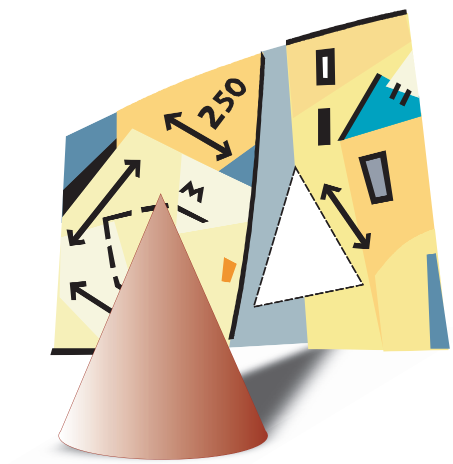
Model Fund Portfolio: Don't Fear Real Estate or the Stock Market

By James B. Cloonan



The bull market continued through the first quarter of 2017.

For the year to date as of March 31, the S&P 500 index as measured by SPDR S&P 500 ETF (SPY) was up 6.0%, and the Model Fund Portfolio was up 4.8%.

Real estate has been underperforming; this is mirrored by the the performance of the model portfolio's exchange-traded fund (ETF) that invests in real estate investment trusts (REITs), the Vanguard REIT Index (VNQ). It is not unusual for real estate to have its own cycles; this is why it is valuable for diversification. However, over the long term, real estate has about the same returns as the overall market.

Longer-term results for the Model Fund Portfolio can be viewed in Figure 1 and Tables 1 and 2.

For over a year now, I have been hearing from members that the market is overpriced and that they were going to hold off additional investing or reduce holdings until the next big pullback. There will eventually be a big pullback, but it might well never get down to where it was a year ago or, for that matter, where it is today. It is, I believe, riskier to be out of the market than to be in it—always assuming that you are in the market with the appropriate proportion of assets based on your individual situation.

Portfolio Changes

There are no changes in the Model Fund Portfolio at this time. However, I am looking at a number of possibilities and expect to make changes soon.

There are no changes in the Level3 Passive Portfolio, as shown in Table 3.

Looking Forward

I am somewhat concerned over the excessive talk and lack of specific action in Washington, particularly in areas that I feel are important to corporate and investor success. We need to have a corporate and individual tax plan, and it is almost too late for something this year. The promised deregulation is still mostly promises and the one regulation that made sense—the requirement that advisers for retirement assets be fiduciaries—seems likely to be the first significant one to be eliminated.

Figure 1. Model Fund Portfolio vs. Comparison (Through 3/31/2017)

