

THE AAIL BEGINNER'S PORTFOLIO

By James Cloonan

Over the past five years the Beginner's Portfolio, an experimental portfolio of small stocks, has been periodically discussed in my Matter of Opinion column. Interest in this portfolio leads us to provide detailed information about it in this special feature format, which will be updated on an annual basis. This is the first such special feature on the Beginner's Portfolio.

We will, of course, report on anything new and any changes to the portfolio in the Matter of Opinion column, but we will report details and portfolio returns in the annual special feature.

THE ORIGIN OF THE PORTFOLIO

We began the Beginner's Portfolio just over five years ago not to prove any one theory of investing but to show that a consistent approach could be followed without great time requirements. We also wanted to examine and share the problems and procedures of managing a portfolio of small stocks.

A secondary consideration was our hope that we could convert a few "fundaholics" into managing at least a part of their portfolio.

Our approach was based on historical evidence that small-capitalization stocks (these are now more commonly called micro-cap stocks) and stocks with low price-to-book ratios outperformed the market over

the long run. It was also based on the belief that a portfolio could be managed by making adjustments only once a quarter.

Based on practical experience in the handling of our portfolio (it is a real portfolio), we have adjusted the guidelines; the rules provided at the end of this article represent our latest ideas for managing such a portfolio. The result through the past five years can be seen in Table 1.

The purpose of the portfolio was to study processes and not to be an advisory letter. Because of this, we have not listed the stocks as we purchased them, although anyone with a database could have screened using our rules and come up with approximately the same selections.

At this time, I thought it would give a feeling of reality to the process if we showed the stocks bought, sold, and currently held. They are presented in

**TABLE 1.
BEGINNER'S PORTFOLIO VS. PASSIVE PORTFOLIOS
FIVE-YEAR PERFORMANCE AND RISK (1993-1997)**

	Beginner's Portfolio	S&P 500 Index*	Russell 2000*	Micro Caps*
Annual Return (%)				
1993	32.3	9.8	18.7	21.0
1994	2.0	1.1	-0.6	3.1
1995	20.7	37.4	28.7	34.5
1996	22.3	22.9	18.1	17.6
1997	44.3	33.2	24.6	22.8
5-Year Annualized Geometric Mean (%)	23.5	20.1	17.4	19.4
5-Year Annualized Arithmetic Average (%)	24.3	20.9	17.9	19.8
5-Year Annual Volatility (Risk)** (%)	14	14	10	10
Sharpe Ratio***	1.38	1.16	1.28	1.47

*Based on passively managed portfolios. The S&P 500 is represented by the Vanguard Index 500 fund; the Russell 2000 by the Vanguard Index Trust Small-Cap fund; and micro caps by the DFA U.S. Small-Cap Fund.

**As measured by standard deviation—how much actual returns varied around the average from year to year. It is based on a normal curve, and two-thirds of the time variation will be less than % indicated.

***A measure of how much excess return (return above Treasury bills) is generated for each unit of risk.

Note: Standard deviation and the Sharpe ratio are only significant if these investments are a dominant part of all your investments. Otherwise their calculations should be based on performance and risk characteristics of your total portfolio.

Table 2.

One interesting point to note is the side benefit to the way stocks are sold in the portfolio. Most stocks are sold because they have negative earnings; the only winners that are sold are those that have gone up enough to double the size or price/book criteria. As a result, losses are taken and most profits continue to run.

This provides a beneficial tax effect—realizing losses but deferring most gains. As you can see from the table, although the portfolio is ahead about \$926,000, taxes have been deferred on \$355,000.

We did not tax-manage the portfolio, but individuals might want to adjust the timing of sales a bit to make losses short-term and gains long-term. However, I emphasize the words “a bit”: A slight variation makes sense, but don't defeat the approach by focusing too much on tax consequences.

TACTICAL CHANGES

During the five-year period, examination of results has led to modification of some of the criteria. As can be seen in Table 3, turnover is very costly. A number of changes have been made to reduce turnover costs. These include:

- Putting a stock with negative 12-month earnings on probation rather than selling it. It seems in several cases the loss is due to a one-time occurrence and the damage to the stock price has already occurred.
- Letting market capitalization and price/book go to 2½ times initial criteria rather than 2 times.
- Not rebuying stocks that have been sold within the last two years to avoid forever marginal stocks that cause turnover.
- The elimination of stocks with bid-ask spreads of over 8%, while continuing to buy stocks between the spread.
- While it will only affect larger portfolios, we now eliminate stocks if the average daily volume is not twice the size of the position we are establishing. The spread on such thinly traded stocks will hurt us

TABLE 2. THE BEGINNING

Realized Capital Gains (as of 1/31/98)

