If you want to do it yourself

By James B. Cloonan

In past articles, I suggested that with the higher total cost of using a mutual fund, some investors that were on the fence might be better off by taking the next step and managing their own portfolio. For individuals without a portfolio value large enough to diversify, mutual funds are essential. But for those who are able to purchase enough stocks to have a diversified portfolio, self-management may make sense. How many stocks are "enough"? Somewhere between 10 and 20 stocks is sufficient. With Shadow Stocks, closer to a minimum of 20 might be best. Sophisticated diversification models are not necessary, but investors should avoid owning stocks that are similar in industry or cyclical tendencies.

Regardless of portfolio size, those individuals who do not have the time or interest to choose their own stocks shouldn't bother. There is always a trade-off to be considered. Most no-load mutual funds will have total costs of less than 2%. An individual with a $120,000 portfolio may pay about $2,000 a year in expenses and fees to a fund. If it takes four hours a week to handle your own portfolio, that comes to 200 hours to save $2,000. You must consider the value of your time, and a major consideration will be whether you enjoy the investing effort. Also, remember that the $2,000 saved in the above example may be aftertax income based on the new tax laws.

Many members have asked me where to start. Even if you decide to go with Shadow Stocks, there is a big gap between the universe of 500 stocks and the selection of 20 (a good minimum) to 50 (a maximum, practically speaking, unless the portfolio is extremely large).

Selecting stocks that will outperform the market is a difficult task. Only about one-third of the mutual fund managers succeed in outperforming the S&P 500 in any period. For learning purposes, I have decided to develop a portfolio from the Shadow Stocks but based on some general, rather than personal and judgmental, criteria.

By general criteria, I mean well-defined measures that are available from an annual report, 10-K, statistical service, or the newspaper. By personal and judgmental, I mean unmeasurable analyses such as: How good is their advertising, do I like the approach of management, or is there a future for this kind of product? I am doing this to get a feel for the practical aspects of managing such a portfolio, and I will share these experiences with you.

I am taking the posture that:

- This money can be committed to the stock market for the long-term (over five years);
- While I am committed to the Shadow Stock concept, I want to be a little on the cautious side;
- I have other savings in safe investments to meet emergencies, and the Shadow Stock portfolio includes only the appropriate portion of my assets.

A number of preliminary screens come to mind, but I decided on the following—at least as a beginning. The stocks must:

- Be on the Shadow Stock list;
- Have positive earnings for the past three years (a year longer than the basic Shadow Stock requirement);
- Be listed on the New York Stock Exchange, the American Stock Exchange, or NASDAQ national list;
- Pay a dividend;
- Not be an oil and gas or other partnership depository;
- Have a share price greater than $8.00 to avoid high-percentage bid/ask spreads;
- Not be in the top 25% in terms of price-earnings ratios; and
- In addition, there will be some practical eliminations based on executions, typical bid/ask spread, and liquidity.

As I go about developing this portfolio of about 50 stocks, I will discuss the problems of when to drop a stock, balancing the amount invested in each stock, and other practical problems, such as record-keeping and evaluation. I will also share the reasons for rules. Because I want this to be an example of techniques and problems, I intend to share insights. Because I don't want this to be an advocacy, I won't share the names of the stocks selected.

There is nothing major about the approaches taken. It will be interesting to check the performance of a rather simple approach. I would always hope that an individual using personal and judgmental criteria and not necessarily general criteria could do better. The approach is only a starting point.

James B. Cloonan is president of the AAII. His column is his own opinion and does not necessarily reflect the position of the Journal.