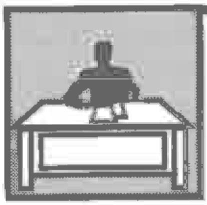

A Matter of Opinion

The Beginner's Portfolio had beginner's luck. However, it is not intended to be your adviser, but rather to show how a portfolio can be managed following consistent rules.

The Beginner's Portfolio: A Performance Review

By James B. Cloonan

I now have a full year's experience with what I am going to call the Beginner's Portfolio. It is a beginner's portfolio only in the sense that the rules are easy to follow and, since it is examined only quarterly, it takes very little investor time.

The portfolio rules are based on the most persuasive academic theory and on practical rules that have been well-tested. These rules are quantitative rules and thus stock selection can be easily carried out from a database. In my heart I feel that individuals with time can look at qualitative variables to choose the best stocks from among those selected by quantitative screens.

The Beginner's Portfolio had a total return of 32.3% for 1993. For new members, I should point out that this is a real portfolio and the yield is net of all commissions and other costs.

Certainly the Beginner's Portfolio had some beginner's luck and I would not expect this portfolio, based on the historical performance of its theoretical base, to outperform the market by such an amount on a regular basis.

The portfolio began January 1, 1993, with 24 stocks (see my August 1993 column) and wound up with 24. Ten stocks were sold and replaced with others and two more are being sold at this time. Eleven of the 12 stocks were sold because their 12-month earnings went negative and one was sold because its market capitalization went to more than twice my criteria.

Commissions, from a deep discount broker, came to about half of 1% of portfolio value. Three of the stocks more than doubled and five were up about 50%.

The Beginner's Portfolio rules as followed are listed in the accompanying tables. There are a few adjustments that I suggest:

- The original rules stated that when a company has a loss for the trailing 12 months, it is to be sold; I have modified this to negative earnings from operations. I do not sell based on one-time write-downs because the damage is already done and may not impact future performance.
- As the market has increased in value, the cut-off points for price-to-book-

Rules for Building and Maintaining the Test Portfolio

Stock purchases must meet these criteria:

- Price-to-book-value ratio is less than 0.61*
- Market capitalization is between $11 million and $55 million*
- The firm's last quarter and last 12 months earnings were positive
- No financial stocks or limited partnerships will be purchased

Stocks are sold if any of the following occurs:

- Last 12 months earnings are negative
- The price-to-book-value ratio goes above 1.2
- Market capitalization goes above twice the initial criteria
- Sell part of holding if it exceeds two times the average holding, and funds are needed to buy other stocks that meet the purchase criteria

Stock Order Rules

- Market orders are not used. Instead, orders are placed between the bid and ask prices unless the difference between the two is 3/8 or less, in which case purchases are placed at the offer price and sales are placed at the bid price
- Unfilled orders should be adjusted after a week, but the original purchase criteria should not be violated
- If price changes cause a stock to become ineligible (due to changes in price-to-book-value ratio and market capitalization) when only part of the order has been filled, keep what is already purchased and cancel balance of order

**Will change gradually with overall market value*

(continued on p. 24)

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

Rules for Building and Maintaining the Test Portfolio (continued)

Portfolio Management Rules

- Decisions are made only at the end of each quarter
- 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, keep the excess receipts—up to 5% of portfolio value—in cash until next quarter. If the excess receipts are greater than 5% of the total portfolio value, distribute the amount above 5% to smaller holdings that still qualify as buys. Buy in efficient quantities
- At end of quarter, if receipts from stocks sales are insufficient to buy all newly qualifying stocks, buy in order of lowest price-to-book-value ratio in amounts equal to the average holding. Also, if any existing holding is twice the average, sell shares until the holding is down to average and use the receipts to buy qualifying stocks
- The share price is greater than $4

value ratio and market capitalization must move upward. For a new portfolio, these will be about 0.68 for the price-to-book-value ratio and $63 million for market capitalization. However, rather than use completely static numbers, I suggest starting with a 0.61 price-book-value ratio and $55 million in market capitalization and expanding these gradually if you are not selecting enough stocks.

For those with time, I suggest generating a pool of stocks with price-to-book-value ratios less than 0.80 and market capitalization under $90 million, and then using your own criteria and analysis to choose the final portfolio. The Beginner's Portfolio is not intended to be your adviser, but rather to show how a portfolio can be managed following consistent rules and with not much more effort than selecting mutual funds.