

Sound Mind Investing

AMERICA'S PREMIER CHRISTIAN FINANCIAL NEWSLETTER

Performance Momentum and SMI's Fund Upgrading Strategy

While SMI's Just-the-Basics strategy relies heavily on index funds, Fund Upgrading involves investing the stock portion of your portfolio in actively managed mutual funds. For a "how-to" overview of Upgrading, see your "New Reader Guide."

Then, read here for an explanation of the philosophical underpinnings of Upgrading and the "momentum" indicator that serves as our primary guide for fund selection and making buy/sell decisions.

by Austin Pryor and Mark Biller

At the start of the 1980s, the reigning media investment superstar was Joe Granville. When he told his followers to sell everything, many of them stampeded to the exit door causing the Dow Jones Industrial Average to fall more than 3% on the heaviest volume of trading in the history of the New York Stock Exchange up to that time. But Granville failed to predict the start of the great 1980s bull market. As the rally began, he advised his followers to "go short" (selling shares with the expectation of buying them back later at lower prices) in hopes of profiting when the market collapsed. After missing the major market advance of the early 80s, he finally turned bullish—just in time for the crash of 1987.

After Granville, Robert Prechter captured center stage with forecasts based on a rather mysterious theory of market movements and mass psychology called the Elliott Wave. In the early 1980s, he was the first to call for a Dow move to the then incredible heights of 2700+, a forecast that was widely derided as absurdly optimistic. He expected the 90s to be disastrous for the stock market and advised, "The 1990s will be the decade of cash. Stay in U.S. treasury bills." When the 90s boomed, Prechter lost the influence he once commanded.

We could also add Elaine Garzarelli (who gained prominence when she advised getting out of the market shortly before the '87 crash and then faded from public view when she couldn't sustain a guru-level of omniscience), Mary Meeker (queen of the Internet analysts who could cause dot.com stocks to skyrocket with a mere favorable mention, but then let her followers lose 80%-90% of their capital by silently standing by as the mania collapsed), and the Gardner brothers of Motley Fool fame (who eventually threw in the towel on their "Foolish Four" strategy when it misfired for several years). One respected Wall Streeter says: "Investors are always looking for a messiah. The system will always produce a new superstar, and inevitably, the star will fall flat on his or her face."

Market gurus come and go because it's impossible to predict future market movements with consistent accuracy.

That's also one of the reasons that a majority of actively managed stock mutual funds (those funds with a manager who tries to figure out which stocks will perform best) nevertheless underperform the general market averages. Another reason the average actively managed fund trails the overall market is cost, a point often touted by indexing advocates. To understand why this is true, recognize that the returns of all investors combine to make up "the market." Furthermore, the returns of all mutual funds taken together will, by default, be very close to this overall market average. Thus, after subtracting operating expenses of 1%-2% per year plus commission costs, it's easy to see why most funds trail the market. Only rare managers are able to add enough value through their management to overcome these costs. This is why if you buy and hold one particular fund for several years, you are unlikely to keep up with the market indexes.

Does this mean that there is no reason to invest in actively managed mutual funds? At first glance, that would seem to be the case. Many investors, in fact, simply concede that the cost hurdle is too difficult, and invest primarily in market-tracking index funds. (This is the approach used in our Just-the-Basics strategy.) Indexers know that the results in their portfolio will be similar to the market as a whole. More often than not, index investing does better than the "average" fund.

WHAT "UPGRADING" IS

Fund Upgrading provides an option for investors seeking to do better than settling for the market's average return. But in exchange for that potential upside, you must *continually* stand ready to adjust your holdings so as to own only those funds that are demonstrating the best results *at any given time*. Upgrading is a fine-tuning process, whereby you initially invest in the top performers of recent months and then sell them when they surrender their place of leadership.

Fund Upgrading is necessary because, as economic conditions and expectations change, market leadership rotates



among large-, medium-, and small-sized companies. Furthermore, as this rotation takes place, it naturally favors some strategies over others. At times, a cautious value strategy is best; other times aggressive growth investors are rewarded. But although market conditions are constantly changing, fund managers rarely do. What we mean is that managers who are trained to invest in large growth companies (for example), can't change their philosophical stripes overnight and turn into small-cap value managers just because that sector is strong at the moment. For the most part, they just keep doing what they believe in—invest in the shares of large growth companies.

