



# **Guide to AAII Model Portfolios**

**A**  
solid source  
for investment  
ideas and education

**AAII**'s purpose is to provide investment education and information. Our ongoing goal is to prepare individual investors to effectively manage their investments and to provide the necessary education, data and support to help them in that effort.

Over the years, however, we became increasingly aware that many of our members wanted more specific help. In talks with members, we found that there is a need for an intermediate level of support—not a complete advisory letter, but some specific guidance for individuals in developing an effective investment program—a real-world example of how to take an investment approach and construct and monitor an actual portfolio. **AAII addresses this need by offering our members access to three model portfolios:**

- **AAII Model Mutual Fund Portfolio**
- **AAII Model Exchange-Traded Fund (ETF) Portfolio**
- **AAII Model Shadow Stock Portfolio**

This brief guide is offered as a starting point for those members interested in following the investment direction and education we offer through the AAI model portfolios. The performance of these real-world portfolios has been impressive, but please be advised that a bit of study and commitment is required of members seeking to follow our portfolios.

Beyond this guide, AAI offers a Web page at [www.aai.com/modelportfolios](http://www.aai.com/modelportfolios) for more timely information and additional guidance.

## Year-to-Year Performance

	10-Year Annual Return (%)	Annual Rate of Return (%)									
		2010	2009	2008	2007	2006	2005	2004	2003	2002	2001
Model Fund Portfolio	7.9*	20.3	24.9	-35.9	10.2	16.1	5.4	17.7	—	—	—
Model ETF Portfolio	—	21.9	40.0	-40.5	-6.6	—	—	—	—	—	—
Shadow Stock Portfolio	20.0	45.4	72.3	-50.8	-1.8	29.4	17.9	43.7	73.1	10.8	21.4
S&P 500 (VFIX)	1.3	14.9	26.5	-37.0	5.4	15.6	4.8	10.8	28.5	-22.1	-12.0

*Data as of 12/31/2010.*

*\* This is a simple average of the 10-year return figures for current funds held in the Model Fund Portfolio. The actual model portfolio began in June 2003.*

## AII Model Mutual Fund Portfolio

This portfolio serves to illustrate a unique approach to mutual fund selection for today's fund investor. The Model Mutual Fund Portfolio represents a diversified portfolio of funds that have outpaced the overall market on a total and risk-adjusted basis. Our emphasis is on modest fees, consistency, risk control, and selecting funds that utilize approaches that an individual investor, rather than an institution, should follow.

The recent lineup of funds is outlined below. The portfolio is easy to follow and, by design, the funds don't change much. For a deeper discussion of the selection criteria and an up-to-date list of holdings and fund performance, please visit the Model Mutual Fund Portfolio area on AII.com ([www.aaii.com/fundportfolio](http://www.aaii.com/fundportfolio)). Also, look for our ongoing commentary about the Model Mutual Fund Portfolio in the pages of the March, May, August and November issues of the *AII Journal*.

### To make it into the Model Mutual Fund Portfolio, a fund must meet the following criteria:

- It must be a pure no-load fund.
- It must have a long track record, preferably at least 10 years.
- 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- and 10-year periods (if available).
- It must not have had a three-year period with negative returns over the past 10 years.

