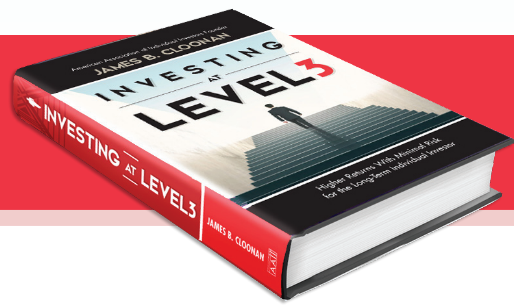
INVESTING AT LEVEL3

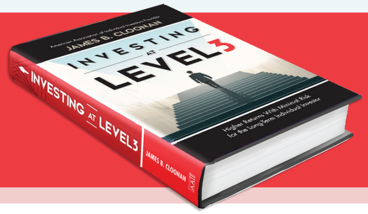


Passive Portfolios

QUICK START GUIDE

In his book, "Investing at Level3," Jim Cloonan discusses a number of ways an investor may be able to obtain higher-than-market returns. He breaks down the investor involvement into three groups: passive, intermediate and active. Ultimately, it is up to you the investor to select a level of involvement that matches your interests, time availability and abilities.

Jim introduces three "passive" portfolios that primarily use a variety of index mutual funds and exchange-traded funds (ETFs). This Quick Start Guide will walk you through the process of investing in these passive portfolios, from the initial portfolio selection and asset allocation to portfolio contributions to, finally, the withdrawal stage as you near and ultimately enter retirement. It includes page numbers and references from the book for easy further reading. So let's get started!



1. Choose Your Level3 Passive Portfolio

In "Investing at Level3," three different passive portfolios are introduced:

- **Plan Z**

  The Plan Z portfolio is 100% invested in the Guggenheim S&P 500 Equal Weight ETF (RSP), an exchange-traded fund that invests in the S&P 500 but equally weights each stock in the index. Over the long run, such a portfolio should return 2% to 3% above the cap-weighted index, based on its real-world performance since its introduction in 2004 as compared to the cap-weighted S&P 500 (for an illustration of how the Plan Z portfolio would have performed relative to the cap-weighted S&P 500 index since 2004, see Figure I.1 on page 28 of the book).

- **Enhanced Plan Z**

  While Jim feels that the Plan Z would beat the vast majority of portfolios and mutual funds, he feels that Plan Z can be improved upon with some diversification. While Jim believes that diversification may reduce volatility, he warns that it doesn't necessarily reduce real risk—the likelihood of your portfolio having a lower dollar value than expected when you need to withdraw money from the portfolio (i.e., at retirement). However, Jim does feel that some diversification can reduce the chance of an extreme pullback in your portfolio as well as reduce the duration of a pullback.

  The "enhanced" Plan Z portfolio weights the portfolio 90% to the Guggenheim S&P 500 Equal Weight ETF (RSP) and 10% to the Vanguard REIT ETF (VNQ). Equity REITs have outperformed the S&P 500 over the past 50 years by about 1% annually, according to Ibbotson's SBBI Yearbook, and can provide some useful diversification.

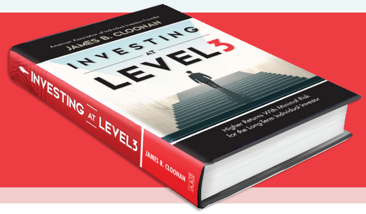
- **Level3 Passive Portfolio**

  The final passive portfolio Jim mentions includes some new ETFs that have shown promise since their introduction. PowerShares Russell 1000 Equal Weight Portfolio ETF (EQAL) includes some mid-cap stocks, which historically outperform large-cap stocks, so it should provide a higher return than the Guggenheim S&P 500 Equal Weight ETF. It does have a limited track record, however, only being around since the start of 2015. In addition, it currently has higher costs and is more thinly traded, which might offset better performance. Jim, though, believes that the EQAL is far enough along at this time to use it as at least a partial substitute for the RSP.

  Even though RSP increases the emphasis on value stocks beyond that of a cap-weighted S&P 500 index fund and EQAL gives some weight to value and mid-cap stocks, since value and mid-cap segments are superior performers, Jim feels they should be given additional weight. For that reason, the Vanguard Mid-Cap Value ETF (VOE) is added to the Level3 Passive Portfolio, so that the overall portfolio is weighted as such:

  - 30% RSP
  - 30% EQAL
  - 30% VOE
  - 10% VNQ

  Jim feels strongly that any of these three passive portfolios will outperform the majority of investment portfolios, mutual funds and ETFs, so ultimately the choice of which passive portfolio to follow is up to you.



