

# Rebound: Model Shadow Stock Portfolio Strongly Up, But Still Playing Catch-Up

By James B. Cloonan

**W**ell, the Model Shadow Stock Portfolio is up 30.1% year-to-date and that is good.

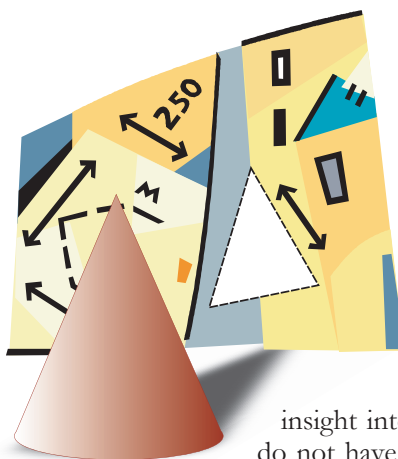
The portfolio is also way ahead of the S&P 500 (as measured by the Vanguard 500 Index fund), which is up 3.0%—and that is also good.

*But* we also have to face the brutality of bear market mathematics: When you are down 50%, you have to go back up 100% just to get to where you were before the bear market hit. And for that, we still have quite a ways to go.

You can view the overall historical record in Figure 1, which shows the cumulative return and compound annual returns for various periods for the portfolio, and Table 1, which provides the entire history of the Model Shadow Stock Portfolio.

## Qualifiers High But Declining

This quarter, we had 26 stock candidates that passed our basic criteria. The number of qualifiers is down from 92 last December, and 87 last March. In contrast, during the



bull market, the number of qualifying stocks averaged about four, and sometimes we had to expand our criteria in order to find stocks to replace those we sold.

Does the number of qualifying stocks that meet our value requirements provide any insight into the stock market's direction? Right now, we do not have enough data to make an informed judgment, but we will continue to monitor it over time.

## Portfolio Changes

Table 2 highlights the activity in the portfolio for the three months ending May 31, 2009.

At the beginning of June we sold five stocks:

- Providence Service Corp. (PRSC) was sold because the price increased so much that it violated our price/book limit (above three times the initial criterion, which is currently 0.80) and became a growth stock. This is the first stock in quite a while that we have sold because it went above our market capitalization or valuation limits.
- Cobra Electronics (COBR), D&E Communications

**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	13.3	30.1	(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)	6.6	3.0	(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)	7.4	6.1	(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)	9.2	1.8	(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 5/31/2009.

(DECC), P&F Industries (PFIN), and SigmaTron International (SGMA) were sold because they were on probation and had an additional quarter of negative earnings.

At the beginning of June, we purchased three new stocks:

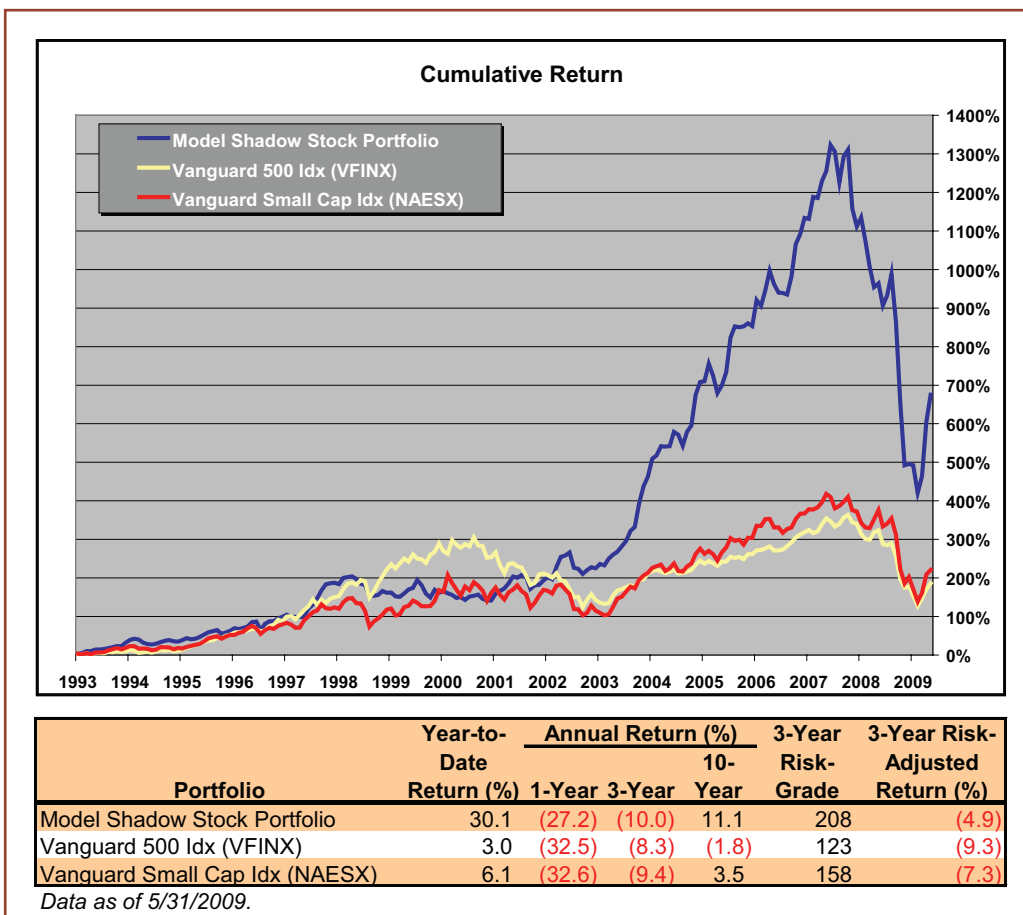
- Alamo Group (ALG), a Seguin, Texas-based firm that manufactures agricultural and roadway maintenance equipment in the U.S. and Europe;
- OYO Geospace Corp. (OYOG), a Houston, Texas-based company that specializes in the seismic instrument and equipment business in the U.S. and internationally; and
- Twin Disc (TWIN), a Racine, Wisconsin-based designer, manufacturer and distributor of power transmission equipment worldwide.

Although we started with 26 candidates, we narrowed the number by increasing our liquidity requirement (see Stock Order Guidance in Table 4) and eliminating stocks that barely qualified or would not qualify based on analysts' estimates of future earnings.

As a final tiebreaker, we looked at our entire portfolio balance and chose sectors that are underrepresented.

If we continue to have such a large number of stocks to choose from, we may change the normal criteria or formalize a tie-breaker system.

**Figure 1. Model Shadow Stock Portfolio vs. Benchmarks (Through 5/31/2009)**



**Table 2. Second-Quarter 2009 Transactions**

Company (Ticker)	Reason
<b>Sell</b>	
Cobra Electronics Corp. (COBR)	negative earnings
D&E Communications (DECC)	negative earnings
P&F Industries, Inc. (PFIN)	negative earnings
Providence Service Corp. (PRSC)	exceeded value limits
SigmaTron International (SGMA)	negative earnings
<b>Buy</b>	
Alamo Group, Inc. (ALG)	
OYO Geospace Corp. (OYOG)	
Twin Disc, Inc. (TWIN)	

**Unsettling Unknowns**

While the stock market and the economy look more stable than they did three months ago, there are still a lot of unknowns out there. Government policy on the automakers is now clear, but how well the industry will do is far from certain.

Housing, while showing signs of stabilization, is still a major problem and mortgage money is still not abundant.

There is more bullish sentiment—but that might not be a good thing.

If the bulls are right, the economy should be looking better by the next Model Shadow Stock Portfolio column in the October *AAIL Journal*. In the meantime, we will update portfolio performance on AAIL.com each month. ▲