*(portfolio criteria continued on next page)*

## AII Model Mutual Fund Portfolio

Fund (Ticker)	Style	Market-Cap Size	YTD Return (%)	Annual Return (%)			Fund Assets (\$ Mil)	Expense Ratio (%)	Standard Deviation (36-Mo. Ann'l) (%)	3-Year Risk-Adjusted Return (%)
				1-Year	5-Year	10-Year				
Aston/Optimum Mid Cap N (CHTTX)	Low Value	Mid-Cap	7.2	21.8	10.0	10.7	1,850.2	1.15	29.1	9.4
CGM Focus (CGMFX)	Very Low Value	Giant-Cap	-3.3	9.6	3.9	13.7	2,998.2	1.23	32.5	-18.1
CGM Realty (CGMRX)	Low Value	Mid-Cap	5.2	21.4	8.0	20.3	1,740.6	0.93	39.7	-1.7
FMI Common Stock (FMIMX)	Low Value	Mid-Cap	6.8	19.9	8.0	11.2	1,131.2	1.24	24.3	11.9
Madison Mosaic Mid-Cap (GTSGX)	Very Low Value	Large-Cap	9.3	26.6	4.5	7.6	159.1	1.26	21.9	5.4
Manning & Napier Pro-Blend Extnd Term S (MNBAX)	Very Low Value	Giant-Cap	3.9	13.6	5.3	6.7	773.4	1.08	15.8	5.1
Meridian Value (MVALX)	Very Low Value	Mid-Cap	3.1	15.0	3.3	7.4	921.1	1.09	21.6	3.2
Northern Small Cap Value (NOSGX)	High Value	Small-Cap	6.5	22.4	2.9	9.9	1,739.5	1.00	26.5	7.1
Royce PA Mutual Investment (PENNX)	Low Value	Small-Cap	9.1	26.8	4.8	11.2	5,250.8	0.92	26.6	7.9
RBC Microcap Value S (TMVSX)	High Value	Nano-Cap	5.8	20.2	0.4	9.0	144.8	1.07	28.0	4.2
Portfolio Average			5.2	18.8	3.5	nmf	1,670.9	1.10	24.2	2.9
Vanguard Tot Stock Mkt Idx (VTSMX)	Low Value	Giant-Cap	6.3	17.5	3.1	4.4	60,842.5	0.18	22.3	3.7

*Data as of 3/31/2011.*

- Net assets must be less than \$9 billion for giant- and large-cap funds, \$4 billion for mid- and small-cap funds, and \$1 billion for micro- and nano-cap funds.
- It must have an expense ratio of less than 1.25% if assets are less than \$3.5 billion and 1% or less if assets are over \$3.5 billion.
- It must currently be open to individuals, with a minimum investment of less than \$25,000 and available to residents of larger states.

## Managing Your Mutual Fund Portfolio

- AAI recommends that you purchase your funds directly from the fund family or through a discount broker and invest equal dollar amounts in each fund you select for inclusion in your portfolio.
- 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. But funds do stray from their past approaches and on occasion funds get new managers so, for those reasons, you should hold at least four different funds. If you want to winnow down our list you can use your own criteria or simply make sure that you select funds that have different “styles” or “market cap sizes” as outlined in the table on page 3.
- Because the AAI Model Mutual Fund Portfolio is composed of a list of well-diversified mutual funds, you need not be concerned with the overall list of funds changing very often. As always, current performance data and fund listings are available online at [www.aai.com/modelportfolios](http://www.aai.com/modelportfolios).

## Getting Started: AAI Model Fund Portfolio

AAI communicates information about our Model Fund Portfolio to our membership via both print and online methods. Our ongoing print coverage is provided through James Cloonan’s AAI Model Portfolios column in the *AAI Journal*. Performance information and commentary are always posted and kept up-to-date on the AAI website at [www.aai.com/fundportfolio](http://www.aai.com/fundportfolio).

We encourage members to study this guide, read the *Journal* articles and, if you have Internet access, to visit the Model Mutual Fund Portfolio area of [AAI.com](http://AAI.com) prior to investing any funds.

### Receive Ongoing AAI Model Fund Portfolio Coverage

Online at:  
[www.aai.com/fundportfolio](http://www.aai.com/fundportfolio)

- Model Fund Portfolio holdings
- Monthly performance results
- Model Fund Portfolio selection rules
- Fund size & style definitions
- Archive of commentaries

AAI Journal  
Model Portfolios Columns

- March—Model Fund and ETF Portfolios
- May—Model Fund and ETF Portfolios
- August—Model Fund and ETF Portfolios
- November—Model Fund and ETF Portfolios

*Note: Back issues of the AAI Journal can be found online at: [www.aai.com/journal](http://www.aai.com/journal).*

## AII Model ETF Portfolio

This portfolio is comprised solely of exchange-traded funds (ETFs) and was developed based on concepts similar to those of the AII Model Fund Portfolio—it focuses on low-cost exchange-traded funds selected to work together in a diversified portfolio. In trying to sort out an overall balanced portfolio of ETFs, AII tackled two separate and important issues:

- First, what asset classes belong in an effective portfolio, and
- Second, which of the many exchange-traded funds purporting to represent that class will actually do the best job of mirroring that class in terms of return and risk.

The rationale used in building the Model ETF Portfolio is to achieve diversification across the asset classes listed below while maintaining a weighting that, in our assessment of historical data, will provide the maximum opportunity for long-term rates of return. For more on the rationale behind the ETFs we selected for this portfolio, please visit [www.aai.com/etfportfolio](http://www.aai.com/etfportfolio).

