The guidelines for the Practical Portfolio

By James B. Cloonan

Last month I announced I would begin investing in a portfolio of stocks with a set initial amount ($250,000). I am doing this to examine and discuss the practical problems of choosing stocks and managing a portfolio.

In choosing stocks for the portfolio, I started with the AAII Shadow Stocks, but I then reduced the number of issues by making some assumptions about what type of investor I wanted to represent. In this case, I am assuming a more conservative investor, and so I eliminated stocks with very high price-earnings ratios and stocks that do not pay cash dividends. In addition, some practical rules have been added to reduce transaction costs: I have eliminated low-priced stocks and will limit transactions to a minimum of 200 shares.

This is really only a first-stage portfolio. All of the criteria are quantitative, and the information necessary to evaluate the criteria is easily available. There is no qualitative research—no study of the company or management, and no personal judgment. I certainly hope that those investors with the time to evaluate qualitative corporate data or more difficult-to-obtain quantitative information would do better. However, I feel that this first-stage effort is a solid basic approach that an individual could start with before becoming more sophisticated. Most of all, it will provide a chance to discuss all of the everyday problems that occur in managing a stock portfolio.

I am also operating on the assumption that the investor is busy. Thus, the portfolio will only be reviewed once a month, presumably in two to four hours over a weekend. A more thorough analysis will be required once a year. New companies will only be added at the annual evaluation.

A summary of the guidelines are shown in Table 1 on the next page. I have purchased no stocks as yet because I had not spelled out all of the rules. I missed a lot of profit by not starting January 1, but I'm more interested in the portfolio's performance relative to the market. I will begin soon and, as mentioned last month, will share procedures and progress but not the individual stocks, because the focus is on the procedures and problems, and not on specific stocks.

James B. Cloonan is the president of AAII. His column is his own opinion and is not necessarily the Journal's.

Table 1. Rules for the Practical Portfolio

Initial purchase requirements	Sell rules (Evaluation period*)
1. Market value between $20 million and $100 million	If drops below $15 million or rises above $200 million (A)
2. Low institutional holding	Don't sell existing shares on this criteria alone
3. Positive earnings for past two years	Negative earnings for past year (A)
4. Minimal analyst interest	Don't sell existing shares on this basis alone
5. Listed on exchange or national NASDAQ list	Sell if delisted (M)
6. Pays annual dividend	Sell if ceases to pay dividends (A)
7. Not a partnership depository	—
8. Price greater than $8/share	If drops below $8/share, don't buy more but don't sell existing shares on this basis alone
9. P/E ratio not in top 25% of stocks that have passed the above criteria	Don't purchase more stock if P/E rises to top 25%; sell existing shares if moves into top 10% (A)
10. Reasonable execution costs**	Don't purchase more shares but don't sell existing shares on this basis alone **Also**: Sell existing shares at bankruptcy or merger (M)

*A = Make any change only at annual evaluation.
M = Make any change at monthly evaluation.

**I'll discuss this problem and the experiences I run into as this series continues.

Portfolio management rules

1. Buy minimum of 200 shares at a time.
2. Initially buy 400 shares of stocks priced under $15/share, 300 shares of stocks between $15/share and $22/share, and 200 shares of stocks above $22/share.
3. Try to balance dollar amounts equally among stocks within the 200 share minimum transaction guideline. However, never sell shares simply to balance the portfolio, but do balance the portfolio with new share purchases.
4. Reinvest dividends and the proceeds of sales and keep cash balances in a money market fund until reinvested.
5. Portfolio's initial value is $250,000; no additional funds will be added, but dividends, interest, and capital gains will be reinvested.