THE AAII BEGINNER'S PORTFOLIO: AN ANNUAL PERFORMANCE REVIEW

By James B. Cloonan

While new Nasdaq rules and the switch to decimal pricing have reduced the spread between the price a buyer is willing to pay versus the price a seller is willing to accept for a particular stock, the spread continues to be significant for smaller-capitalization stocks, particularly those that have low volume.

Every year at about this time, I like to take a look at the "Beginner's Portfolio" to see how it has performed both in absolute terms and relative to the appropriate indexes.

The Beginner's Portfolio is an experimental portfolio of small stocks that we started eight years ago 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.

Our investment approach in the portfolio is based on the historical evidence that small-capitalization stocks, now more commonly called micro-cap stocks, and stocks with low price-to-book-value ratios, have outperformed the market over the long run. It is 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, we have adjusted the guidelines; the rules provided in Table 1 represent our latest ideas for managing such a portfolio. The performance results through the past eight years can be seen in Table 2.

In reviewing the performance of the portfolio, there are a few items of practical concern to any individual trading stocks similar to those that we have picked here.

TRADING VOLUME

The first issue concerns trading volume. While new Nasdaq rules and the switch to decimal pricing have, in my observation, reduced the bid-ask spreads (the difference between the price a buyer is willing to pay for a particular stock and the price a seller is willing to accept for the same stock), the spread continues to be significant for smaller-capitalization stocks. This is particularly true of stocks that have low volume.

While I have in the past suggested avoiding stocks whose trading volume was low, I think that this suggestion needs emphasis. I would avoid stocks whose daily trading volume is not at least four times the size of the position you wish to initiate. In our Beginner's Portfolio rules, we continue to require the bid-ask spread quoted to be 6% of the stock price or less.

Another approach would be to adjust your emphasis slightly. For instance, because there are once again a large number of value stocks in the market, and because there is such a slight difference in many of the price-relative-to-book-value ratios, I would give even more emphasis to trading liquidity. For example, one qualifying stock might have a price-to-book-value ratio of 0.50 and another, 0.55. Strictly adhering to the Beginner's Portfolio rules, we would choose the 0.50 stock. But since this difference is so slight, I would go with the 0.55 price-to-book-value ratio stock if it had twice the daily trading volume of the 0.50 stock.

If you want to quantify this, I would first eliminate a stock if the trading volume were not four times the position you want. Second, until trading volume is 10 times the size of your intended position, I would choose the higher trading volume stock if its price-to-book ratio has a disadvantage of

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TABLE 1.
BEGINNER'S PORTFOLIO RULES

PURCHASE AND SALE 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 0.60. (This figure will change gradually with changes in overall market values.)
- Market capitalization must be between $17 million and $125 million (will also change).
- 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.
- 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 first item under stock order rules concerning spreads when buying shares.
- Price-to-sales ratio must be less than 1.00.

Stocks are sold if any of the following occurs:

- If last 12 months' earnings 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 stock's price-to-book-value ratio goes above 2½ times the initial criterion.
- Market capitalization goes above 2½ times the initial maximum criterion.

STOCK ORDER RULES

- If the quoted bid-ask spread is more than 6% (ask price minus bid price, divided by asked price), the stock is eliminated from consideration. Better to stretch other criteria, if necessary, than pay high spreads.
- Stocks are eliminated if the average daily number of shares traded is not four times the amount needed for the position, since the spread will be too high and not negotiable either now or when sold.
- 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 ask 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, it is placed again in a few days with a slight adjustment. In NYSE and Amex stocks, good-till-canceled (GTC) orders are used to keep place in line in the specialist's books. If market isn't close to desired price, it 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 cancelled.

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, quarterly reviews are made early in February, May, August, and November.
- 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, the excess receipts—up to 5% of portfolio value—are kept in cash until 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 market capitalization screen may be moved 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, purchases are made in order of lowest price-to-book-value ratio in amounts equal to the average holding.
- Note that if you are managing your own portfolio, it should consist of at least 10 stocks. More than 20 stocks are not needed until the portfolio exceeds $1 million.

less than 10%. For example, if Stock A has a price-to-book-value ratio of 0.50 and an average daily trading volume of four times your intended position, and Stock B has a price-to-book ratio of 0.54 with a trading volume of six times your intended position, I would choose Stock B since there is less than a 10% difference between 0.50 versus 0.54.

If stocks under consideration have a daily trading volume of 10 times your intended position, then go back to a pure price-to-book-value ratio decision criteria—assuming all the other criteria are met.

ADJUST THE SCREENS

Another factor operating in the market is that in order to get a workable number of stocks to consider, you may have to tighten your initial price-to-book screen. The previous 0.85 criteria may give you far too many stocks. On our last quarterly revision, we tightened the initial screen to 0.60 to get down to 35 stocks.

In other words, as the market changes, the initial screen can be adjusted to produce a workable number of choices to evaluate.

TABLE 2.
BEGINNER'S PORTFOLIO VS. PASSIVE PORTFOLIOS
NINE-YEAR PERFORMANCE AND RISK (1993–2001)

	Annual Return (%)			
	Beginner's Portfolio	S&P 500 Index*	Russell 2000*	Micro Caps*
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
1998	–8.9	28.6	–2.6	–14.3
1999	0.0	19.5	19.6	29.8
2000	–7.9	–10.1	–4.2	–3.6
2001 (six months)	31.4	–6.8	7.4	15.0
9-Year Annualized Rate of Return (%)	13.7	13.9	11.6	13.5
9-Year Annual Volatility (Risk)** (%)	18.3	16.4	11.7	15.1
Risk/Reward Ratio***	0.555	0.613	0.614	0.564

**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.*
****As measured by the Sharpe ratio—how much excess return (return above Treasury bills) is generated for each unit of risk; the higher the number, the better the returns relative to 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.

SMALL CAPS: COMEBACK KIDS

In the past, when small-cap stocks underperformed for the maximum amount of time (three years) historically and then came back, they maintained their advantage for quite some time. While nothing ever repeats exactly, it would seem that small stocks have an excellent chance of performing well over the next few years, since they have outperformed large caps for the past one and a half years.

I always emphasize, however, that the individual investor should diversify among large-cap and small-cap equities. ✥

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Use the Search tool to review past articles that reported on the Beginner's Portfolio and other related articles such as:
- "A Lifetime Strategy for Investing in Common Stocks"
- "Using Price-to-Sales Ratios to Screen for Out-of-Favor Stocks"

Go to the Stock Screens area under Tools on the left-hand side of the home page for other small-cap stock screens:
- 2001 Shadow Stock screen
- Ralph Wanger screen

Use the Quotes & Research section to check bid and ask prices and volume, as well as news on stocks you are considering.