That's why performance leadership among mutual funds is constantly rotating, and why numerous academic studies have shown that very few funds can consistently perform in the top ranks year after year. By implication, then, these studies indicate that there is very little predictive value in using *long-term* past performance as a forecaster of performance over the coming 6-12 months.

One solution, then, is *not* to try selecting a super-great fund and hold on to it for many years. Investing in a particular fund and staying with it for the long haul is unlikely to result in outstanding performance over the entire period. Strategies that point you toward "all-weather" performers that you can supposedly buy and forget about—such as *Forbes* Honor Roll, *Consumer Reports* recommended funds, or Morningstar's well-known "star system"—do not result in superior performance.

THE ORIGINS OF "UPGRADING"

Some years ago, Burton Berry, founder of a helpful mutual fund ranking newsletter called *No Load Fund X*, conducted an interesting study of mutual fund performance. He identified the 25 funds that had the best track records over a particular five-year period and posed this question: how many of these funds will be in the top performing group again the following year? *The surprising answer was only two. He tried it again for a different*

five-year period, and the answer was none. Altogether, he checked out 17 different five-year periods and found that, on average, only two of the top 25 performers of the past five years made the list again the following year.

These facts offer evidence that selecting funds on the basis of a recent five-year track record is not likely to identify the best funds for the coming year. But there's more. Several studies have shown there is value in concentrating on a fund's more recent (i.e., shorter-term) track record as a predictor of future success. It seems prudent, therefore, to initially invest in a top-performing fund that has done an excellent job of late. When the fund falters (as it inevitably will), we must stand ready to exchange it for one of the new leaders. In his newsletter, Berry proposed a way to measure fund performance that would pinpoint how and when to make the necessary changes.

He devised a strategy which he called "upgrading." His basic assumptions, which our years of experience bear out, were that (1) performance results that are more than one year old are not very meaningful, and (2) more recent months should be weighted more heavily than distant months. These assumptions led Berry to develop a methodology for evaluating mutual fund performance based on each fund's most recent 1-month, 3-month, 6-month, and 12-month performance. His approach also involved awarding extra rating points for funds that place in the top of their peer group for each of the time frames being measured.

Building on Berry's two assumptions, SMI developed a similar formulaic approach (which we call "performance momentum") that we use to rank the performance of mutual funds. These momentum-based rankings are available to SMI readers in our *Fund Performance Rankings* (FPR), and form the basis for our fund selection within the Fund Upgrading strategy.

HOW PERFORMANCE MOMENTUM IS CALCULATED

When assessing an investment's track record, the first question to be

answered is "Which period of time are we evaluating?" Last month? Last year? The last full market cycle? *The answer to this question has more influence on the outcome of a fund's ranking than any other single factor.*

Most financial magazines use quite lengthy time frames when measuring performance and compiling their ratings. *Forbes*, *Bloomberg Businessweek*, and *Consumer Reports* all use periods of at least five years. This is much longer than is either necessary or beneficial. SMI typically looks only at the past 12 months, giving greater weight to the more recent months.

Look at it this way. As the baseball season hits the midway mark, who do you think is more likely to win the league pennant—the team that has done the best over the past five years, the team that won last year, or the team that has been the most dominant this year and is currently leading the league? In sports, the teams that have been strongest of late are the more likely winners in the coming months. The same is true in the world of mutual funds, and the momentum calculation is one good way to identify the contenders for the performance title.

SMI's momentum score itself is easy to calculate—simply add up a fund's most recent 3-month, 6-month, and 12-month performance. Notice that the most recent three month's performance is reflected in all three of these statistics. The past three-months represent 100% of the first number, 50% of the second number, and 25% of the final number. In this way, a fund's more-recent performance is given greater weight. Stated another way, momentum counts each fund's most recent three-month performance three *times more* than it does the 12th month back. This formula takes into account both assumptions mentioned earlier: that results older than 12 months aren't very relevant, and that more recent months should be weighted more heavily than distant months.

Our approach to this calculation is slightly different from Mr. Berry's, however. The major differences: (1) we omit the 1-month performance results



and the star system for awarding extra rating points, and (2) we assign funds to risk categories using the SMI risk ladder, which is based on the nature of a fund's portfolio holdings. We made these changes to get a clearer picture of how each fund compares against its peers within the same risk category, as well as to tone down the higher turnover that results from weighting the most recent month's performance so heavily in the calculation. We make no claim that our approach is superior to Burton Berry's, and remain indebted to him for introducing us to the "upgrading" concept.