2. Allocate Your Capital

Once you have chosen a passive portfolio to invest in, you allocate your capital accordingly:

- **Plan Z:**
  - 100% Guggenheim S&P 500 Equal Weight ETF (RSP)
- **Enhanced Plan Z:**
  - 90% Guggenheim S&P 500 Equal Weight ETF (RSP)
  - 10% Vanguard REIT ETF (VNQ)
- **Level3 Passive Portfolio:**
  - 30% Guggenheim S&P 500 Equal Weight ETF (RSP)
  - 30% PowerShares Russell 1000 Equal Weight Portfolio ETF (EQAL)
  - 30% Vanguard Mid-Cap Value ETF (VOE)
  - 10% Vanguard REIT ETF (VNQ)

3. Add More Cash

Want to add cash to your passive portfolio? Good for you! Any new cash you add should be divided using the allocation weighting of whichever passive portfolio you are using. If your portfolio allocation starts getting too far away from the initial targets, consider investing additional cash in those funds that are most underweighted relative to the target allocation. We provide more guidance on rebalancing later on in this guide.

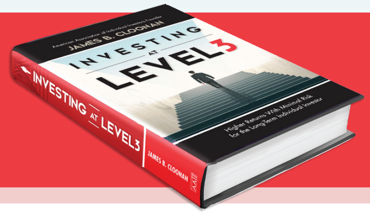
4. Track Your Progress With the "My Level3 Worksheet"

In Chapter 7 of "Investing at Level3," Jim discusses several ways you can reinforce the behavior you desire in your own Level3 strategy. One way to reinforce this desired behavior is with the My Level3 Worksheet Jim discusses starting on page 243.

This spreadsheet allows you to set up your own estimates and equivalent Level3 investment plan on a quarterly or annual basis. It then shows the cumulative values of a variety of portfolio scenarios, as well as your own Level3 portfolio. From the beginning and through the years, this worksheet allows you to view your average expectation, look at what the worst-case scenario may be, and record your actual performance.

You should review and update the My Level3 Worksheet regularly and visualize the possibility that no matter where you are you could—and at least once in your investing experience, probably will—be down to the worst-case drawdown line.

To download your copy of the My Level3 Worksheet, click **here**.



5. Rebalancing

Over time, depending on which Level3 passive portfolio you are following, the weights of the funds in your portfolio will move away from the initial target allocations. As this happens, you may need to think about rebalancing your portfolio.

Jim suggests the following rebalancing approach:

- Don't rebalance any holding unless you have held it 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.

6. Entering the Withdrawal Stage

In Chapter 5 of "Investing at Level3," Jim provides detailed instructions on how to start transferring assets from equity into "safe" investments as you near retirement. You can find the complete explanation starting on page 161.

For the sake of brevity, here are the basic strategy rules for the Level3 withdrawal stage. Remember that until this point your portfolio is 100% in equities:

1) Keep four years of estimated withdrawal needs in the safe (fixed income) portion of your portfolio (but no more than 20% of your total portfolio).

2) Make withdrawals as you need them.

3) When you make a withdrawal, see if the market is above or within 5% of its all-time high. (Please note that using 5% is arbitrary. You could use 1%, 10% or even 20%, which is the usual definition of a bear market. The higher the criteria, the less activity there will be. It's your choice, but pick one and stick to it.) If so, take the withdrawal from the equity segment. Otherwise take it from the safe segment.

4) Whenever the market is back above its previous high after a pullback, return to taking withdrawals from the equity segment and also begin to restore the safe portion from the equity portion gradually. (Jim recommends doing this over two years, restoring half of the deficit—the amount below four years of withdrawal—each year. Any restoration would stop if a new down year prompts reverting to the safe portion for withdrawals.)

The safe, or defensive, portion of your portfolio doesn't have to be Treasuries or insured, but it should be very safe in the default sense and also be safe from significant price volatility in the short term. The best of course would be short-term Treasuries or insured CDs. Depending on the exact form of the defensive strategy, immediate liquidity might be required.

If the time of withdrawals is definitely set, then Treasury STRIPS can be effectively used (see "A Pseudo-Life Annuity: Guaranteed Annual Income for 35 Years," by Robert Muksian, June 2012 *AAII Journal*).

If withdrawals are on an "as needed" basis, then an insured savings account or an exchange-traded fund of safe short-term securities would be better. In fact, with so many appropriate ETFs in existence and the ease of making changes as well as the ability to sell whatever quantity is necessary, they become an ideal investment for the safe portion.

Updated 12/2017.