Name (Exchange: Ticker)*	Sales (\$)	Cost Basis (\$)	Gain/Loss (\$)
AEL Industries (M: AELNA)	16,600.50	20,295.00	-3,694.50
Alba Waldensian (A: AWS)	18,674.37	19,912.50	-1,238.13
Allegheny & Western (M: ALGH)	34,800.00	19,870.00	14,930.00
Allied Research Corp. (A: ALR)	14,879.50	19,120.00	-4,240.50
Arrow Automotive (A: AI)	24,499.14	25,400.01	-900.87
Astrosystems Inc. (M: ASTR)	27,452.50	23,485.00	3,967.50
Audiovox Corp. (A: VOX)	83,717.17	73,655.00	10,062.17
Barrys Jewelers Inc. (M: BARY)	13,942.50	24,120.00	-10,177.50
Ben Franklin Retail (M: BFRS)	26,150.00	24,475.00	1,675.00
Bennetton Group SPA (N: BNG)	23,674.20	22,150.00	1,524.20
Brock Candy (M: BRCK)	49,002.50	22,560.00	26,442.50
Bufete Industrial (GBI)	49,548.33	28,084.00	21,464.33
Concord Fabrics (A: CIS)	17,957.39	18,600.00	-642.61
Culbro Corp. (N: CUC)	21,486.78	22,025.00	-538.22
Data Syst's & Software (M: DSSI)	55,619.37	46,355.00	9,264.37
Datron Systems (M: DTSI)	13,440.00	16,970.00	-3,530.00
Diagnostic Retrieval (A: DRS)	45,425.98	22,072.50	23,353.48
Dynamics Corp. of Amer (N: DYA)	66,110.29	19,212.50	46,897.79
EDO Corporation (N: EDO)	47,634.36	41,884.00	5,750.36
Eldec Corporation (M: ELDC)	48,100.00	20,470.00	27,630.00
Fibreboard Corp. (A: FBD)	66,922.76	21,075.00	45,847.76
Fluor Daniel/GTI (M: FDGT)	48,169.87	50,890.00	-2,720.13
Foodarama Supermarket (A: FSM)	19,099.35	20,875.00	-1,775.65
Frequency Electronic (A: FEI)	187,584.97	40,460.00	147,124.97
GBC Technologies (M: GBCT)	20,900.00	17,660.00	3,240.00
Greenman Brothers (A: GMN)	29,676.50	19,260.00	10,416.50
Hampton Industries (A: HAI)	21,762.76	18,090.00	3,672.76
Kahler Corp. (M: KHLR)	29,680.00	20,670.00	9,010.00
LDI Corporation (M: LDIC)	11,190.00	22,560.00	-11,370.00
Luria & Sons (N: LUR)	20,937.29	21,225.00	-287.71
Marsh Supermarkets (M: MARSA)	23,565.00	25,770.00	-2,205.00
Methode Electronic (M: METHA)	28,440.00	21,060.00	7,380.00
Moog Inc. (A: MOG.A)	75,447.46	20,225.00	55,222.46
Motts Holdings Inc. (A: MSM)	12,659.58	20,212.50	-7,552.92
Nuclear Metals Inc. (M: NUCM)	23,732.00	22,220.00	1,512.00
Nycor Inc (M: NYCO)	10,920.00	22,080.00	-11,160.00
Orbit International (M: ORBT)	21,202.50	24,172.50	-2,970.00
Oriole Homes Corp. (A: OHC.B)	32,265.91	39,687.50	-7,421.59
Perini Corporation (A: PCR)	34,486.34	42,137.50	-7,651.16
Proler International (N: PS)	17,349.41	39,365.00	-22,015.59
Ramsay Health Care (M: RHCI)	27,920.00	20,370.00	7,550.00
Rexon Inc. (M: REXN)	30,130.00	20,745.00	9,385.00
Salem Corporation (A: SBS)	56,085.61	20,187.50	35,898.11
Sea Containers Ltd. (N: SCR.B)	46,048.45	45,375.00	673.45
Seaway Food Town (M: SEWY)	79,417.34	20,060.00	59,357.34
Sifco Industries (A: SIF)	18,039.37	18,900.00	-860.63
Spaghetti Warehouse (N: SWH)	32,884.89	35,674.00	-2,789.11
Specialty Chemical (A: CHM)	17,976.88	23,900.00	-5,923.12
Tandy Crafts Inc. (N: TAC)	45,965.94	47,800.00	-1,834.06
Todd Shipyards Corp. (N: TOD)	25,661.63	20,775.00	4,886.63

Realized Capital Gains (as of 1/31/98)