**The Model ETF Portfolio consists of the following domestic and foreign stock asset classes:**

- Large-capitalization stocks
- Mid-capitalization stocks
- Small-capitalization stocks
- Micro-capitalization stocks
- REITs
- Master limited partnerships

## AII Model ETF Portfolio

ETF (Ticker)	Weight in Portfolio (%)	YTD Return (%)	Annual Return (%)		
			1-Year	3-Year	Since 4/1/2006
PowerShares FTSE RAFI US 1000 (PRF)	13.33	19.5	19.5	0.4	3.4
Rydex S&P MidCap 400 Pure Value (RFV)	13.33	22.5	22.5	3.5	3.9
Rydex S&P SmallCap 600 Pure Value (RZV)	13.33	28.1	28.1	7.2	1.3
First Trust DJ Select MicroCap Index (FDM)	13.33	25.7	25.7	0.4	-0.1
iShares Cohen & Steers Realty Majors (ICF)	13.33	29.2	29.2	-1.5	-1.3
ALPS Alerian MLP ETF (AMLP)	13.33	-	-	-	-
Vanguard FTSE All-World Ex-U.S. (VEU)	5.00	11.9	11.9	-4.6	-
SPDR S&P International Small Cap (GWX)	5.00	24.5	24.5	-1.3	-
Vanguard Emerging Markets (VWO)	5.00	18.9	18.9	-0.4	10.4
SPDR Dow Jones Int'l Real Estate (RWX)	5.00	21.1	21.1	-6.4	-
<b>Portfolio Return*</b>		<b>21.9</b>	<b>21.9</b>	<b>0.5</b>	<b>1.2</b>
<b>Benchmarks:</b>					
iShares D.J. U.S. Index (IYY)		<b>16.4</b>	<b>16.4</b>	<b>-2.1</b>	<b>1.9</b>
iShares MSCI EAFE Index (EFA)		<b>7.6</b>	<b>7.6</b>	<b>-7.0</b>	<b>0.6</b>
<b>ETF Benchmark (80% IYY/20% EFA)</b>		<b>14.7</b>	<b>14.7</b>	<b>-3.0</b>	<b>1.7</b>

\*Performance of actual portfolio including reinvested dividends. Other figures are weighted averages.

Data as of 12/31/2010.

## Managing Your ETF Portfolio

The current recommended initial weighting is to give each domestic holding an equal weight (for a total of 80% in domestic ETFs) and each foreign issue an equal weight (for a total of 20% in foreign stock ETFs). If you choose not to hold a particular ETF, maintain the equal weightings in each of the domestic and foreign areas, and keep the balance of 80% domestic stock ETFs and 20% foreign stock ETFs.

The ETFs selected are part of a total portfolio, thus you need not be concerned with the overall list of funds changing very often. As always, current performance data and ETF listings are available online at [www.aaii.com/etfportfolio](http://www.aaii.com/etfportfolio).

## Getting Started: AAI Model ETF Portfolio

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We encourage members to study this guide, read the *Journal* articles and visit the Model ETF Portfolio area of AAII.com prior to investing any funds.

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## AII Model Shadow Stock Portfolio

The Model Shadow Stock Portfolio provides guidance for investing in the promising micro-cap value sector of the market. The portfolio was initially conceived to show the membership of AII how to capitalize on the most promising academic research to manage a stock portfolio without having to commit a great deal of time and effort to day-to-day monitoring. *In fact, AII manages this real-money stock portfolio (it is not a hypothetical portfolio) by simply reviewing holdings on a quarterly basis.*

The Model Shadow Stock Portfolio reflects the following beliefs:

- The best stocks for individual investors are not the same stocks that are best for institutions.
- Over the long run, research indicates that value stocks outpace the market, as do small (and micro-cap) stocks.
- Excessive trading of small-cap stocks hurts your bottom line; you can achieve solid returns by simply adjusting your portfolio quarterly.
- Ultimately, the best returns come from giving major consideration to risk. Success comes more from concern for the overall portfolio than for individual stocks.

Over the last 10 years, AII's Model Shadow Stock Portfolio has returned an average of 20.0% each year versus 1.3% for the S&P 500.