Applying the momentum rankings *within* each SMI risk category, and thereby rating a fund only against other funds of the same type, is an important part of the process. Doing so assures that we stay reasonably diversified, and don't end up owning a portfolio of funds all invested in similar types of stocks. As important as it is to make good fund selections, there are two decisions that are even more important: the asset allocation decision—i.e., what percentage of your investments are in stocks and what percentage in bonds—and the decision of how much to invest in each stock and bond risk category. Our *New Reader Guide* explains how to make these critical decisions for yourself in light of your personal risk tolerance and season of life.

OVERVIEW OF THE PROCESS

Here, then, is an abbreviated run-down of how the Fund Upgrading strategy leads to the funds recommended in SMI's model portfolios:

(1) Using a database of mutual fund performance to which we subscribe, we place each of the funds we follow (well over 1,500) in its proper risk category. Then we rank each fund according to its most recent performance momentum.

(2) The first time through, we begin by looking at the top 5-10 funds in each risk category. We rule out funds with characteristics that might make them unsuitable for our purposes, such as those that charge loads, are closed to new investors, are not available through the brokerage firms we recom-

mend, and those with a higher relative risk than seems appropriate for that particular risk category. (These criteria are appropriate when choosing recommendations for thousands of SMI readers, most of whom do not wish to trade a lot; it doesn't mean the funds eliminated in this way won't prove to be good performers in the coming months.) We settle on four finalists which make our recommended list.

(3) As long as a current recommendation continues to have a momentum score that ranks in the top one-fourth or so of its peer group, we continue to recommend it. Any fund that has fallen out of the top quartile is *usually* sold. Funds that have fallen below the median are *always* sold.

(4) When we need a replacement, we begin the process again. ♦

STARTING AN UPGRADING PORTFOLIO

First, of course, you need to control your risk by picking a mix of stocks and bonds that is appropriate for your individual situation. For help with this, see SMI's *New Reader Guide*.

Once you know what percentage of your money you intend to invest in stocks, you can proceed to implement Upgrading, although the implementation may differ slightly if you are in a retirement plan at work that offers limited choices. In this section, we'll discuss how to implement Upgrading in an account that has no restrictions on which mutual funds you can purchase. In the next section, we'll cover how to use Upgrading in a company retirement plan, such as a 401(k) or a 403(b).

If your account is a taxable account, or a self-directed account like an IRA, one of the first decisions you have is which discount broker is best for you. While most discount brokers that offer a broad range of mutual funds will probably work for an Upgrading account, SMI currently recommends Schwab, Fidelity, or Scottrade for most new readers. The reason is that, at present, they offer the best combination of fund selection, low costs, and short no-transaction-fee holding periods.

FREQUENTLY-ASKED QUESTIONS

For a quick overview of how to set up your Upgrading portfolio, we encourage you to read the "Easy as 1-2-3" page in any issue of the SMI newsletter. The following questions do not repeat that basic information, but rather focus on a few common questions asked by readers as they start Upgrading.

Q: Which is the best broker to use for an Upgrading strategy?

A: As of late 2011, there are several good options available. Scottrade is a good option for small accounts and for those whose top priority is minimizing fees. SMI also recommends Schwab and Fidelity. All of these brokers offer a broad range of mutual funds, with many of them available on an NTF (no transaction fee) basis. Scottrade and Schwab only require NTF funds to be held 90 days to avoid NTF early-exit penalties, whereas that limit is 180 days at Fidelity. Your specific investing approach will largely dictate which broker is the best option for you, as there are a broad range of costs/features available.

Q: How many funds do I need to hold in each category?

A: You only need to own one fund in each of the five stock risk categories. However, your returns will more closely follow those published for our model portfolios when more (or all) funds are held in each category you invest in. There's a balance to be reached here. First, the size of your account may dictate that you own only one or two funds in each category. If so, that's fine—Upgrading still works with just one fund in each category. If your account size allows you to purchase all four recommended funds in each category, and in doing so you don't find the monthly updates to be too time-consuming (because they will involve more fund upgrades), we would encourage you to own them all. The basic rule is to own as many as you can afford *and* still manage efficiently.

Q: How do I know which of the four funds to purchase in each risk category?

A: On the "Recommended Funds" page, you'll see that the funds are ranked 1-4 in each category. *The simplest way to choose is to select the*



highest rated fund that is available at your broker. If the top-ranked fund isn't available or is closed to new investors, buy the next highest-ranked fund that is available to you at your broker.

