The growth in value of the Beginner's Portfolio prompts some revisions of the original rules regarding company size, number of stocks held, and reasons for selling.

Dealing With Success: Adjusting Rules to Deal With a Larger Portfolio

By James B. Cloonan

After trailing the large-cap indexes (the Dow Jones industrial average and the Standard & Poor's 500) for the first half of the year, the experimental Beginner's Portfolio caught up in late August, as did many micro-cap stocks. The Beginner's Portfolio, however, attained its return year-to-date (currently 26%) with considerably less volatility than either the Dow or S&P 500.

The run-up of the market has changed the market capitalization of most stocks, and consequently, it has changed the criteria levels for the Beginner's Portfolio. The maximum market capitalization for inclusion in the portfolio has moved from $100 million to $125 million. That means the sell criteria moves to $250 million.

The success of the Beginner's Portfolio has created a bit of a problem. Over the past 4½ years, our original $500,000 has grown to $1,260,000 and it is becoming more difficult to get executions of stock trades with our original plan of having a 25-stock portfolio.

While most of our members would not have over $1 million in a single portfolio of this type, some will, and the ways of dealing with larger portfolio value leads to ways of moving beyond the simple approach of the Beginner's Portfolio.

Some of the ways of coping with larger portfolio value are rather direct. For instance, you could expand the criteria to allow selection of more stocks, increase the number of stocks in the portfolio and thereby reduce the dollars invested in any one stock. Another tactic would be to move from once-a-quarter rebalancing to once-a-month rebalancing and build the position in each stock more gradually.

It is clear that transaction costs, particularly the bid/ask spread, are significant with micro-cap stocks. For that reason, reducing any turnover that isn't necessary will significantly increase returns. On the other hand, because of our effort to be conservative, we sell stocks that have a loss from operations for the previous 12-month period. However, we have noticed that losses of this kind are frequently from a one-time write-down, and the impact of such write-downs is often a long-term positive and the negative price impact has already occurred. As a result, we are changing our sell rule to help reduce transaction costs. A loss over the last 12 months will put the stock on a probationary status, but it will be sold only if the following quarter's results are negative. From then on, a probationary stock is sold only if the 12-month results are negative and the most recent quarter's earnings are also negative. When 12-month earnings return to positive, the stock will be taken off probation.

Another approach would be to loosen some of the criteria to include more stocks and to use subjective and individualized criteria to select stocks for the portfolio. This expands our view and offers the possibility of higher returns with, of course, additional effort. This approach would not only permit larger individualized portfolios, but would reduce competition for the same stocks.

More importantly, with the addition of individual criteria but the maintenance of value constraints, we can move the educational process along to what might be called the Intermediate Portfolio. Note well that while we call it the Beginner's Portfolio because of the simplicity of running it, the portfolio is basically an extreme value, micro-cap index fund. Recent history has shown that while index funds are inherently simple, it is difficult to beat them. In other words, we do not know for sure that adding criteria and working harder will, in fact, raise returns. Some approaches will likely increase returns, others will not.

The work on the Beginner's Portfolio and our observations of the stocks over the last 4¾ years has, I hope, provided some insight into what may or may not improve returns. In any event, we will start working on modifications, but we will continue to maintain the pure Beginner's Portfolio.

We will, of course, keep you informed about the results of our testings.

The Beginner's Portfolio was constructed in January 1993 as an experiment to examine the practical problems of following a small-stock approach. The rules that are used for the portfolio most recently appeared in the June 1997 AAII Journal.

James B. Cloonan is chairman of AAII.