

Model Fund Portfolio Update: How to Deal With the Issue of Fund Closings

By James B. Cloonan

My semiannual update of the Individual Investor's Fund Portfolio details a number of changes. This includes not only changes to the portfolio itself, but also to the criteria and the recommendation process.

How We Deal With Fund Closings

Because two of our recommended mutual funds have closed to new investors but remain on our recommended list for those who already own them, we will continue to maintain them in the model portfolio. Members who wish to invest in our recommended funds but did not do so prior to the fund closings can develop their own mutual fund portfolio from the remaining funds on the recommended list.

We wish to keep the model portfolio at a maximum of 10 funds; therefore, we will not add all the funds on the recommended list to our model portfolio, but only replace those that have a sell recommendation. While all of the funds on the recommended list meet our qualifications and we would not hesitate to own them, a real-life portfolio cannot add mutual funds forever without selling some existing funds. In order to monitor performance, we will track not only the model portfolio, but also all recommendations—whether we own them in the model portfolio or not.

Also, we realize that some members who invest in our recommended funds will not add every single new recom-



mendation to their portfolio. Consequently, whenever we provide more recommendations than are necessary, we will list them in order of preference—based on the qualitative criteria shown in Rule No. 8 of our revised selection criteria list.

The Revised Criteria

Before reviewing the revised criteria, let me once again explain the thought process that drives our selections.

As you have probably noticed from my articles, I place a great deal of emphasis on risk, but not on total risk avoidance—otherwise, I would simply own a portfolio consisting entirely of riskless Treasury bills. I emphasize risk because I believe that risk analysis provides the best route to providing the highest returns while still keeping within a suitable risk framework.

And it appears to me—as it does to many others—that the risk of a particular holding is more consistent over time than its rate of return. Or, put another way, there is a much better chance that a stock will have the same risk in the future that it had in the past, than there is that a stock's return in the future will be the same as in the past.

As can be seen in our selection criteria, we look at risk from both theoretical and practical perspectives. We use the

traditional statistical measures of volatility to require a higher risk-adjusted rate of return than the market. But we also require that a fund not have had a loss in the past 10 years, in the belief that this significantly reduces the chance of it having a loss in the future. We consider a loss to be a rolling 36-month period with a negative return, since we feel that three years is the bare minimum investment horizon for equity investing.

The revised selection rules are presented in the accompanying list. Note that the following changes have been made:

- We eliminated “no two years in a row with negative returns” as an absolute criteria. This was originally intended as an early warning. But there is a difference between being down a few percentage points eight and nine years ago, and being down significantly over the last two years. For that reason, recent negative performance will be part of the tie-breaking process of Rule No. 8.
- We have eliminated the criteria that a fund be primarily a domestic stock fund. Although we believe it is a mistake to add foreign funds just to diversify, if a foreign stock fund can pass the criteria on its own merits there is no need to eliminate it. While I doubt that an international or world fund will ever qualify, there is no reason for specific elimination.
- The net asset and expense limits have been adjusted to consider the mission and size of the fund. New

style and size ranges are presented in the box on page 28.

- A new criterion, Rule No. 8, has been added to accommodate members who start following the portfolio at different times. Some funds may close to new investors, but still qualify for inclusion for those who already own them. This situation has already occurred—both FMI Common Stock Fund (FMIMX) and Tamarack Microcap Value (TMVSX, formerly SHSTX) have closed. Some readers will need to choose other funds, while those that already own these funds should keep them until we recommend a sale. So we need new recommendations to replace funds sold, as well as to substitute for closed funds. Because different members will need different numbers of funds, we will list the new recommendations in order of preference. However, I want to make

it clear that all of the recommendations qualify under the selection criteria, and the difference between them is small. You may certainly use your own rationale in choosing among them, but we will use our order of preference to make changes in our own model portfolio.

Portfolio Performance

Figure 1 graphically depicts the returns for the Fund Portfolio and illustrates the performance relative to two market indexes.

Table 1 shows the performance results for the Fund Portfolio—the individual funds in the portfolio and the historical performance over the same time period for the new qualifying funds. The table reports the actual portfolio results for the first year of the Fund Portfolio; the longer-term data is based on the history of the included

