# A Matter of Opinion

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## Shadow Stocks......

Over recent years there have been a number of intensive studies, and some casual ones, relating to increased performance (yields) of some category of stock versus the market in general. Some of these studies have been very well validated and others have been partially indicative. The results indicate that either security markets are not highly efficient or that the past definition of "highly efficient" is missing some ingredient. The difference is philosophic. The reality is that certain approaches to choosing stocks (not short-term timing approaches) produce better results than dart throwing and do so over long periods of time.

The problem in identifying the criteria for a better selection stems from the fact that many of the methods overlap one another and it is difficult to ascertain the important characteristic. For example, early casual studies indicated that low priced stocks did better than average, but the Small Stock Effect, which we have discussed extensively, encompasses a large number of low priced stocks, and company size seems to be more important. Following the studies of small (I hate the word small when applied to companies with market value of 25-100 million dollars) stocks came investigation of "neglected companies"—those which are not covered by professional analysts. It should come as no surprise that a large proportion of neglected companies are also small, but neglect did not account for all of the impact produced by the Small Stock Effect. In addition, neglect did not include the evaluation effect that might be caused by institutional holdings.

Evaluation approaches that utilize P-E ratios have produced at least some evidence of excess yields, but most of this effect is explained by the Small Stock Effect or neglect. There has been some evidence that "new issues" perform better than seasoned issues, but this evidence is for a short period of time and it appears that the Small Stock Effect may account for the difference in performance.

Sorting through all of the existing evidence, a picture emerges of a class of stock that, *if combined in a diversified portfolio*, will produce not only higher than average *total yield*, but a yield significantly higher than any increased risk would justify. Because the characteristics of such a company and its stock encompass several previously studied characteristics, we have coined a new descriptive phrase, "Shadow Stock".

*Shadow Stocks* as a group have the following characteristics:

1). They are relatively small compared to giant corporations, but are large enough to be clearly developed. Our best size estimate is a market value (shares outstanding x price) of between \$25 and \$100 million. A further refinement would be to examine them by their relative size in their industry, rather than comparing them to all corporations.

2). They are not well researched by professional analysts. This characteristic is measured by two indicators: the number of analysts providing financial projections and institutional holdings.

3). Inefficiencies in market pricing operate in the right direction—they are underpriced rather than overpriced. Some evaluation of P-E ratios, either current or future, is necessary to eliminate the overpriced stocks.

In short, *Shadow Stocks* are those whose companies are of a size that permits dramatic growth, those that are not well researched by the professionals and those whose neglect has led to *underpricing*.

It is our opinion that individual investors can increase the yields of their portfolios to well above the yields of the various indices by reducing the universe of stocks down to *Shadow Stocks* and then selecting a diversified portfolio (10-20 stocks) from among them by a more in-depth analysis oriented at trying to choose those whose past history and present position indicate they have the greatest chance of realizing their growth potential.

The above approach is not without its problems. The size and neglect characteristics mentioned above mean that the stocks you should be choosing are the ones that will not be covered in depth in the more popular services. By and large, you will be looking at companies which would rank from 1200-2500 in market value on a list of U.S. Corporations.

*M/G Market Data Graphics* does provide number of shares, price and institutional holdings, together with other information on a single line of data which could be used for initial screening. The S&P Stock Guide also provides this information, but with 5000 stocks there are a number of companies below the top 2500 that would have to be checked.

Following an initial screen, a trip to the library or a broker's office is probably necessary for detailed information on the remaining companies. A lot of work—but we never said it would be easy, and the various studies indicate that the real (after inflation) yields could be double those of the stocks contained in the popular indices.