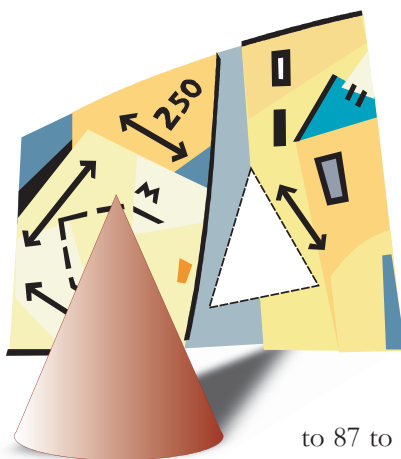


Model Shadow Stock Portfolio Up 66%, as Market Move Mystifies Pundits

By James B. Cloonan



The Model Shadow Stock Portfolio continues to do well in 2009—and if the portfolio continues to hold up, it will rival the year 2003 as our best year ever.

The Model Shadow Stock Portfolio is up 66.6% as of the end of August, compared to a positive 15.0% return for the S&P 500 (as measured by the Vanguard 500 Index fund). The long-term results and comparisons to other indexes can be seen in Table 1.

Despite this performance, we still have not recouped all the losses from 2008. It will probably be awhile before the Model Shadow Stock Portfolio and the general market completely recover and the purple line in Figure 1 reaches a new high.

The positive movement of the stock market this year has already mystified many pundits.

Probably the most positive indicator about the rest of 2009 is that so many analysts say the market can't possibly go higher.

Qualifiers Still Above Average

The number of qualifying stocks in our initial screen dropped to 15 (three of which we already owned), which is still above the long-term average. Over the past year, the qualifiers have gone from 92 to 87 to 26 to 15.

In January 2010, I will have enough data to provide a chart and we can begin to examine if the number of qualifying stocks correlates with the direction of the overall market or a segment of it.

Portfolio Changes

Table 2 highlights the portfolio activity at the beginning of September. We sold two stocks because they violated probation:

- Nu Horizons Electronics (NUHC), and
- Rex Stores Corp. (RSC).

We also purchased two new stocks at the beginning of September:

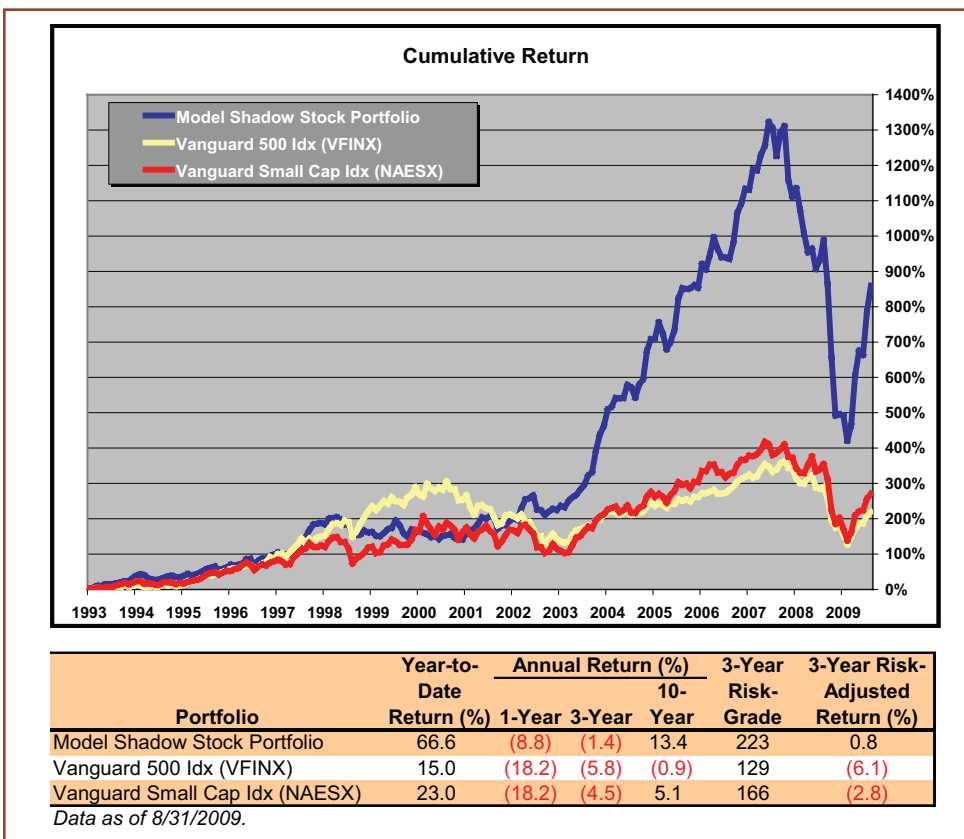
- Jackson Hewitt Tax Service (JTX), a tax preparation chain, and