Q: How do I know which fund is the most likely to be replaced soon?

A: The 1-4 rankings change from month to month depending on the latest performance. That means the funds routinely move up and down in the rankings. Having said that, when a fund is replaced in a risk category, more often than not it's the #4 rated fund from the previous month that is replaced.

You can also look at the momentum scores for each of the four funds for clues. If they are all very close, the 1-4 rankings may not be as significant as if there are one or two funds with very high momentum scores, with a large gap between them and the other recommended funds in that category.

Q: How long is each fund held?

A: A fund is held until it falls out of the top 25% of its risk category. On average, recommended funds are held about nine months. Some are held less than that, some much longer. If a fund drops quickly in our rankings, it will be sold as quickly as is warranted. As a result, funds are often sold before they reach the 12-month holding period required for preferential tax treatment, though not frequently within the six month "NTF early sale penalty" limit some brokerages impose. Even that happens occasionally though, and is simply an occasional cost of this particular investing strategy. As you can see though, by holding each fund an average of nine months, Upgrading is definitely not a frequent trading strategy.

Q: Does it cost a lot to switch funds?

A: No, it doesn't. In fact, with an account at one of the better fund supermarkets (such as Scottrade, Schwab, or Fidelity), Upgrading is a fairly low-cost way to invest. Certainly it's not as cheap as some strategies, like indexing. But because so many of SMI's recommended funds are offered on an NTF (no transaction fee) basis, most of our fund switches cost you nothing. Upgraders pay normal trading commissions on the funds labeled "Yes" on

SMI's "Recommended Funds" page, and pay early-exit penalties occasionally when they sell an NTF fund they've held less than 3-6 months (varies by brokerage). But because our average holding period is roughly nine months, these penalties are not too frequent.

Q: Why are closed funds sometimes included on the "Recommended Funds" page? It would seem better to drop the fund when it closes, so there are always four open funds in each category.

A: We never recommend a fund that is *already* closed. However, sometimes funds close *after* they've been placed on our recommended list. When that happens, we already have potentially thousands of readers owning that fund as part of our Fund Upgrading strategy. To drop it from our recommended funds page at that point would do those readers a disservice. Removing closed funds from the list would cause more confusion and frustration than it would alleviate.

It is true, though, that a closed fund is of no use to someone looking for new funds. That's why there is *always* at least one open fund in every category. Multiple funds are offered in each category because some funds close to new investors, others are only available through certain brokers, and some Upgraders like to hold multiple funds in each category. ♦

UPGRADING IN A 401(K) OR OTHER RETIREMENT ACCOUNT

If you participate in a 401(k) or 403(b) plan at work, you will want to select your investments in a way that complements your overall investing strategy. The number and quality of the fund choices available to you through your plan will determine how best to approach this.

Things are simpler if you are blessed to have an above average number of funds available in your retirement plan. The ideal is to have what's referred to as a "brokerage window" in your plan. This allows you to select from most or all of the funds available at a leading fund

supermarket. That means you could use our "Recommended Funds" list without much modification.

But even if your plan doesn't have a brokerage window option, you can still effectively apply an Upgrading approach with as few as a dozen or so funds in your plan. Doing so requires us to use a "fallback strategy." Before getting to the explanation, however, we want to point out that this approach is not ideal. There's a trade-off involved. You're going to give up the relative stability you enjoy when you diversify across all five of the major stock-risk categories as we recommend. What you gain is the freedom to select the best performing funds available, regardless of risk category.

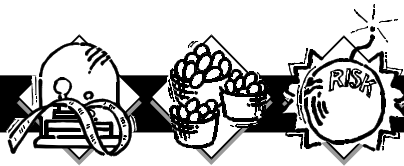
Depending on which funds are offered in your particular 401(k), you could conceivably end up having all your money invested in just one or two of the risk categories (in small-cap growth funds, for example, or large-company value funds, or perhaps foreign funds).

Concentrating your investments in just one or two kinds of categories in this way raises your risk. *This means it's very important to check your fund holdings each month and follow the selling rules faithfully.* If you're heavily invested in an asset class that begins to fall significantly, the system will automatically move you to funds that are doing better. But "user error" on your part can undermine even theoretically sound systems. Your selling discipline is your life preserver. Use it!