Figure 1. Individual Investor’s Fund Portfolio Performance vs. Benchmarks

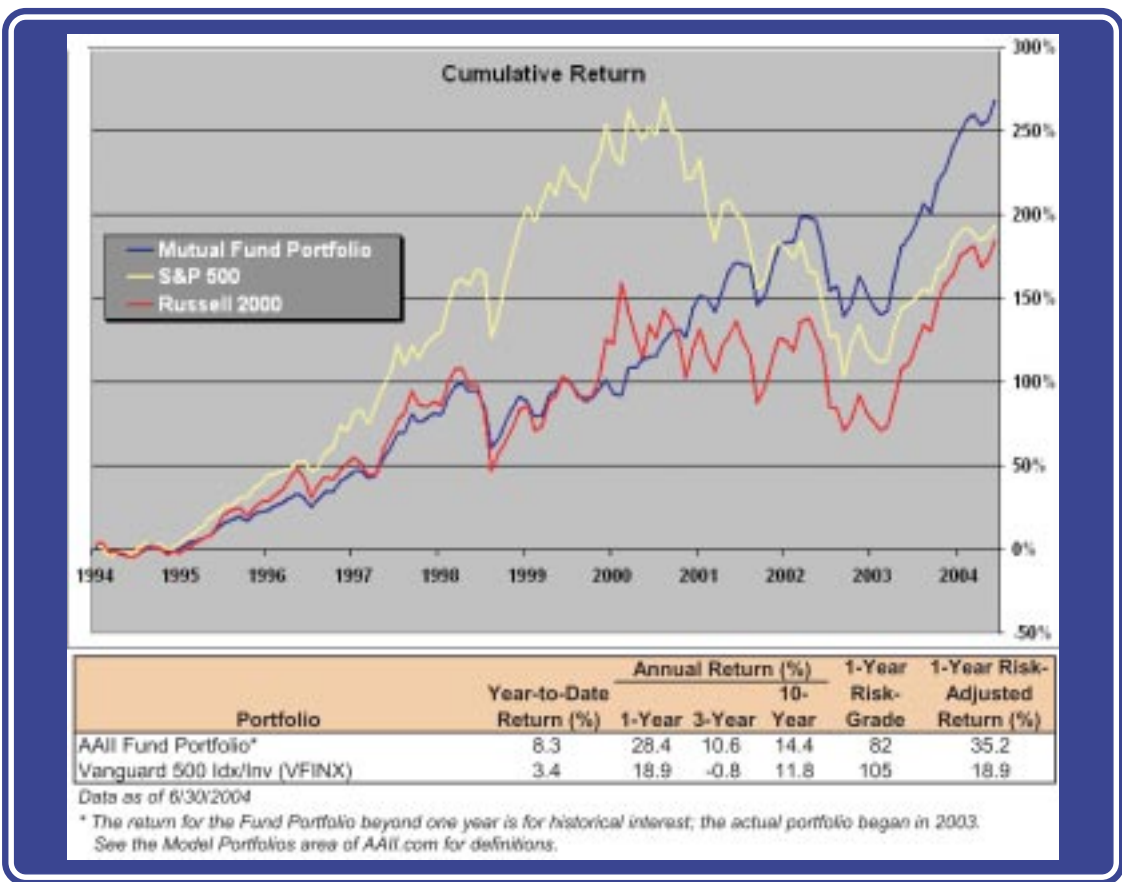


Table 1. Individual Investor's Fund Portfolio

Fund (Ticker)	Style	Market-Cap Size	Annual Ret (%)				Fund Assets (\$ Mil)	Exp Ratio (%)	1-Yr Risk-Grade	1-Yr Risk-Adj Ret (%)
			YTD Ret	1-Yr	3-Yr	10-Yr				
Ariel Fund (ARGFX)	High Value	Small-Cap	11.8	28.8	12.9	15.4	2,462.9	1.10	81	36.1
Fenimore Value (FAMVX)	High Value	Mid-Cap	6.6	21.6	9.3	13.6	640.9	1.24	77	28.0
Mosaic Eq Mid-Cap (GTSGX)	High Value	Large-Cap	6.2	22.1	8.5	11.1	72.7	1.25	84	26.6
Meridian Growth (MERDX)	High Value	Mid-Cap	7.1	33.6	10.2	14.6	1,174.4	0.95	99	35.4
Royce PA Mutual/Inv (PENNX)	High Value	Small-Cap	8.2	33.9	11.5	13.9	970.2	0.93	83	41.8
T Rowe Price Cap Apprec (PRWCX)	High Value	Giant-Cap	5.1	20.2	10.3	13.4	3,505.2	0.83	58	33.3
Royce Premier/Inv (RYPRX)	High Value	Small-Cap	12.9	37.9	13.5	14.2	2,176.6	1.16	90	43.6
Thompson Plumb (THPGX)	High Value	Giant-Cap	3.9	19.4	6.1	17.9	1,333.7	1.07	118	17.7
Recommended funds now closed to new investors										
FMI Common Stock (FMIMX)*	High Value	Small-Cap	9.7	24.9	9.6	14.2	393.6	1.25	83	30.4
Tamarack Microcap Val "S" (TMVSX)**	Very Hi Value	Micro-Cap	10.7	41.6	15.0	14.9	229.3	1.03	85	50.4
Portfolio Average			8.3	28.4	10.6	14.4	1,296.0	1.08	82	35.2
Vanguard 500 Idx/Inv (VFINX)	Moderate Value	Giant-Cap	3.4	18.9	-0.8	11.8	77,822.7	0.18	105	18.9
Newly recommended funds, listed in order of preference										
Meridian Value (MVALX)	High Value	Large-Cap	6.6	27.5	9.3	19.7	2,124.5	1.11	83	33.7
Exeter Pro Blend Ext. Term A (MNBAX)	High Value	Giant-Cap	4.3	13.6	4.7	11.4	256.5	1.17	68	18.8
Mairs & Power Growth (MPGFX)	Moderate Value	Giant-Cap	10.3	26.1	10.4	18.0	1,595.6	0.75	85	31.3