Table 1. Model Shadow Stock Portfolio: Annual Performance Since Inception

	Avg An'l Ret Since Incep (%)	YTD Ret (%)	Annual Rate of Return (%)																
			2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993	
Shadow Stock Portfolio	14.8	66.6	(50.8)	(1.8)	29.4	17.9	43.7	73.1	10.8	21.4	(7.7)	(0.0)	(8.9)	44.3	22.3	20.7	2.0	32.3	
S&P 500 (VFINX)	7.2	15.0	(37.0)	5.4	15.6	4.8	10.8	28.5	(22.1)	(12.0)	(9.1)	21.1	28.6	33.2	22.9	37.4	1.2	9.9	
Vanguard Small Cap (NAESX)	8.2	23.0	(36.0)	1.2	15.6	7.4	19.9	45.6	(20.0)	3.1	(2.7)	23.1	(2.6)	24.6	18.1	28.7	(0.5)	18.7	
DFA US Micro Cap (DFSCX)	10.1	18.1	(36.7)	(5.2)	16.2	5.7	18.4	60.7	(13.3)	22.8	(3.6)	29.8	(7.3)	22.8	17.6	34.5	3.1	21.0	

Data as of 8/31/2009.

Figure 1. Model Shadow Stock Portfolio vs. Benchmarks (Through 8/31/2009)



- MedCath Corp. (MDTH), a group of hospitals that focus on cardiovascular care.

We bought Jackson Hewitt because it qualified before they announced their earnings for the first quarter. These quarterly earnings were bound to be negative because earnings for tax service businesses tend to be negative for two quarters and positive for two. Therefore, Jackson Hewitt will not qualify by the time you read this. However, you can ignore the latest quarter earnings rule in this case if you wish to purchase the stock.

Stay the Course

It is very difficult to get a handle on the economy, much less the stock market.

The signs of recovery we are seeing may have been paid for from long-term growth. The impact of all the stimulus efforts on the economy will likely continue for another year or more, but if the market believes the intermediate term will be damaged by short-term stimuli, it may not react to favorable economic developments as strongly as hoped. In the longer term, the case for inflation a few years out is fairly strong, and I believe the Federal Reserve will do whatever it feels necessary to reduce unemployment. However, the stock market

Table 2. Third-Quarter 2009 Transactions

Company (Ticker)	Reason
Sell	
Nu Horizons Electronics (NUHC)	negative earnings
Rex Stores Corp. (RSC)	negative earnings
Buy	
Jackson Hewitt Tax Service (JTX)	
MedCath Corp. (MDTH)	

About the Model Shadow Stock Portfolio

The Model Shadow Stock Portfolio provides guidance for investing in the promising micro-cap value sector of the market. It reflects AAll Founder James B. Cloonan's investing philosophy, which holds that:

- The best stocks for individual investors are not the same stocks that are best for institutions, and
- Success comes more from concern for the overall portfolio than for individual stocks.

The Model Shadow Stock Portfolio is an actual portfolio with real dollars invested. Updates on portfolio activity are provided both in the *AAll Journal* in this column, and on our Web site at www.aall.com/aallportfolios.

Table 3. Model Shadow Stock Portfolio Rules

Purchase and Sales Rules

Stock purchases must meet these criteria:

- No bulletin board or pink sheet stocks will be purchased.
- Price-to-book-value ratio must be less than 0.80. (Figure will change gradually with changes in overall market values.)
- Market capitalization must be between \$17 million and \$200 million. (Figure will change gradually with changes in overall market values.)
- The firm's last quarter and last 12 months' earnings from continuing operations must be positive.
- No financial stocks or limited partnerships will be purchased.
- No stocks on foreign exchanges or ADRs will be purchased because of different accounting and/or withholding tax on dividends.
- The share price must be greater than \$4.
- In order to reduce trading by avoiding stocks that are forever marginal, any stock that was sold within two years will not be rebought.
- Note second item under Stock Order Guidance concerning spreads when buying shares.
- Price-to-sales ratio must be less than 1.2. (Figure may change gradually with changes in overall market values.)

Stocks are sold if any of the following occur:

- 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-to-book-value ratio goes above three times the initial criterion.
- Market capitalization goes above three times the initial maximum criterion.
- After two years, sell if not qualifying as a buy currently. (But do not sell until there is a qualified stock to buy.) The two years should be measured from the last time the stock qualified, not from when you purchased it.