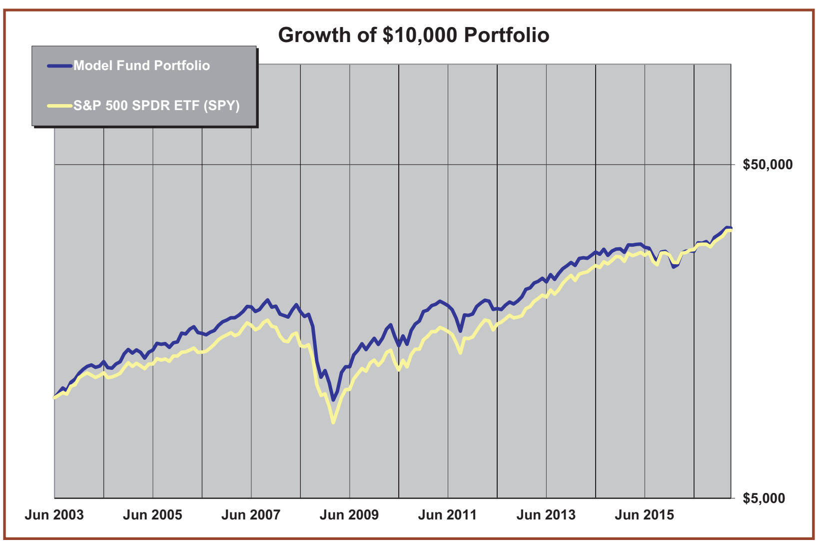


Table 1. Model Fund Portfolio

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	6.1	27.0	14.0	10.0	11.7	1,588.5	1.12	15.5	(7.9)
MF	Fidelity OTC (FOCPX)	Large-Cap	13.0	27.6	15.9	12.3	12.5	10,878.2	0.91	15.7	(9.3)
ETF	First Trust US IPO (FPX)	Large-Cap	6.4	15.6	15.8	10.6	nmf	697.3	0.60	12.5	(2.3)
ETF	Guggenheim S&P 500 Equal Weight (RSP)	Large-Cap	5.3	17.0	13.6	8.1	10.4	13,145.9	0.40	10.8	(11.4)
ETF	Guggenheim S&P 500 Eq Wt Consu Stpl (RHS)	Large-Cap	4.6	4.0	15.7	11.6	nmf	510.4	0.40	10.1	2.4
ETF	Guggenheim S&P MidCap 400 Pure Value (RFV)	Mid-Cap	1.4	23.6	13.1	7.4	nmf	212.2	0.35	17.4	(4.3)
ETF	Guggenheim S&P SmallCap 600 Pure Value (RZV)	Small-Cap	(5.8)	19.8	11.8	6.0	nmf	240.1	0.35	20.1	(8.0)
ETF	SPDR S&P Insurance (KIE)	Large-Cap	4.0	26.2	17.6	6.1	nmf	1,027.0	0.35	12.3	(13.7)
ETF	Vanguard REIT Index (VNQ)*	Large-Cap	1.0	3.1	9.7	5.0	10.4	34,260.6	0.12	14.9	(11.9)
Avg of Funds in Actual Model Fund Portfolio†			**4.0**	**18.2**	**14.1**	**8.6**	**11.3**	**6,951.1**	**0.51**	**11.6**	**(7.4)**
Actual Fund Portfolio Performance††			**4.8**	**19.1**	**10.5**	**6.2**	**8.9**	**—**	**—**	**11.6**	**(6.4)**
Optional Investment:											
ETF	iShares Barclays 1-3 Year Treasury Bond (SHY)	Bonds	0.2	0.1	0.5	1.9	2.5	11,030.6	0.15	0.8	0.3
Comparison:											
ETF	SPDR S&P 500 (SPY)	Giant-Cap	6.0	17.0	13.2	7.4	8.8	241,041.8	0.10	10.2	(8.4)

nmf= no meaningful figure
**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 3/31/2017.

This strong market is at least partially based on the hope for tax reform and a reduction of anti-business (particularly small business) regulation. Too much political nonsense could bring the current bull market to a screeching halt. I hope we will have more action by the time of the next Model Fund Portfolio column in August. In the meantime, please keep up with all the Model Portfolios at AAII.com.

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" (www.level3investing.com).

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

Table 2. 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**	4.8	6.0	32,288	31,763
Since Incep**	**8.9**	**8.8**	**32,288**	**31,763**

**June 30 to December 31, 2003*
***Through March 31, 2017. Portfolio was started on June 30, 2003.*

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.

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 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. ▲

Table 3. Level3 Passive Portfolio

Fund (Ticker)	Initial Weight	Return (%) Since 5/31/16
Guggenheim S&P 500 Equal Weight (RSP)	40%	14.0
PowerShares Russell 1000 Equal Weight (EQAL)	20%	13.4
Vanguard Mid-Cap Value (VOE)	20%	16.6
Vanguard REIT Index (VNQ)	20%	3.2
Weighted Avg of ETFs in Portfolio*		**12.2**
Actual Level3 Passive Portfolio**		**12.2**
Comparison:		
SDPR S&P 500 (SPY)		14.6

**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 3/31/2017.

For more on the Level3 approach, go to www.level3investing.com.

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).