Name (Exchange: Ticker)	Sales (\$)	Cost Basis (\$)	Gain/-Loss (\$)
Unitel Video Inc. (A: UNV)	21,762.77	24,849.00	-3,086.23
USA Classic Inc. (M: USCL)	27,390.00	25,547.50	1,842.50
Village Supermarket (M: VLGEA)	18,690.00	19,370.00	-680.00
Washington Homes (N: WHI)	27,351.58	33,475.00	-6,123.42
Watsco Inc. (N: WSO)	68,322.72	24,875.00	43,447.72
Worldway Corp. (N: WCN)	25,300.00	21,300.00	4,000.00
Total Realized Capital Gains	2,014,573.76	1,502,693.51	511,880.25

Unrealized Capital Gains (as of 1/31/98)

Name (Exchange: Ticker)	Cost Basis (\$)	Value (1/31/98) (\$)	Gain/-Loss %
AMREP Corp. New (N: AXR)	52,985.00	64,380.00	21.51
Applied Extrusion (M: AETC)	58,160.00	58,000.00	-0.28
Baltek Corp. (M: BTEK)	25,130.00	26,737.50	6.40
Beazer Homes US (N: BZH)	59,293.50	79,320.60	33.78
BRT Realty Trust (N: BRT)	35,240.00	62,000.00	75.94
Catherines Stores (M: CATH)	47,335.00	65,000.00	37.32
Continental Materials (A: CUO)	32,600.00	66,875.00	105.14
Ecology & Environment (A: EEI)	34,087.50	46,000.00	34.95
Federal Screw Works (M: FSCR)	11,810.00	55,000.00	365.71
Int'l Shipholding (N: ISH)	59,275.00	59,937.50	1.12
Lechters Inc. (M: LECH)	35,680.00	35,441.00	-0.67
Liberty Homes (M: LIBHA)	28,620.00	27,000.00	-5.66
McRae Industries (A: MRI.A)	29,137.50	31,764.60	9.02
Natural Wonders (M: NATW)	49,095.00	48,125.00	-1.98
Noland Company (M: NOLD)	36,605.00	45,000.00	22.93
Oilgear Company (M: OLGR)	19,270.00	32,062.50	66.39
PDK Labs Inc. (M: PDKL)	50,740.00	71,880.00	41.66
Providence & Worcester (A: PWX)	37,680.00	88,612.50	135.17
PS Group Holdings (N: PSG)	53,930.00	49,000.00	-9.14
Raytech Corp. (N: RAY)	64,991.75	57,099.00	-12.14
Sea Containers (N: SCR.B)	37,825.00	57,626.00	52.35
Sonesta Intl Hotels (M: SNSTA)	20,620.00	60,000.00	190.98
Taco Cabana Inc. (M: TACO)	57,927.50	65,256.00	12.65
TCI International (M: TCII)	19,757.50	15,750.00	-20.28
Trans-Lux (A: TLX)	25,731.00	39,150.00	52.15
Transzonic Cos. (A: TNZ)	26,975.00	58,000.00	115.01
Total Unrealized Capital Gains	1,010,501.25	1,365,017.20	35.08

Summary

Portfolio Value 1/31/98 (\$)	1,430,171.00
Portfolio Value 12/31/92 (\$)	503,984.00
Total Gains (\$)	926,187.00
Realized Capital Gains (\$)	511,880.00
Unrealized Capital Gains (\$)	354,516.00
Dividends or Interest (\$)	59,791.00

Exchange Key:
N = New York Stock Exchange
A = American Stock Exchange
M = Nasdaq

*Ticker and exchange at time of sale. Please note that some are no longer listed due to mergers, name changes, etc.

either now or when we sell.

In addition, price-to-sales ratio has been added as a tie-breaker between qualified stocks. While the evidence of the importance of the price/sales is strong, I still feel price/book and market capitalization are stronger.

Because different databases, some very large, are being used by investors now, we are formalizing a criteria that limits stocks to those listed on the New York Stock Exchange, American Stock Exchange, Nasdaq National Market, and Nasdaq Small Cap. For a variety of reasons, we do not feel Bulletin Board or pink sheet stocks are suitable for the portfolio.

SOME OBSERVATIONS

In a portfolio of this type with extreme value criteria, there should not be many big losers. In fact, there have been only six positions with losses of over 25%. On the other hand, the high portfolio returns have been the result of one or two stocks a year with exceptional returns (over 100%).

As can be seen from the average monthly returns over the five-year period (Table 4), there is a bit of a January effect, but August and September are stronger. The volatility from month to month is very high, and the variations by month could easily be chance. In addition, the cost of transactions makes it unprofitable to trade stocks on a calendar basis, and there are no futures or options on micro caps.

We have monitored the stocks we have sold as well as those in the portfolio. Portfolio performance tests the validity of our buy rules, but information on whether our sell rules are valid requires maintaining a simulated portfolio of stocks sold. Over the years, this portfolio has had positive returns, but considerably less than our real portfolio.