## AII Model Shadow Stock Portfolio

Company (Ticker)	Current Price (\$)	52-Week		Market Cap (\$ Mil)	Price-Earnings Ratio (X)	Price-to-Book Ratio (X)	Dividend Yield (%)	Industry
		High (\$)	Low (\$)					
AeroCentury Corp. (ACY)	18.55	25.00	13.00	28.6	6.4	0.66	0.0	0939 - Rental & Leasing
Alamo Group, Inc. (ALG)	27.02	28.24	16.97	319.1	12.7	1.28	0.9	0206 - Constr'n & Agric'l Mach
Audiovox Corp. (VOXX)	8.04	9.74	6.17	184.4	8.7	0.50	0.0	1003 - Communications Equip
Books-A-Million, Inc. (BAMM)	5.70	8.43	5.27	88.5	6.3	0.80	3.5	0963 - Retail (Spec Non-Apparel)
Capital Senior Living Corp. (CSU)	7.08	7.35	4.21	191.7	54.5	1.16	0.0	0806 - Healthcare Facilities
CONN'S, Inc. (CONN)	4.48	9.13	2.94	142.3	13.2	0.33	0.0	0966 - Retail (Technology)
CSS Industries, Inc. (CSS)	19.58	21.92	14.87	190.0	nmf	0.81	3.1	0927 - Printing & Publishing
Ennis, Inc. (EBF)	16.79	19.62	13.72	435.2	9	1.29	3.7	0518 - Office Supplies
Flexsteel Industries (XSI)	17.9	18.75	13.1	111	11	1.00	1.7	021 - Furniture & Fixtures
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**Go online for the most current list of companies, or see the January, April, July or October issues of the AII Journal.**

## A True Do-It-Yourself Model

To pick the right stocks for AAI's Model Shadow Stock Portfolio, we focus primarily on portfolio formation and risk reduction. The stocks in the AAI Model Shadow Stock Portfolio are largely risky stocks when evaluated separately. But when taken together as a portfolio, most of that individual stock risk has been diversified away. In fact, the average risk of the individual stocks has been reduced by about 70%. The central point of our Model Shadow Stock Portfolio is that the risk of any individual stock is not important if your portfolio is well diversified. What is important is how the addition of that stock affects the risk of your overall portfolio. If you are not following our full portfolio but instead use our list of stocks as a tool to generate investment ideas, we suggest that you adhere to our overall strategy by selecting and monitoring a portfolio that consists of at least 10 stocks. Choosing stocks in different sectors will provide added diversification and protect your portfolio from some sector volatility. Furthermore, be sure to consider fees when making your investments. While there is no recommended minimum, investments should be large enough so that fees are insignificant.

While the Model Shadow Stock Portfolio minimizes risk, it is still prudent to take into account your personal risk tolerance. Investors are worried about the amount they invest in a micro-cap strategy and rightly so. Even a properly diversified micro-cap portfolio will be more volatile than the total market because these stocks are inherently more risky. The worst time to sell a stock is at the bottom, so be sure not to put so much weight into your micro-cap portfolio that you cannot stomach the losses.

## Two Ways to Build Your Own Shadow Stock Portfolio

Follow the printed guidance provided here and issued in the AAI Model Portfolios columns in the January, April, July and October *AAI Journals*—remember, this portfolio was designed to require only simple modifications on a quarterly basis when company fundamentals change.

~ OR ~

Utilize the online resources we offer at [www.aai.com/stockportfolio](http://www.aai.com/stockportfolio) where we provide monthly updates on the “Passing Companies” that meet our criteria for inclusion in the Shadow Stock Portfolio. On the next page, you will find a sample list of Passing Companies—we run this screen monthly, so please seek out our online information for the most current list of stocks.

## Ongoing Management of Your Stock Portfolio

AAI's Model Shadow Stock Portfolio is not intended to be an advisory service in the usual sense of that term—it is not intended to be a list of individual stock recommendations. Instead, the model portfolio serves to show you *how to use a value-oriented approach to select micro-cap stocks in an effort to build your own Shadow Stock Portfolio*. Profitable micro-cap investing requires extra care. The portfolio construction and monitoring rules were developed over the years to minimize real-world costs and maximize profits.

In the pages of the *AAI Journal*, we provide quarterly commentary on AAI's Model Shadow Stock Portfolio (ours has been running for over 18 years) and provide suggestions on how you can vary our approach to build a portfolio suitable for your own specific needs. At our website ([www.aai.com/stockportfolio](http://www.aai.com/stockportfolio)), we present the detailed rules for building and managing a Shadow Stock Portfolio as well as a monthly list of stocks that meet the criteria for inclusion.