*Closed to new investors on April 15, 2004.

**Tamarack Micro Cap Value Fund was originally recommended when it was the Babson Shadow Stock Fund (SHSTX). Since the recommendation, the fund has been converted into a multi-class fund. Although shareholders of the fund prior to the conversion are able to purchase additional shares without a load, new shareholders must purchase a class of shares that carry a load. We don't recommend funds carrying loads for this portfolio, so we consider it closed to new shareholders.

Fund Actions:

Ariel (ARGFX) to be sold in early August.

Buy Meridian Value (MVALX) to replace Ariel (ARGFX).

Source: S&P Micropal, RiskGrades.com. Data as of 6/30/2004. See the Model Portfolios area on AAIL.com for definitions.

funds.

As you can see, the performance results of the model portfolio have exceeded the market on both an absolute and risk-adjusted basis. While we are happy to see our funds outpace the market and most equity mutual funds, we are even happier that the portfolio has done this with considerably less risk.

Recommended Changes: Our Rationale

In terms of the individual mutual funds on our recommended list, we are recommending the sale of one fund—the Ariel Fund (ARGFX). This

fund has performed well, but we believe it has grown too large to successfully continue in its stated mission, and it does not meet the new criteria for size and expenses. However, I want to make an important point here: Funds do not change quickly. When we recommend the sale of a fund, you do not have to accomplish this quickly, particularly if there is a reason to hold the fund a bit longer. For example, if your holding is close to qualifying as a long-term holding for tax purposes, I would certainly recommend that you hold it until the year is up and then replace it—particularly considering the new capital gains rates. In a retirement account, of course, taxes won't matter.

In the model portfolio, we are replacing the Ariel Fund with Meridian Value (MVALX). We chose MVALX over the other two qualifiers, Exeter Pro Blend A (MNBAX) and Mairs and Power Growth (MPGFX) based on practical considerations. These practical considerations are also the basis for our preference ranking, and include: number of states in which the fund is available for sale, Web site information, and shareholder services. You can see that these preference considerations are relatively minor; we certainly recommend these two funds to those who don't hold the two funds in the portfolio that have closed, FMI Common Stock and Tamarack Microcap Value.

Individual Investor's Fund Portfolio: Selection Rules

To make it into the Individual Investor's Fund Portfolio, a fund must meet the following criteria:

- 1) **It must be a pure no-load fund.** While it may charge a penalty for short-term redemptions, the penalty must be paid to the fund and benefit the shareholders. I feel this type of penalty is desirable particularly for small-cap and mid-cap funds to offset the transaction costs caused by short-term traders.
- 2) **It must have been in existence for at least 10 years.** In the future, I will discuss how it might make sense to make exceptions to this rule in certain circumstances.
- 3) **It must have had higher returns than the S&P 500 index on both an absolute and risk-adjusted basis for the most recent five-year and 10-year periods.** I am interested in future performance, and the funds with the highest returns in the past are not necessarily those that will perform best in the future. But I feel that better funds always outperform the market (S&P 500 index) in the long and intermediate run, and risk-adjusted return is an essential risk control.
- 4) **It must never have had a three-year period with negative returns.** This requirement seeks consistency. In addition, I feel an investment horizon of three years is the minimum for equity investing. This rule emphasizes the importance of never having to sell your portfolio holdings at a loss.
- 5) **Net assets must be less than \$5 billion for giant- and large-cap funds, \$2.5 billion for mid- and small-cap funds, and \$1 billion for micro- and nano-cap funds.** I believe it is too difficult to invest in areas that offer unusual opportunities with a cumbersome amount of assets.
- 6) **It must have an expense ratio of less than 1.25% if assets are less than \$2.5 billion and 1% or less if assets are over \$2.5 billion.** Many of the selected funds will be smaller in size, and I can therefore justify the 1.25% level, which is somewhat above the average for stock funds. However, I believe that a higher expense ratio not only will cost in the future (past expenses are reflected in past returns), but says something about management's attitude. However, there may be justifiable exceptions.
- 7) **It must currently be open to individuals, with a minimum investment of less than \$25,000 and available to residents of larger states.** However, I will follow openings and closings of otherwise qualified funds.
- 8) **If more funds qualify than are needed, new qualifiers are listed in terms of preference based on a number of quantitative and qualitative factors.** These may include: stability of risk, turnover ratio, manager tenure, and shareholder services, in addition to basic criteria.