**Table 3. 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)	8.50	18.40	3.15	13.1	3.2	0.36	0.0	
Alamo Group (ALG)*	11.34	26.46	9.22	113.1	11.7	0.62	2.1	qualified as of 6/5/09
Allion Healthcare (ALLI)	5.45	7.45	2.60	141.9	11.8	0.82	0.0	
Avalon Holdings Corp. (AWX)	2.56	5.50	0.92	9.7	25.6	0.24	0.0	
Books-A-Million (BAMM)	6.97	8.80	1.70	110.2	9.2	1.05	2.9	
Cascade Corp. (CASC)	24.50	53.76	12.81	265.9	nmf	1.15	0.8	earnings probation (2008q4)
Ennis (EBF)	11.25	19.78	6.91	291.2	nmf	0.99	5.5	earnings probation (2008q4)
Flexsteel Industries (FLXS)	8.01	12.55	4.98	52.7	nmf	0.49	2.5	earnings probation (2009q3)
Greenbrier Companies (GBX)	8.14	26.00	1.86	136.1	25.4	0.60	0.0	
Hastings Entertainment (HAST)	4.16	8.91	1.26	40.5	14.3	0.39	0.0	qualified as of 6/5/09
L.S. Starrett Company (SCX)	8.59	28.50	5.30	57.0	45.2	0.36	5.6	
Marlin Business Servs (MRLN)	4.21	9.33	1.19	53.1	nmf	0.34	0.0	earnings probation (2008q4)
Nu Horizons Electronics (NUHC)	3.66	5.66	1.00	67.8	nmf	0.46	0.0	earnings probation (2009q4)
OYO Geospace Corp. (OYOG)*	24.25	67.85	9.00	144.1	14.4	1.24	0.0	
Paragon Shipping (PRGN)	5.46	21.33	2.25	148.4	2.0	0.45	3.7	qualified as of 6/5/09
RCM Technologies (RCMT)	2.03	4.58	0.77	26.0	nmf	0.43	0.0	earnings probation (2008q4)
Rex Stores Corp. (RSC)	10.57	16.35	5.52	98.3	nmf	0.42	0.0	earnings probation (2008q4)
Saga Communications (SGA)	6.22	26.72	3.00	26.5	nmf	0.40	0.0	earnings probation (2008q4)
Shoe Carnival (SCVL)	13.20	18.45	6.05	170.5	35.7	0.79	0.0	qualified as of 6/5/09
Standard Motor Products (SMP)	6.38	10.02	1.36	120.9	nmf	0.73	0.0	earnings probation (2008q4)
Standex Int'l Corp. (SXI)	10.97	30.00	7.85	135.5	nmf	0.70	1.8	earnings probation (2009q3)
SureWest Communic'ns (SURW)	8.84	18.50	6.20	126.2	147.3	0.47	0.0	qualified as of 6/5/09
Tufco Technologies (TFCO)	3.82	7.49	1.77	16.5	nmf	0.45	0.0	earnings probation (2009q2)
Twin Disc, Inc. (TWIN)*	7.34	23.34	4.02	81.0	5.2	0.69	3.8	qualified as of 6/5/09
Willis Lease Finance (WLFC)	12.51	15.39	7.25	113.8	4.3	0.62	0.0	

\*Company is new to the model portfolio.

Source: AAIL's Stock Investor Pro/Thomson Reuters. Data as of 6/5/2009.

### Explanation of Notes

**Approaching Size Limit:** Stocks are sold if their market capitalization goes above three times the initial maximum criterion. The current market capitalization maximum for initial screening is \$200 million. Stocks are marked "approaching size limit" if their current market cap exceeds 2½ times the initial criterion, or \$500 million.

**Approaching Value Limit:** Stocks are sold once their price-to-book-value ratio goes above three times the initial criterion. The current initial price-to-book ceiling is 0.80. Stocks are marked "approaching value limit" if their current price-to-book-value ratio exceeds 2½ times the initial criterion, or 2.00.

**Currently Qualifies:** Stock still qualifies as a buy when the screen is run with current data. Stocks that don't currently qualify as a buy are held until they meet one of the sell rules.

**Earnings Probation:** 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 becoming positive, the stock is sold. The date within the parentheses lists the fiscal quarter during which the company first reported negative trailing 12-month earnings.

**Not Qualified as a Buy for 2 Yrs:** Stock has not met the buy criteria for over two years and can be sold if cash is needed.

**See the Shadow Stock Portfolio area of AAIL.com for more information.**

**Table 4. 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.

**James B. Cloonan is founder and chairman of AAIL. Cara Scatizzi provided research assistance.**