Ongoing performance of AAI's Model Shadow Stock Portfolio is tracked online, but keep in mind that a portfolio can be built by simply following the investment moves outlined in the AAI Model Shadow Stock Portfolio columns found quarterly in the *AAI Journal*.

## Stock Portfolio Management Criteria

It is our belief that a quarterly review of the following purchase, sale and management criteria is all that is needed to build your own Shadow Stock Portfolio. Simply review your holdings on a quarterly basis to see if any fundamental changes make them candidates for sale (see sell rules below). If you have new investment funds available or cash from sales, you can look at AAI's online list of Passing Companies ([www.aaii.com/stockportfolio](http://www.aaii.com/stockportfolio)) to see if any companies meet your needs for inclusion in your Shadow Stock Portfolio.

### Stock purchases must meet these criteria:

- Price-to-book-value ratio must be less than 0.80.\*
- Market capitalization must be between \$17 million and \$200 million.\*
- Price-to-sales ratio must be less than 1.2.\*
- The firm's last quarter and last 12 months' earnings from continuing operations must be positive.
- The share price must be greater than \$4.
- No bulletin board or pink sheet stocks will be purchased.
- No financial stocks or limited partnerships will be purchased.
- No foreign stocks will be purchased because of different accounting and/or withholding tax on dividends.
- Any stock that was sold within two years will not be rebought.
- Note second item under stock order guidance (below) concerning spreads when buying shares.

*\*These figures will change gradually as market values change. Any changes will be noted in the Journal and online.*

### Stocks are sold if any of the following occur:

- The stock reports a string of negative earnings:
  - If last 12 months' earnings from continuing operations are negative, the stock is put on probation; if a subsequent quarter has negative earnings prior to 12-month earnings from continuing operations becoming positive, the stock is sold.
- The stock's price increases so that it is no longer considered a small/micro-cap value stock:
  - The stock's price-to-book-value ratio goes above three times the initial criterion.
  - Market capitalization goes above three times the initial maximum criterion.

In summary, we sell when the market recognizes the value of one of our holdings, thus driving up the price so that it no longer remains in the "shadows" of Wall Street.

### Stock order guidance:

- These rules are for general guidance. Your own experience, market conditions and size of position will impact decisions.
- Market orders are not used. Instead, if the quoted bid/ask spread is less than 2% (ask price minus bid price, divided by ask price), place a limit order at the ask price for a buy and at the bid price for a sell. If the bid/ask spread is more than 2%, try to place a limit order between the bid and ask prices to keep transaction costs low. If necessary, build a position gradually. With low commissions, it is often better to place partial orders than to try to establish a large position all at once. Be patient.
- Be careful if the dollar value of the average daily number of shares traded is not four times the amount needed for your position. It may be too difficult to get in and out of the position, but you may be able to grow the position gradually and sell gradually.
- For NASDAQ stocks, it appears to be better to use day orders. If the order is not filled, it is placed again with a slight adjustment. For NYSE and Amex stocks, good-till-canceled (GTC) orders are used to keep a place in line in the specialists' books. If the market isn't close to the desired price,

the price is adjusted in a few days with a new GTC order.

- If price changes cause a stock to become ineligible (due to changes in the price-to-book-value ratio or market capitalization) when only part of the order has been filled, shares already purchased are kept but the balance of the order is canceled.

**Management rules:**

- Equal dollar amounts are invested in each stock initially.
- Decisions are made only at the end of each quarter. In order to react to the majority of earnings reports as soon as possible, quarterly reviews are made early in February, May, August, and November.
- Best judgment is used for tenders or mergers, but all criteria must be obeyed.
- At the end of a quarter, if receipts from stocks sold exceed requirements for new purchases, the excess receipts—up to 5% of the portfolio’s value—are kept in cash until the next quarter. If the excess receipts are greater than 5% of the total portfolio value, the amount above 5% is distributed to smaller holdings that still qualify as buys. Efficient quantities are purchased: If over 10% of the portfolio is in cash, the price-to-book-value ratio can be moved up, but never over 0.90.
- At the end of a quarter, if receipts from stock sales are insufficient to buy all newly qualifying stocks, purchases are made in order of lowest bid/ask spreads.
- Note that if you are managing your own portfolio, it should consist of at least 10 stocks. If you are developing the portfolio gradually you can do it stock by stock, but don’t put more than 10% of your funds in each additional stock. More than 20 stocks are not needed until the portfolio exceeds \$1 million.

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