Since one of the most common sins among individuals is to sell too soon, I suggest all investors maintain a simulated portfolio of stocks sold to validate sell rules. While the Beginner's Portfolio appears to have valid sell rules, when I examined my personal portfolio, I found I was selling too soon.

IN SUMMARY

While the Beginner's Portfolio has performed very well, there is no way of knowing how it will do in the future. That it has outperformed almost all mutual funds in a bull market is somewhat of a surprise since it is an extreme value-oriented fund. I would have expected it to shine in weak markets more than strong ones.

Whether it continues to beat the

S&P 500 and virtually all mutual funds or not, I think it shows that with a consistent approach, even with limited time, individuals can manage their own portfolios. However, they must have the discipline to select a strategy and follow it regularly.

In addition to our complete annual report on the Beginner's Portfolio, we will provide interim reports, particularly if there are new insights. Next year we will also have results and

comments on our new Intermediate Portfolio, introduced in the February 1998 *AAII Journal*. ♦

TABLE 3.
MISCELLANEOUS PORTFOLIO STATISTICS

Annual turnover rate (approximate)*	50%–30%
Cost of turnover—sell and buy (approximate)—commissions and spread	5%
Portfolio turnover cost per year—% of portfolio value (approximate)	2.5%–1.5%

*Changed rules has this going down toward 30%

TABLE 4.
AVERAGE RETURNS BY MONTH

	Return (%)
January	3.60
February	0.70
March	1.70
April	-1.20
May	1.70
June	2.80
July	0.00
August	5.10
September	3.80
October	2.20
November	-0.60
December	2.40

BEGINNER'S PORTFOLIO RULES

PURCHASE AND SALE RULES

Stock purchases must meet these criteria:

- Price-to-book-value ratio is less than 0.85. (This figure will change gradually with overall market value.)
- Market capitalization is between \$17 million and \$125 million (will also change).
- The firm's last quarter and last 12 months' earnings from continuing operations were positive.
- No financial stocks or limited partnerships will be purchased.
- The share price is greater than \$4.
- In order to reduce turnover by avoiding stocks that are forever marginal, do not re-buy a stock you have sold within two years.
- Note first item under stock order rules concerning spreads when buying shares.
- From the list of stocks remaining after the above screens have been applied, choose those with the lowest price-to-sales ratios in order until you have used up available funds. If you cannot find enough stocks that qualify, raise the market capitalization criterion a bit.

Stocks are sold if any of the following occurs:

- If last 12 months' earnings are negative, put stock on probation. If a subsequent quarter has negative earnings prior to 12-month earnings becoming positive, sell the stock.
- The stock's price-to-book-value ratio goes above 2½ times the initial criteria.
- Market capitalization goes above 2½ times the initial criteria.

STOCK ORDER RULES

- If the quoted bid-asked spread is more than 8% (asked price minus bid price, divided by asked price), eliminate the stock from consideration. Better to stretch other criteria, if necessary, than pay high spreads.
- Eliminate stocks if the average daily volume is not twice the volume you need for your position. The spread will be too high and not negotiable either now or when you sell.
- Market orders are not used. Instead, orders are placed

between the bid and ask prices unless the difference between the two is 4% or less, in which case purchases are placed at the offer price and sales are placed at the bid price.

- For Nasdaq stocks, it appears to be better to use day orders. If the order is not filled, place it again in a few days with a slight adjustment. In NYSE and Amex stocks, use good-till-canceled (GTC) orders so you keep your place in line in the specialist's books. If market isn't close to your price, adjust in a few days with a new GTC order.
- If price changes cause a stock to become ineligible (due to changes in price-to-book-value ratio or market capitalization) when only part of the order has been filled, keep what is already purchased and cancel the balance of the order.

MANAGEMENT RULES

- Decisions are made only at the end of each quarter. In order to react to the majority of earnings reports as early as possible, consider doing the quarterly reviews early in February, May, August, and November. Be consistent.
- Best judgment is used for tenders or mergers, but all criteria must be obeyed.
- At end of quarter, if receipts from stocks sold exceed requirements for new purchases, keep the excess receipts—up to 5% of portfolio value—in cash until next quarter. If the excess receipts are greater than 5% of the total portfolio value, distribute the amount above 5% to smaller holdings that still qualify as buys. Buy in efficient quantities. If over 10% of portfolio is in cash, move the market capitalization screen up a bit (for instance, from \$125 million to \$140 million) to find new qualifying stocks.
- At end of quarter, if receipts from stocks sales are insufficient to buy all newly qualifying stocks, buy in order of lowest price-to-book-value ratio in amounts equal to the average holding.
- Divide your portfolio so that you have at least 10 stocks. For portfolios over \$100,000, investing in 15 to 20 stocks is sufficient. You will not need more than 20 stocks until your portfolio exceeds \$1 million.