Thinly Traded Stocks: Putting a Practical Approach to the Test

By James B. Cloonan

For some time now, I have wanted to run an actual small stock portfolio that consists of a limited number of less frequently traded stocks, so that I could share with you the problems of dealing in thinly traded stocks.

What is my purpose? The research conducted by Professors Fama and French (Journal of Finance, June 1992), discussed in this column in the September 1992 issue, seemed very persuasive to me, but I feel the need to test it in a small portfolio. Such a test also presents the opportunity to examine the practical problems of following a theoretical approach in the real world of wide bid/ask spreads, thin markets, and partial executions.

As you will recall, the research, based on data covering the years 1963 through 1990, showed that the smaller the market capitalization of a company, the higher its stock returns. In addition, the lower the ratio of market price to book value, the higher the returns. The highest returns came from those stocks that were in the lowest decile of market capitalization and the lowest decile of price-to-book ratios.

My objective became to construct a portfolio of stocks from the 1% of stocks that were in both desirable deciles (10% of 10%).

There are some immediate limitations on the stocks that must be considered in any practical application. For instance, the Fama-French study eliminated financial institutions because so many of the variables examined have a different significance in financial institutions, making comparisons to other non-financial firms invalid. AAII eliminates financial firms in the Shadow Stock series for similar reasons. In addition, since certain information is necessary, stocks must be listed on an available database that has that information.

I also felt the need to impose some additional criteria. Early research on small cap stocks was done on stocks listed on the New York Stock Exchange. While I believe that the base should be expanded to include the American Stock Exchange and NASDAQ stocks, I feel that the most important NYSE listing requirements should be imposed on all stocks under consideration. I also feel that it is important to eliminate stocks that are in danger of being delisted since, in a practical portfolio, turnover must be kept low.

As a consequence of these limitations, the initial stocks chosen for this portfolio have a market capitalization of more than $10 million and are currently profitable. Because of the impact of the bid/ask spread, I found it impractical to buy stocks with prices less than $4.00. Given the initial requirements that the stocks be in the lowest decile of market capitalization and the lowest decile of price-to-book ratios, that currently means a price-to-book ratio of lower than 0.61 and market capitalization less than $55 million.

In the original study, Messrs. Fama and French recalculated their portfolio annually. However, this is not very practical, and I will not eliminate stocks until they exceed the boundaries significantly. Newly qualifying stocks will be purchased as funds become available.

The portfolio will start with about 25 stocks. Using only the best deciles, which leads to limiting consideration to 1% of a 4,000 stock database, this approach would not be practical for a mutual fund or other large portfolio. It may turn out that using lower cutoffs (top fifths or thirds instead of deciles), as is done in most small cap funds, is more practical because of liquidity and transaction costs. I decided to test the extremes and later compare results with those using less restrictive cutoffs.

My intention would be to equally weight all stocks, but this can't be achieved perfectly because sometimes a partial execution will drive the price up and it may no longer qualify for inclusion at the higher price.

The project is under way, and I will discuss practical problems and some solutions, as well as results, from time to time in this column.

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