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# Money Matter\$



A Quarterly Newsletter from Sommers Financial Management

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## We're Still Finding Bargains in Closed-End Funds

by Adam Sommers

It's been over a year since we launched our long/short (L/S) Closed-End Fund (CEF) Arbitrage strategy. In the seven months prior to that, we experimented with L/S pairings, to test our strategy.

We had a client commit \$10,000 to try out our Long/Short CEF-Arb strategy on March 28, 2016. One year later, on March 31st, their account was valued at \$11,315—**up over 13%, after fees**. The biggest swoon the account experienced was a drop of 2.9% in October. That compares to the S&P 500, which saw a 17% return in the same 12-month timeframe, but experienced a drop of 6% in June. This is what the investment world would call a good upside/downside ratio. We captured 76% of the market's move up, but only 48% of the move down. A golden goose? Almost! 🐓

The biggest issue we've had with the long/short design is that it is hedged, or offset, by shorting market-index-ETFs. This results in underperformance when the market performs well. While this may not be important to our clients looking for stability, others want to leverage our CEF analysis to achieve more robust (*i.e. aggressive*) returns.

This spring, I set out to **create a portfolio of mis-priced, bargain CEFs that we don't hedge**. In order to reduce volatility, and keep the downside lesser than that of the S&P 500, **I decided to use a 60/40 Stock/Bond allocation, akin to a typical**

**"Balanced Fund"** in the mutual fund world.

We place U.S. stocks, real estate and international stocks in the "Stock" bucket, and high quality, high yield and international bonds in the "Bond" bucket. Our volatility projections are higher than a typical balanced mutual fund, but our goal is 2% annual out-performance.

**Our two CEF strategies share many of the same funds, but are not identical handfuls.**

Additionally, we weight the portfolio holdings differently, based on each strategy's objective.

For the hedged, or long/short version, we calculate the amount of hedge based on volatility. The more volatile the CEF, the more we hedge. The more we hedge, the less return we expect.

We then weight both strategies by a calculation equivalent to "Expected Return/Volatility". We aim to achieve the highest return with the least amount of risk (volatility).

All this to say **we now have two Closed-End Fund Arbitrage models available** to our clients. One aims for the steady, positive returns with very little volatility in principal. The other is a balanced portfolio of stock and bond CEFs that aims to out-perform typical balanced mutual funds by using our specially developed process of identifying mis-priced CEFs. Give us call to discuss either strategy—or both!

**"While this may not be important to our clients looking for stability, others want...to achieve more robust returns."**

### One-Year Returns

Dow Jones Industrial 30  
Average: 19.4 %

S&P 500 U.S. Large Company Stock Index:  
16.0 %

S&P Moderate Allocation  
Index (AOM): 8.4 %

SPDR Gold Index (GLD):  
- 6.2 %

iShares Aggregate Bond  
Index (AGG): - 0.3 %

SFM's "THE NAKED ALPHA  
FUND": 10.1 %

## ETF EXTRA — Vanguard High Dividend Yield ETF — (VYM)

VYM is our most widely held ETF, is included in both our growth and income portfolios, and trades commission-free at TD Ameritrade. From ETF.com: "VYM selects high-dividend-paying US companies, excluding REITS, and weights them by market cap. Investors can access VYM at a very low round-trip cost thanks to its tiny fee, excellent tracking, and robust liquidity. This makes it a great choice for those looking for cheap, liquid high-dividend equity exposure, though income-starved investors can find higher yields elsewhere."

### VYM's Notable Statistics

|                             |             |
|-----------------------------|-------------|
| Dividend Yield:             | 2.95 %      |
| Total Assets in the Fund:   | \$18.3 Bil. |
| Expense Ratio:              | 0.08 %      |
| 3-Year Avg. Annual Return:  | 9.7 %       |
| Max Draw Down (last 3 yrs): | - 13.7 %    |