Stock Order Guidance

- These rules are for general guidance. Your own experience, market conditions and the size of the position will impact your own decisions. The results in the model portfolio were obtained while sometimes paying more.
- 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 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 price-to-book-value ratio or market capitalization) when only part of the order has been filled, stocks 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 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 is not needed until the portfolio exceeds \$1 million.

Table 4. The Model Shadow Stock Portfolio

Company (Ticker)	Current Price (\$)	52-Week		Market Cap (\$ Mil)	P/E Ratio (X)	P/B Ratio (X)	Div Yield (%)	Notes
		High (\$)	Low (\$)					
AeroCentury Corp. (ACY)	13.35	17.20	3.15	20.6	5.2	0.55	0.0	
Alamo Group (ALG)	13.87	19.79	9.22	139.4	19.5	0.71	1.7	qualified as of 9/4/2009
Allion Healthcare (ALLI)	6.88	7.74	2.60	183.5	15.0	1.01	0.0	
Avalon Holdings Corp. (AWX)	2.61	4.40	0.92	9.9	nmf	0.25	0.0	earnings probation (2009q2)
Books-A-Million (BAMM)	11.61	15.00	1.70	183.3	14.3	1.74	1.7	
Cascade Corp. (CASC)	26.12	50.25	12.81	284.3	nmf	1.22	0.8	earnings probation (2008q4)
Ennis (EBF)	13.92	18.16	6.91	360.3	nmf	1.22	4.5	earnings probation (2008q4)
Flexsteel Industries (FLXS)	7.73	11.44	4.98	50.8	nmf	0.48	2.6	earnings probation (2009q3)
Greenbrier Companies (GBX)	13.12	22.45	1.86	224.3	nmf	1.20	0.0	earnings probation (2009q3)
Hastings Entertainment (HAST)	3.98	8.12	1.26	38.5	22.1	0.37	0.0	
Jackson Hewitt (JTX)*	4.61	17.83	2.80	132.7	7.3	0.59	0.0	
L.S. Starrett Company (SCX)	10.00	27.19	5.30	66.3	52.6	0.42	4.8	
Marlin Business Servs (MRLN)	7.56	8.85	1.19	95.3	nmf	0.65	0.0	earnings probation (2008q4)
MedCath Corp. (MDTH)*	9.26	22.52	5.70	181.9	38.6	0.48	0.0	qualified as of 9/4/2009
OYO Geospace Corp. (OYOG)	20.32	52.54	9.00	121.2	18.0	1.01	0.0	
Paragon Shipping (PRGN)	3.89	13.22	2.25	167.8	1.7	0.32	5.1	
RCM Technologies (RCMT)	2.00	2.83	0.77	25.8	nmf	0.42	0.0	earnings probation (2008q4)
Saga Communications (SGA)	13.07	25.96	3.00	55.7	nmf	0.81	0.0	earnings probation (2008q4)
Shoe Carnival (SCVL)	14.81	18.45	6.05	191.3	40.0	0.88	0.0	
Standard Motor Prods (SMP)	12.44	13.00	1.36	237.5	nmf	1.38	0.0	earnings probation (2008q4)
Standex Int'l Corp. (SXI)	18.07	30.00	7.85	222.4	nmf	1.27	1.1	earnings probation (2009q3)
SureWest Communic'ns (SURW)	12.65	18.50	6.20	179.2	1,265.0	0.67	0.0	qualified as of 9/4/2009
Tufco Technologies (TFCO)	2.80	6.89	1.77	12.1	nmf	0.33	0.0	earnings probation (2009q2)
Twin Disc, Inc. (TWIN)	12.75	19.00	4.02	140.6	12.4	1.31	2.2	
Willis Lease Finance (WLFC)	12.03	15.39	7.25	110.4	4.4	0.56	0.0	

*Company is new to the model portfolio.
Source: AAIL's Stock Investor Pro/Thomson Reuters. Data as of 9/4/2009.

can behave very well during inflationary periods, although more in nominal terms than real (inflation-adjusted) terms.

All in all, I can think of no compel-

ling reason to deviate from your normal asset allocation in either direction.

The year 2009 will be behind us when the next Model Shadow Stock

Portfolio column appears in the January 2010 *AAIL Journal*, but you can track the portfolio at the Shadow Stock Portfolio area on AAIL.com each month. ▲

James B. Cloonan is founder and chairman of AAIL.