Here are the steps for implementing Upgrading in your 401(k) using SMI's *Fund Performance Rankings*:

1. Using the material from your 401(k) statement or HR department, create a list of all the stock funds available to you in your 401(k) plan. Don't include money market, bond, or hybrid funds (combination of both stocks and bonds) because Upgrading is designed to help you only with the stock allocation portion of your portfolio.

2. Look up each stock fund in the FPR and record its momentum score. The directory at the back will be helpful in locating the funds.



3. Rank the funds according to their momentum scores.

4. You will initially want to buy the top three, four, or five funds, depending on the number of stock funds you have to choose from (see table below).

5. In order to build your new portfolio, you first need to dismantle your old one. So, go online, access your 401(k) account, and enter instructions to sell all your current stock-oriented holdings. Then, purchase the top-ranked stock funds you selected in Step 4 above. Invest your stock allocation money equally among the funds you've chosen.

Number of Stock Funds to Choose From	How Many You Should Own At Any One Time	Rank That Must Be Maintained To Continue
8 to 14	3	Top 5
15 to 19	3	Top 6
20 to 24	4	Top 8
25 to 29	4	Top 10
30 to 50	4	Top 12
Over 50	5	Top 25%

6. Repeat the ranking process each time you get a new quarterly FPR. You should hold each fund as long as it ranks among the leaders. The cutoff point that defines the leadership is fluid (see third column in the table); it varies depending on the number of stock funds available to you. For example, if you have 8-14 stock funds in your 401(k), you would initially buy three funds and hold each one as long as it maintained its leadership position, that is, ranked among the top five.

7. When any fund drops out of the leadership, sell it and invest the proceeds in the highest ranking fund you don't already own.

We devised the table with the idea of eventually using the top 25% cutoff (as we do in regular Upgrading) as the number of available funds in a 401(k) grew. The numbers you see in the table felt "right" as we considered how the strategy would play out in real time, but admittedly are arbitrary. You can adjust them if it seems appropriate to you to do so. The goal is to set a high standard, but not so high that you make it difficult for the fund to maintain it (in which case you would continually be selling funds when they

falter only slightly).

Our readers participate in thousands of 401(k) plans, most of which have different lists of funds from which to choose. So, it's impossible to generalize with confidence concerning the degree of success you might expect when applying this approach to your particular plan. Still, the backtesting results we've obtained are encouraging, and signify to us that, if you have at least a few strong performers among your list of options, you have a very good chance of getting market-beating results.

GOOD NEWS! THIS PROCESS IS AUTOMATED FOR SMI WEB MEMBERS

If you're planning to employ this strategy, you should consider using the 401(k) Fund Tracker available to SMI web members.¹ You create a list in the Tracker by entering all the stock funds available to you in your 401(k). Then each month you can check those funds' updated momentum scores and ranking by simply clicking a button that generates your plan's monthly momentum-score report. *This will save you significant time and inconvenience when compared with manually looking up each of your funds in the quarterly Fund Performance Rankings printed in the SMI newsletter or the monthly FPR available via our website.*

By the way, checking momentum scores monthly rather than quarterly can be significant. In our testing, updating monthly rather than quarterly improved the average annual returns by about 1% per year.

SUMMARY

Your goal should be to assemble a portfolio of funds that achieves the balance between stocks and bonds that you have decided is appropriate for your situation. Bear in mind that the ratio you select, say 80% stocks and 20% bonds, should apply to your investments taken as a whole, not just the funds in your 401(k) plan. ♦

MAKING THE DECISION TO SELL A FUND

The simplest way to follow the Upgrading strategy is to always sell the

old fund *right away* when it is replaced in a new issue of the newsletter (or when it falls below your cutoff point if you are charting your own Upgrading path within a retirement plan). *This is the preferred approach.*

However, there are times when readers might wish to wait for a short while: (1) when your sale will result in a short-term redemption fee, or (2) when holding a bit longer will qualify you for a more attractive long-term capital gain tax rate.