## Model STOCK Portfolios

### GROWTH-oriented portfolio

| % Wt. | Symbol | Description                        | Div. Yield | 1-year Return | 3-year Return | Expense |
|-------|--------|------------------------------------|------------|---------------|---------------|---------|
| 21%   | VYM    | Vanguard High Dividend Stock ETF   | 2.95%      | 14.4%         | 9.7%          | 0.08%   |
| 19%   | VO     | Vanguard Mid Cap Stock ETF         | 1.46%      | 18.8%         | 8.7%          | 0.06%   |
| 18%   | VB     | Vanguard Small Cap Stock ETF       | 1.48%      | 20.9%         | 7.3%          | 0.06%   |
| 21%   | VIG    | Vanguard Dividend Appreciation ETF | 2.04%      | 15.0%         | 8.8%          | 0.08%   |
| 21%   | IVV    | iShares S&P 500 ETF                | 1.87%      | 19.3%         | 10.4%         | 0.05%   |

### INCOME-oriented portfolio

Average dividend yield: 2.5%

| % Wt. | Symbol | Description                        | Div. Yield | 1-year Return | 3-year Return | Expense |
|-------|--------|------------------------------------|------------|---------------|---------------|---------|
| 39%   | VYM    | Vanguard High Dividend Stock ETF   | 2.95%      | 14.4%         | 9.7%          | 0.08%   |
| 28%   | VT     | Vanguard Total World Stock ETF     | 2.20%      | 20.3%         | 5.4%          | 0.11%   |
| 19%   | VEU    | Vanguard International Stock ETF   | 2.65%      | 21.4%         | 1.4%          | 0.11%   |
| 14%   | VWO    | Vanguard Emerging Market Stock ETF | 2.31%      | 19.1%         | 0.4%          | 0.14%   |



## Model BOND Portfolios

### GROWTH-oriented portfolio

| % Wt. | Symbol | Description                         | Div. Yield | 1-year Return | 3-year Return | Expense |
|-------|--------|-------------------------------------|------------|---------------|---------------|---------|
| 24%   | BND    | Vanguard Total Bond Index ETF       | 2.43%      | -0.3%         | 2.6%          | 0.05%   |
| 24%   | MUB    | iShares National Municipal Bond ETF | 2.21%      | -1.0%         | 3.0%          | 0.25%   |
| 27%   | BSV    | Vanguard Short-Term Bond ETF        | 1.53%      | 0.2%          | 1.3%          | 0.07%   |
| 25%   | MBB    | iShares Mortgage Bond ETF           | 2.48%      | 0.0%          | 2.1%          | 0.29%   |

### INCOME-oriented portfolio

Average dividend yield: 4.6%

| % Wt. | Symbol | Description                                 | Div. Yield | 1-year Return | 3-year Return | Expense |
|-------|--------|---|------------|---------------|---------------|---------|
| 52%   | JNK    | SPDR High Yield Bond ETF                    | 5.92%      | 11.4%         | 2.1%          | 0.40%   |
| 48%   | LQD    | iShares Investment Grade Corporate Bond ETF | 3.19%      | 1.8%          | 3.9%          | 0.15%   |



## Model ALTERNATIVE Portfolios

### GROWTH-oriented portfolio

| % Wt. | Symbol | Description                       | Div. Yield | 1-year Return | 3-year Return | Expense |
|-------|--------|-----------------------------------|------------|---------------|---------------|---------|
| 20%   | RWO    | SPDR Global Real Estate ETF       | 3.52%      | -0.7%         | 4.3%          | 0.50%   |
| 26%   | BAICX  | BlackRock Multi-Asset Income Fund | 3.63%      | 9.4%          | 3.1%          | 0.84%   |
| 27%   | VNQ    | Vanguard U.S. Real Estate ETF     | 4.39%      | -0.8%         | 8.7%          | 0.12%   |
| 28%   | GATEX  | Gateway Fund                      | 1.18%      | 9.6%          | 4.6%          | 0.94%   |

### INCOME-oriented portfolio

Average dividend yield: 3.8%

| % Wt. | Symbol | Description                        | Div. Yield | 1-year Return | 3-year Return | Expense |
|-------|--------|------------------------------------|------------|---------------|---------------|---------|
| 21%   | RWO    | SPDR Global Real Estate ETF        | 3.52%      | -0.7%         | 4.3%          | 0.50%   |
| 31%   | BAICX  | BlackRock Multi-Asset Income Fund  | 3.63%      | 9.4%          | 3.1%          | 0.84%   |
| 33%   | VNQ    | Vanguard U.S. Real Estate ETF      | 4.39%      | -0.8%         | 8.7%          | 0.12%   |
| 15%   | RWX    | SPDR International Real Estate ETF | 3.71%      | 1.3%          | -0.2%         | 0.59%   |