gain for the S&P 500 index as measured by SPDR S&P 500 ETF (SPY).

Longer-term results can be viewed in Figure 1 and Tables 1 and 3.

Portfolio Changes

When I established the Level3 Passive Portfolio, which is a conservative and less-active portfolio approach, I indicated that the Model Fund Portfolio would be made more aggressive to try to take advantage of intermediate-term market trends.

Since inception the Model Fund Portfolio has done only slightly better than the market, as can be seen in Figure 1 and Table 1 (8.8% versus 8.6% for the SPDR S&P 500 ETF). If a portfolio is to be active, it should pursue a policy that will lead to results that are noticeably better than the market, and that is my objective.

Toward that end, one mutual fund and one exchange-traded fund (ETF) have been sold and two sector ETFs purchased; Table 2 summarizes the changes. Fidelity Capital & Income (FAGIX) and iShares MSCI Frontier 100 (FM) have been removed. Fidelity Capital & Income is really a defensive stock fund. It is valuable because it has been able to provide market returns with less than market volatility. But since the portfolio's focus is transitioning to be less concerned with volatility as a measure of risk and more concerned with returns, it does not fit the current objectives.

Even though long-term forward markets (pre-emerging markets) should outperform established markets, iShares MSCI Frontier 100 has a heavy representation of financial institutions in oil-dependent countries, and I believe any potential reward will now be a long time coming.

We have added the Guggenheim S&P 500 Equal Weight Consumer Staples ETF (RHS) and the SPDR S&P Insurance

Figure 1. Model Fund Portfolio vs. Comparison (Through 1/31/2017)

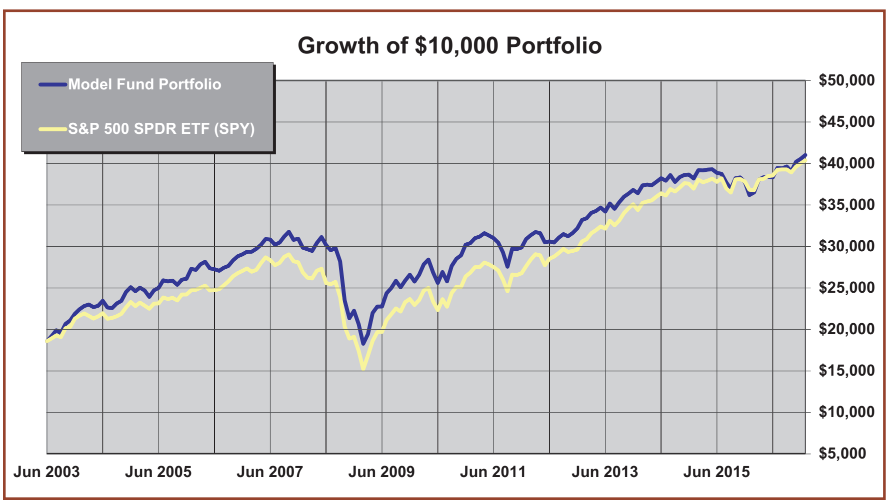


Table 1. Model Fund Portfolio

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)	Mid-Cap	3.0	40.5	14.5	9.8	11.7	1,565.0	1.11	15.8	(7.9)
MF	Fidelity OTC (FOCPX)	Large-Cap	5.7	24.9	16.4	11.5	12.1	10,067.4	0.91	16.2	(9.3)
ETF	First Trust US IPO (FPX)	Large-Cap	2.7	18.3	17.8	10.2	nmf	650.1	0.60	13.1	(2.3)
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	2.1	23.7	14.3	7.8	10.3	12,494.7	0.40	11.0	(11.4)
ETF	Guggenheim S&P 500 EqWt Consu Stap (RHS)*	Large-Cap	1.2	6.5	16.2	11.4	nmf	507.8	0.40	10.1	2.4
ETF	Guggenheim S&P MidCap 400 Pure Value (RFV)	Mid-Cap	1.3	43.9	14.3	7.5	nmf	215.7	0.35	17.5	(4.3)
ETF	Guggenheim S&P SmallCap 600 Pure Value (RZV)	Small-Cap	(2.9)	43.0	13.4	6.3	nmf	265.8	0.35	20.2	(8.0)
ETF	SPDR S&P Insurance (KIE)*	Large-Cap	0.6	29.3	18.6	5.80	nmf	958.6	0.35	12.1	(13.7)
ETF	Vanguard REIT Index (VNQ)**	Large-Cap	(0.0)	12.2	10.4	4.36	10.4	33,739.0	0.12	14.9	(11.9)
Avg of Funds in Actual Model Fund Portfolio†			**1.5**	**26.9**	**15.1**	**8.3**	**11.1**	**6,718.2**	**0.51**	**11.8**	**(7.4)**
Actual Fund Portfolio Performance††			**2.4**	**28.0**	**10.9**	**6.1**	**8.8**	**—**	**—**	**11.8**	**(6.4)**
Optional Investment:											
ETF	iShares Barclays 1-3 Year Treasury Bond (SHY)	Bonds	0.1	0.2	0.4	2.0	2.5	11,086.9	0.15	0.8	0.3
Comparison:											
ETF	SPDR S&P 500 (SPY)	Giant-Cap	1.9	19.9	14.0	6.9	8.6	227,392.8	0.10	10.3	(8.4)

nmf= no meaningful figure
**Added to Model Fund Portfolio at end of January 2017.*
***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 1/31/2017.

ETF (KIE). In both cases, these sectors should prosper if the market continues its upward movement and, importantly, they should outperform other sectors if the bull runs its course in the next year or so.