Redemption fees as we discuss here really come in two types, and it's good to be aware of both. First, some mutual fund companies levy a specific redemption fee if their fund is sold within a certain time frame. The amount of the fee varies, but is typically 1%-2%. The time frame also varies, ranging anywhere from several days to two years. This type of fee is company-specific, and only applies to certain funds. We note these fees in the "Redemption Fee" column on the "Recommended Funds" page; however, these fees can be added at any time, and it's possible our data provider may occasionally not have the most current information. *So it's always a good idea to check on your own if a redemption fee applies before buying a new fund.*

The second type of redemption fee isn't technically a redemption fee, it's a short-term trading fee. This is a fee imposed by your brokerage that applies to all funds, and is imposed any time you purchase a no-transaction-fee (NTF) fund and then sell it before a certain length of time has passed. Each brokerage sets their own amount and time limit for these fees. These short-term redemption fees are one reason to prefer Scottrade and Schwab, as they require just a 90-day holding period to avoid these fees. SMI almost never sells a fund that quickly, which virtually eliminates this issue there. Many other fine brokerages, such as Fidelity, require an NTF fund to be held six months to avoid these fees, and charge \$75 or more per infraction. Quite a difference.

The second exception to immediately selling a fund usually occurs when an investor is closing in on the one-year

¹www.soundmindinvesting.com/member/fund



mark of holding a fund, or when trying to postpone a sale until the beginning of a new tax year. In a taxable account, investors in higher tax brackets can benefit from holding their funds longer than one year, thereby qualifying for the lower capital gains tax rate. Note that this exception is only an issue in taxable accounts—if you are investing in an IRA or other retirement account, taxes are not a consideration and this will have no bearing.

THE \$ SYMBOL

As you've learned, Upgrading uses performance momentum guidelines to provide objective criteria as to when it's time to "upgrade" to a better performing fund. When these guidelines are violated, the fund is recommended for sale even if the six or twelve-month holding period has not yet been met. However, we use a "\$" symbol in the MoneyTalk section of the newsletter when writing about certain stock funds being sold to let you know if delaying the sale is advisable. If the holding has been profitable and is held in a taxable account, investors might elect to retain such a fund until reaching the twelve-month holding period. The fund could then be sold at that time. The "\$" symbol is our way of saying "it's okay to hold on to this fund for a little longer."

However, our reader surveys have indicated a fairly high number of readers continue holding formerly recommended funds long after they are sold. Readers say they kept these funds because the "\$" symbol accompanied the sell recommendation. Apparently the "\$" symbol was being interpreted as a green light for continued ownership into the indefinite future, not just for a few additional months as intended. The problem these readers then face is they have no exit strategy; since the fund is no longer part of the model portfolio, how will they know if we ever reach a point where we would *definitely* advise selling regardless of the tax or redemption fee consequences? They won't.

So how can you tell if it's worth it to hold the old fund after we've recommended it be sold? In researching this problem, we discovered a rough rule of

thumb: it cost procrastinators around one-half percent (0.5%) per month to hold the old fund rather than selling it and buying the new replacement. As a general rule, then, we suggest the following:

1. If a fund is being replaced and *does not* receive a "\$" symbol in the MoneyTalk write-up, sell it immediately regardless of tax or transaction cost consequences.

2. If a fund is being replaced and *does* receive a "\$" symbol in the MoneyTalk write-up, run the numbers and see if your savings on taxes or redemption fees would outweigh a 0.5% per month loss in the value of the fund. (Of course, your actual result will vary from the 0.5% assumption. In some cases, you actually gain by delaying the transaction. Incurring a 0.5% per month loss is merely the average result from recent years.)

Any decision to continue holding such a fund should be a short-term one, that is, you would only continue holding it for a few months in an attempt to achieve a specific short-term benefit, such as (1) pushing any gains into the next year, (2) reaching the 12-month mark and thereby qualifying for long-term capital gains tax treatment, or (3) avoiding a hefty transaction or redemption fee. After that goal is accomplished, you should then replace the fund with one of the currently recommended ones.

WHEN TO SELL AT A LOSS

It's a common dilemma every investor faces at some point—when to give up on a losing investment. There's a very strong inclination to want to delay selling until the investment climbs back up. In Upgrading, we occasionally sell funds at a loss. You need to expect that from time to time, and be prepared to sell anyway. Here's one common sense way to think of the situation that may help make the decision easier: pretend that the investment's current value is actually new cash sitting in a money market account. Would you invest that money in the old fund today if it were new cash you were investing? If not, then it probably makes sense to sell at a loss and reinvest elsewhere.

Sometimes it's wise to delay selling a fund in order to get favorable tax treat-

ment, or to push a gain/loss into the next calendar year. Perhaps the fund is closed and you don't want to get out entirely and then not be able to get back in. Whatever your reason, make sure it has a solid basis and isn't an excuse to avoid making a painful sell decision. ♦

FREQUENTLY ASKED QUESTIONS

Q: How has Upgrading performed?