How Many Funds Should You Hold?

- Equal dollar amounts are invested in each fund initially.
- If you buy mutual funds through a discount broker, having 10 funds is easy enough. If you want fewer funds, you can apply your own criteria to reduce the group.
- It is not necessary to have a portfolio of 10 funds. All of these funds are so effectively diversified that their average risk is reduced only slightly when combined with others in the portfolio.
- On the other hand, you do not want to winnow your selection down to just one fund. While these funds in the past have had similar diversification benefits, changes specific to each fund may alter its level of diversification—for instance, a fund may get a new manager who changes direction, or there may be a change in philosophy. For that reason, you should hold at least four different funds.
- Well-diversified mutual funds do not have to be changed very often, so the screen will only be performed twice a year.

Fund Availability: Keeping a Foot in the Door

The last point I would like to make about the Fund Portfolio also deals with the issue of possible fund closings and keeping your options open.

While we concentrate on funds with a 10-year track record, we will occasionally point out particular funds that have a shorter life but may be attractive due to special circumstances or because there is a high probability that they will eventually qualify. We will do this particularly in the case of micro- and nano-cap stocks because so many of them close before they reach their 10th birthday. As an extreme example, Wasatch Micro Cap Value (WAMVX) was open only three hours before closing. Bridgeway, one of the few managers with nano-cap funds (they call them ultra-small) long ago closed their nano-cap funds as well as their micro-cap fund.

Consequently, while not a recommendation in the usual sense, I have purchased a small number of shares of

Mutual Fund Cap Size and Style

We categorize mutual funds by both the size and style of their stock holdings. Size is measured by the average market capitalization (share price times the number of shares outstanding) of the stocks held by the fund, and style is based on the price-to-book value ratios (price per share divided by net assets per share) of the underlying stocks. Here is how we break down these categories:

Size

Category	Market Cap
Giant-Cap	\$10 billion and greater
Large-Cap	\$4 billion to \$9.9 billion
Mid-Cap	\$2.0 billion to \$3.9 billion
Small-Cap	\$450 million to \$1.9 billion
Micro-Cap	\$250 million to \$449 million
Nano-Cap	\$0 to \$249 million

Style

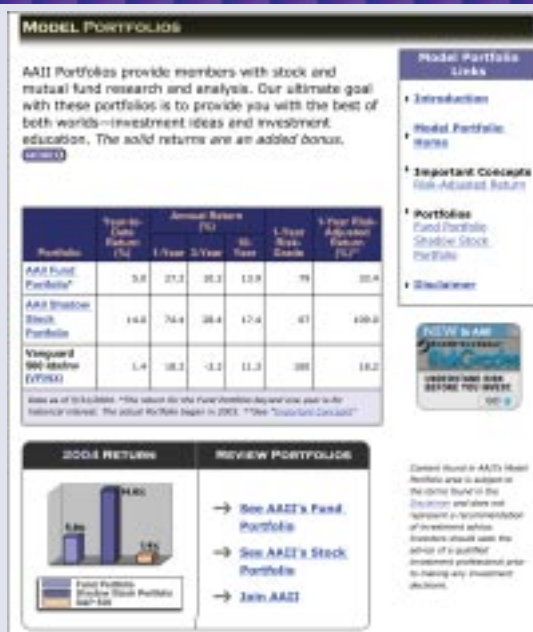
Category	Price-to-Book-Value Ratio
Very High Value	1.49 and below
High Value	1.50 to 2.99
Moderate Value (Blend)	3.00 to 3.99
Low Value (Growth)	4.00 to 4.74
Very Low Value (High Growth)	4.75 and above

Model Portfolios on AAI.com

To access the Individual Investor's Shadow Stock Portfolio and the Fund Portfolio, go to www.aai.com/modelportfolios. The Model Portfolios area includes:

- Current composition for each portfolio,
- Monthly performance results for each portfolio,
- Selection rules for each portfolio, and
- Explanations of important concepts.

Updates are posted after each month's end.



Buffalo Micro Cap (BUFOX) just to keep the option open to buy more later if they close to new investors. They just opened last month and have said they will close when they reach \$250 million. You can open an account for \$2,500, or \$250 in an IRA.

Buffalo has shown ability in the small stock area by running a very successful small-cap fund (BUFSX). It is not on our recommended list because it is only five years old.

I will review the Fund Portfolio here again next February. In the meantime, you can check monthly performance at the Model Portfolios area of AAI.com. ▲