

Investing in Model Portfolios, Risks & Disclosures

Each quarter Capital Markets Evaluation Tools updates its structured stock portfolios. For institutional investors structured stock portfolios can be purchased under an index license, and for individual investors several model portfolios are published quarterly in the Capital Market Observer (see subscriptions). Our model portfolios which are designed to offer a performance advantage relative to the Standard & Poor's 500 stock index (S&P 500). These high performance portfolios are created using the Five Star Ranking System discussed in "Achieving Exceptional Performance".

Model portfolios are designed for sophisticated investors who manage their own investments. Investing in model portfolios is pretty simple. A portfolio can be bought by placing market orders from the "portfolio list" published quarterly in Capital Market Observer. Model portfolios require little maintenance. Therefore, the portfolios can be bought and held for one year before any adjustments are required. At the end of one year the strategy must be rebalanced and depending on the investors tax status this may result in recognition of long-term capital gains income.

The model portfolios presented range in size from approximately 15 to 40 stocks. As would be expected, performance reliability is better as the portfolio size increases. A complete discussion of how portfolios are designed and their performance limitations is presented under the section "Achieving Exceptional Performance". The model portfolios presented are suitable for many investors.

Each sample portfolio offers a different performance range determined by its industry composition. Sample portfolios are constructed with an equally weighted investment amount for each stock. Portfolios hold only one company for each industry selected. Each portfolio is a "structured portfolio" designed to offer investors a consistent performance advantage (or alpha). Structured portfolios fill a critical void between inconsistent active strategies and consistent but unexciting passive strategies (indexing) or exchange traded funds.

Also available is a real estate securities portfolio for investors who want a practical strategy for capturing the outstanding long term performance of the National Association of Real Estate Investment Trusts (NAREIT) equity index.

All results are simulated before transaction costs and taxes and also after assumed transaction costs. With each stock portfolio's simulated results are estimates for turnover and gain recognition. With the data presented investors can estimate expenses and taxes base on their own particular situation.

There are no guarantees of performance for any investment strategy and historic results whether simulated or actual provide no guarantee that future investment conditions can generate similar results.

Definitions and Assumptions

Turn over is the combined value of sales and purchases compared to the end of period market value of the portfolio. If every stock in the portfolio is replaced when the portfolio is re-balanced than turnover would be 200%. Gain recognition occurs when the portfolio is re-balanced and it is expressed in terms of the beginning of the period investment.

How closely a stock portfolio tracks the performance of the Standard and Poor's 500 index is primarily determined by how well it is diversified and by how the portfolio's holdings are weighted. Performance reliability for model portfolios increases versus a broadly diversified bench mark index, such as the Standard & Poor's 500 index, as a model portfolio's diversification increases. Sample portfolios are designed for non-institutional investors and (for these investors) equally weighting of securities improves risk management. In contrast, the S&P 500 index is a market capitalization weighted index (each company's weight is equal to its market capitalization). Performance differences between a model portfolios and the Standard & Poor's 500 index are a function of biases in industry and company representation and because holdings have different proportional weighting. Sample portfolios are more likely to under-perform in years when capitalization has a strong influence on performance (when the S&P weighted average return is substantially higher than its un-weighted average return); the model portfolios are more likely to under-perform. Standard & Poor's 500 index total return is expressed before transaction expenses and fees, so to be consistent the simulated total returns are compared before transaction expenses and fees. The performance chart for the sample portfolios was calculated before transaction expenses and allowance for income taxes and accompanying table presents performance both before and after expenses but not after taxes.

***Calculation of Total Return after Expenses:**

Also presented is an estimated total returns after transaction expenses associated with purchasing the portfolio at the beginning of the year. Transaction expenses were assumed to be five cents per share times the number of shares required to purchase the portfolio at the beginning of the year plus subscription expense.

- **Prime Performance Portfolio:** Simulated returns as presented net of expenses would have reduced annual compounded returns by approximately .24%. For a portfolio rebalanced every year, transaction expenses would have been approximately 5.5% greater; thus re-balancing (assuming no capital gains taxes) can be assumed to increase expenses and reduce long-term compounded annual returns by approximately .0015% per year.
- **PrimePlus Portfolio:** Simulated returns as presented net of expenses would have reduced annual compounded returns by approximately .268%. For a portfolio rebalanced every year, transaction expenses would have been approximately 5.1% lower; thus re-balancing (assuming no capital gains taxes) can be assumed to not significantly change expenses or long-term compounded annual returns.
- **Small Industry Portfolio:** Simulated returns as presented net of expenses would have reduced annual compounded returns by approximately .24%. For a portfolio rebalanced every year, transaction expenses would have been approximately 8.6% greater; thus re-balancing (assuming no capital gains taxes) can be assumed to increase expenses and reduce long-term compounded annual returns by approximately .0021% per year.
- **Option Strategies:** Put and Call option contracts are assumed to have a transaction cost of \$10 per contract. So the cost of implementing option strategies is the ratio of option transaction expenses divided by \$1 million. Option transaction expenses are determined by calculating the number of Standard and Poor's 500 stock index option contracts per million dollars times \$10 per contract times 4 for option strategies managed quarterly or times 2 for option strategies managed semi-annually. **Warning when markets face a liquidity crisis (such as in the fall of 1987, the fall of 2008, or winter 2009) the option market may price put options at unreasonable prices. Under such conditions, option strategies should be discontinued when the puts owned mature. Any time when the breakeven percentage market movement for puts exceeds the comparable breakeven market movement for calls, the options market may reflect an imbalance of orders.**

Also presented for each stock portfolio is simulated estimates for: shares per million if the model portfolio was bought at the beginning of the year, the number of companies bought, re-balancing turnover, and gain recognition. Utilizing this data you can estimate expenses and taxes base on your own particular situation.

There are no guarantees of performance for any investment strategy and historic results whether simulated or actual provide no guarantee that future investment condition can generate similar results.