A: Quite well. As the table on the next page indicates, Upgrading has more than tripled the market's profits over the past decade. The average Upgrading portfolio outperformed the market in nine out of the ten years shown.

Q: It seems like Upgrading involves a lot of buying and selling. How long is each fund normally held?

A: Our approach is not a frequent trading strategy, although it may seem that way at first to someone conditioned to hold their funds "forever." In recent years, stock funds have been held an average of roughly nine months. That doesn't sound too bad, but be forewarned there's some aggravation hidden in that "average" number—about one out of every six funds recommended was held for six months or less before it dropped below the top quartile and needed to be replaced. That's not to say you would have had the same experience—you wouldn't have unless you began the period holding all 20 recommended stock funds and continued to hold four funds in each stock category throughout. But it does illustrate that it's not unusual to occasionally have to sell a fund fairly quickly.

Q: I frequently read that buy-and-hold is the way to invest for the long term. The short-term focus of your fund "upgrading" strategy seems to be frowned upon. Can you explain why your approach seems to run counter to the conventional wisdom?

A: The problem lies in the different ways that the term "buy-and-hold" is defined. In one sense, it means "buy a stock (or stock fund) and hold it for several years." Warren Buffett, one of the world's great investors, has become one of the world's richest men applying this



kind of buy-and-hold strategy. In a recent annual letter to his shareholders, he summed it up this way: "We hope that you do not think of yourself as merely owning a piece of paper whose price wiggles around . . . We hope you instead visualize yourself as a part owner of a business that you expect to stay with indefinitely. . ." Given his track record, who are we to disagree with him? But the problem is that, as mere investing mortals, our stock or fund selection skills are not on the same level as Warren Buffett's. It works for him, but it doesn't work for everyone.

Because we're looking for a strategy that will work for the average investor, we disagree with the "conventional wisdom" that says you should buy a particular fund and hold it for many years. The research we've seen just doesn't support that approach. With very few exceptions, funds that outperform over a short period of time (12-18 months) revert to being average performers soon after. There is very little argument on this point, yet the traditional buy-and-hold advocates act as though a little more effort will make it possible to find magic funds you can buy and forget about. It's not easy to do that. In fact, research has shown that you can't predict the winners for the *next* five years by looking at the winners for the *past* five years. So, you'd better be ready to make adjustments to your fund portfolio as new leaders emerge and old leaders fall back to the middle of the pack.

Having said this, we are still long-term in our philosophy. We think you should commit your money to the market for an extended period, and follow essentially the same allocation guidelines for many years without paying much attention to what the market is doing at any given time. For instance, if you decide that, based on your season of life and risk tolerance, you should be 80% invested in stocks and 20% in bonds, we believe you should keep your 80% invested in stocks regardless of whether the market is going up, down, or sideways at the moment. The one exception to this would be if, *as part of your long-term plan*, you have specific

guidelines in place that tell you when to lower/raise your stock allocation. For one example of such guidelines, see "Bear Markets and Boundaries" in the May 2011 issue of SMI.

In summary, our commitment to buying and holding extends to maintaining your allocations and staying in the market even when your emotions are begging you to sell. But we don't hold that commitment to any specific fund. Leadership is constantly rotating, and significantly improved performance appears to be available by maintaining a shorter-term, opportunistic attitude towards individual funds.

PERFORMANCE OF SMI FUND UPGRADING STRATEGY

Year	Stock ¹ Market	SMI ² Upgrading
2001	-11.0%	4.8%
2002	-20.9%	-14.2%
2003	31.6%	46.6%
2004	12.5%	17.3%
2005	6.4%	12.0%
2006	15.8%	17.4%
2007	5.6%	14.3%
2008	-37.2%	-38.8%
2009	28.3%	33.6%
2010	17.2%	17.8%
Average Annual Return	2.5%	8.4%
Profit on \$100,000 Invested ³	\$28,042	\$124,123

FOOTNOTES: [1] Results shown for the U.S. market are those for the Wilshire 5000 index, the broadest measure of the U.S. stock market, assuming all dividends are reinvested. [2] The Upgrading results are based on actual recommendations for the periods shown. The data assumes all transactions were made on the last trading day of the month. The calculations assume that the portfolio allocation for each risk category was split evenly among all the recommended funds. [3] The dollar results show the amount of profits in an account with a \$100,000 balance at the beginning of 2001. Transaction costs are not included because they vary from broker to broker.