The Level3 Passive Portfolio

There are no changes in the Level3 Passive Portfolio, shown in Table 4. I am hoping that Guggenheim will reduce its expense ratio for the Guggenheim S&P 500 Equal Weight ETF (RSP), since it is currently overweight in the portfolio.

Looking Forward

While we now know who the president is, there is still uncertainty about the implementation of his programs. He has established a priority for reducing government regulation and reducing corporate taxes, two items that should impact the stock market favorably. As always though, the devil will be in the details. It seems likely that the requirement of brokers having to meet the fiduciary standard for retirement assets will be reversed, which I believe is a mistake.

There will be many more changes in rules and laws before the next column on the Model Fund Portfolio in May. In the meantime, you can keep up with the model portfolios at AAII.com.

Table 2. Model Fund Portfolio Transactions

Company (Ticker)	Reason
Buy	
Guggenheim S&P 500 Equal Weight Consumer Staples ETF (RHS)	promising sector
SPDR S&P Insurance ETF (KIE)	promising sector
Sell	
Fidelity Capital & Income (FAGIX)	adjusting portfolio philosophy
iShares MSCI Frontier 100 (FM)	adjusting portfolio philosophy

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

Table 3. Model Fund Portfolio Annual Performance

	Average Annual Return (%)		Cumulative Growth of $10,000 ($)	
	Model Fund Portfolio	S&P 500 SPDR ETF (SPY)	Model Fund Portfolio	S&P 500 SPDR ETF (SPY)
2003*	18.6	15.0	11,858	11,500
2004	17.7	10.7	13,955	12,735
2005	5.4	4.8	14,711	13,350
2006	16.1	15.6	17,086	15,438
2007	10.2	5.4	18,820	16,268
2008	(35.9)	(36.9)	12,071	10,273
2009	24.9	26.4	15,080	12,981
2010	20.3	14.9	18,136	14,914
2011	(1.7)	2.0	17,827	15,207
2012	12.6	15.8	20,075	17,608
2013	26.7	32.2	25,436	23,279
2014	9.9	13.6	27,962	26,439
2015	(4.5)	1.3	26,711	26,793
2016	15.3	11.8	30,807	29,957
2017 YTD**	2.4	1.9	31,554	30,523
Since Incep**	**8.8**	**8.6**	**31,554**	**30,523**

*June 30 to December 31, 2003

**Through Jan. 31, 2017. Portfolio was started on June 30, 2003.

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 (VOE) 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.

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 ETF (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 is more aggressive than in the past, now including some holdings with an intermediate-term focus. The portfolio focuses 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 and long term, and
- Some index funds in investment areas that have been long-term winners.

Portfolio changes are only made every three months, and are sent out in the monthly Model Portfolios Update email.

Table 4. Level3 Passive Portfolio

Fund (Ticker)	Initial Weight	Return (%) Since 5/31/16
Guggenheim S&P 500 Equal Weight (RSP)	40%	10.4
PowerShares Russell 1000 Equal Weight (EQAL)	20%	10.6
Vanguard Mid-Cap Value (VOE)	20%	13.1
Vanguard REIT Index (VNQ)	20%	2.2
Weighted Avg of ETFs in Portfolio*		**9.4**
Actual Level3 Passive Portfolio**		**9.3**
Comparison: Spider S&P 500 (SPY)		10.1

*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. Data as of 1/31/2017.

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 4. 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 necessary. 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 some 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. ▲

James B. Cloonan is founder and chairman of AAII. He is author of the new book "Investing at Level3: Higher Returns With Minimal Risk for the Long-Term Individual Investor" (www.level3investing.com).

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designed to focus on S&P 500 member stocks with lower levels of volatility [PowerShares S&P 500 Low Volatility ETF (SPLV)], stronger price momentum [PowerShares S&P 500 Momentum (SPMO)], dividend growth [ProShares S&P 500 Dividend Aristocrats (NOBL)] and buybacks [SPDR S&P 500 Buyback ETF (SPYB)]. Most of these funds have been around for fewer than 10 years. The decision to allocate to them should be based on the expectation that such funds will be able to achieve outperformance over the long term with the understanding that all return anomalies go through periods during which they underperform.

Other S&P 500 Funds

There are a group of S&P 500 funds that do not fit nicely into any of the aforementioned categories. Some of these are tactical. ProShares offers funds excluding certain sectors, as such as financials [ProShares S&P 500 ex-Financials (SPXN)]. Others are intended for those who desire to incorporate their personal values into their investment strategy, including the Global X S&P 500 Catholic Values (CATH). More than half of these funds have attracted fewer than $10 million in assets, which increases the risk of them being shut down at some point in the future. Furthermore, their unique approaches will result in return characteristics that differ from the S&P 500.

Excluded from this article are leveraged and inverse funds. These funds are very short-term trading vehicles, often intended to be held for no more than one day. They are highly risky and are not intended for an investor seeking exposure to the S&P 500; rather, they are designed for active traders and speculators.

Finding S&P 500 Funds

To identify funds for this article, I searched our Mutual Fund Guide (February 2017 *AAII Journal*) and our Exchange-Traded Fund Guide (August 2016 *AAII Journal*) along with data from Morningstar for funds with S&P 500 in their name.

There may well be additional funds in existence that track or use the S&P 500 as a basis for their holdings. Identifying them would require going through factsheets and/or prospectuses on a fund-by-fund basis—a time-consuming process.

There are also "closet-index" mutual funds. These funds are designated as being active, but their returns and volatility are close to that of the S&P 500 when fees are excluded. They have higher expense ratios than the traditional index funds mentioned this article, lessening their appeal. Looking for R-squared values near 1.0 is one way to spot actively managed funds that are likely closet indexers. A traditional S&P 500 index fund will be more attractive to the closet indexers because of its lower expense ratios. ▲

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