Q: I've noticed SMI recommends Vanguard for its other model portfolio strategies, but not for Upgrading. I can get most of the Upgrading funds through Vanguard's brokerage service. Is there a reason they aren't recommended?

A: We prefer Scottrade, Schwab or Fidelity, and the reasons are pretty simple. A comparison of the policies at each of these companies makes clear that, while Vanguard does many things well, hosting an Upgrading-based account isn't one of them. For starters, no-transaction-fee funds require a minimum investment of \$3,000 each at Vanguard, which makes it more difficult for many

SMI readers to carry out an Upgrading strategy that calls for holding five or more funds in varying percentages. On top of that, shares held less than six months at Vanguard carry redemption fees of 1% or \$50, whichever is greater. In an Upgrading strategy, six months is a tolerable, if occasionally inconvenient, holding period requirement. But with holding periods of just 90 days required at Scottrade and Schwab, why go with the more restrictive rules and penalties at Vanguard? Finally, the NTF universe at Vanguard is smaller than at our recommended brokers. As a result, we heartily recommend using Vanguard for what they excel at: the lowest-cost, best run index funds in the business. But for Upgrading, we feel there are better options. That said, it is certainly possible to upgrade using a Vanguard brokerage account.

Q: What's the best way to dollar-cost-average using Upgrading?

A: For those unfamiliar with the dollar-cost-averaging (DCA) concept, all it means is to invest the same amount of money at regular time intervals. It is a systematic "formula" strategy that can be quite useful because it requires that you make your buying and selling decisions based solely on mechanical guidelines. Your constant dollar amounts force you to buy more shares when the price is low and fewer shares when the price is high. The beauty of DCA is that it frees you from the worry of whether you're buying at the "wrong" time.

The trouble with DCA in an Upgrading portfolio is that it can trigger extra fees if you're not careful. Not all funds can be purchased without a transaction fee (NTF), so buying them repeatedly can trigger multiple commissions. And even with NTF funds, if you buy regularly, you ensure that when it is time to sell, you'll owe a short-term redemption fee on at least some of your purchase.

Thankfully, there are several easy ways to get around these problems. One is to start each year slightly underweighted in bonds. Since we invest our bond money in index funds that don't change throughout the year, you could then DCA into the bond



funds without fear of triggering any extra fees. Another idea is to put your new contributions into a money market fund initially. Then when it's time to replace a fund in your Upgrading portfolio, simply add any funds in the money market account to the proceeds from selling the old fund, and invest the combined total in the new replacement fund. If you hold two funds in each of SMI's five stock risk categories, you would be replacing roughly one fund per month, making this a good match for many DCA investors. (The Sound Mind Investing Funds described below provide a DCA alternative that is exceptionally easy as well.)

Q: How can I take advantage of the Upgrading strategy without having to do the monthly upgrading myself?

A: The Sound Mind Investing Funds utilize the same Upgrading philosophy and approach as the SMI newsletter.

The Funds are managed independently of the newsletter however, so their results will vary from the newsletter's results. Investing in the Funds will eliminate the time commitment involved with upgrading on your own, but does involve paying additional fees. More information on the Sound Mind Investing Funds, including risks, fees, and expenses, is available at the Funds' website at www.smifund.com. Be sure to thoroughly review the Funds' prospectus before investing.

Q: There's a lot of information here. Can you summarize in plain English why Upgrading works?

A: Recognizing that all funds get hot and then cool off due to the market shifting its favor between styles and sizes, and that you can benefit from these shifts by switching funds as conditions dictate, is a departure from the conventional wisdom that you should

try to find "good funds" and hold them through thick and thin. But the Upgrading system works for that very reason, as it usually gets us into top performing funds early enough to enjoy a good part of their success before they inevitably fall out of favor. As a hot fund cools off, Upgrading tells us to sell it, and shows us what new type of fund the market is favoring next. While this may seem like unrepentant performance chasing (it is), it's worth noting that funds in our Upgrading strategy have been held an average of 9 months in recent years, indicating that once a particular fund gets hot, it often stays that way for quite a while. Not every fund purchase works out, but enough of them do, and the duration that we benefit from each is long enough that Upgrading has been able to put together a superior performance record. ♦



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