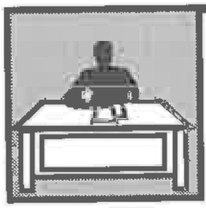

A Matter of Opinion

The purpose of the portfolio was to study processes and to show that a consistent approach could be followed without great time requirements—and the results show promise.

A Closer Look at the Beginner's Portfolio: Interesting Side Benefits

By James B. Cloonan

We began the Beginner's Portfolio 2½ years ago not to prove any one theory of investing, but to show that a consistent approach could be followed without great time requirements. We also wanted to examine and share the problems and procedures of managing a portfolio of small stocks.

Our approach was based on historical evidence that small-capitalization stocks (these are now more commonly called micro-cap stocks) and stocks with low price-to-book ratios outperformed the market over the long run. It was also based on the belief that a portfolio could be managed by making adjustments only once a quarter.

Based on practical experience in the handling of our portfolio (it is a real portfolio), we have adjusted the guidelines; the rules provided below represent our latest ideas for managing such a portfolio. As you know (from my previous reports) the portfolio had a return of 32.2% in 1993 and 2.0% in 1994. It is ahead 5.4% through the first four months of 1995.

The purpose of the portfolio was to study processes and not to be an advisory letter. Because of this, we have not listed the stocks as we purchased them, although any one with a database could have screened using our rules and come up with approximately the same selections.

At this time, I thought it would give a feeling of reality to the process if we showed the stocks bought, sold, and currently held. They are presented in the tables on the following pages.

One interesting point to note is the side-benefit to the way stocks are sold in the portfolio. Most stocks are sold because they had negative earnings; the only winners that are sold are those that have gone up enough to double the size or price/book criteria. As a result, losses are taken and most profits continue to run.

This provides a beneficial tax effect—realizing losses but deferring most gains. As you can see from the table, although the portfolio is ahead about $215,000, taxes have been deferred on $120,000. I would estimate over the long term that the return on the portfolio will be derived from about 40% short-term gains and dividends and 60% long-term capital gains, with the gains deferred two to three years on average.

We did not tax manage the portfolio, but individuals might want to adjust the timing of sales a bit to make losses short-term and gains long-term. However, I emphasize the words "a bit": A slight variation makes sense, but don't defeat the approach by focusing too much on tax consequences.

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Beginner's Portfolio Rules

Stock purchases must meet these criteria:

- Price-to-book-value ratio is less than 0.65. (This figure will change gradually with overall market value.)
- Market capitalization is between $11 million and $60 million (will also change).
- The firm's last quarter and last 12 months' earnings from continuing operations were positive.
- No financial stocks or limited partnerships will be purchased.
- The share price is greater than $4.
- In order to reduce turnover by avoiding stocks that are forever marginal, do not re-buy a stock you have sold within two years.
- Note first item under stock order rules concerning spreads when buying shares.

Stocks are sold if any of the following occurs:

- Last 12 months' earnings are negative.
- The price-to-book-value ratio goes above two times the buy criteria.
- 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

- If the quoted bid-asked spread is more than 8% (asked price minus bid price, divided by asked price), eliminate the stock from consideration. Better to stretch other criteria, if necessary, than pay high spreads.

The Beginner's Portfolio
Realized Capital Gains

Ticker Symbol	Company (Exchange*)	Sales ($)	Cost ($)	Gain (Loss) ($)
AALR	Advanced Logic Research (NM)	10,920	19,080	(8,160)
AELNA	AEL Industries Cl A (NM)	16,601	20,295	(3,694)
ALR	Allied Research Corp. (AM)	14,880	19,120	(4,240)
BFRS	Ben Franklin Retail (NM)	26,150	24,475	1,675
BRCK	Brock Candy Cl A (NM)	49,003	22,560	26,443
CUC	Culbro Corp. (NY)	21,487	22,025	(538)
DTSI	Datron Systems (NM)	13,440	16,970	(3,530)
EDO	EDO Corp. (NY)	47,634	41,884	5,750
ELDC	Eldec Corp. (NM)	48,100	20,470	27,630
FBD	Fibreboard Corp. (AM)	66,923	21,075	45,848
FSM	Foodarama Supermarket (AM)	19,099	20,875	(1,776)
GMN	Greenman Brothers (AM)	29,677	19,260	10,417
HAI	Hampton Industries (AM)	21,763	18,090	3,673
KHLR	Kahler Corp. (NM)	29,680	20,670	9,010
LDIC	LDI Corp. (NM)	11,190	22,560	(11,370)
LUR	Luria (L) & Sons (NY)	20,937	21,225	(288)
MSM	Motts Holdings (AM)	12,660	20,213	(7,553)
NUCM	Nuclear Metals (NM)	23,732	22,220	1,512
NYCO	NYCOR (NM)	10,920	22,080	(11,160)
ORBT	Orbit International (NM)	21,203	24,173	(2,970)
PCR	Perini Corp. (AM)	34,486	42,138	(7,652)
RHCI	Ramsay Health Care (NM)	27,920	20,370	7,550
REXN	Rexon (NM)	30,130	20,745	9,385
SCRB	Sea Containers Cl B (NY)	21,974	24,650	(2,676)
SIF	SIFCO Industries (AS)	18,039	18,900	(861)
CHM	Specialty Chemical (AM)	17,977	23,900	(5,923)
TOD	Todd Shipyards (NY)	25,662	20,775	4,887
UNV	Unitel Video (AM)	21,763	24,849	(3,086)
USCL	USA Classic (NM)	27,390	25,548	1,842
VLGEA	Village Super Market (NM)	18,690	19,370	(680)
		760,030	680,565	79,465

*Key to Exchanges: AM = American Stock Exchange NY = New York Stock Exchange NM = Nasdaq National Market NS = Nasdaq Small Cap

- Market orders are not used. Instead, orders are placed between the bid and ask prices unless the difference between the two is 4% or less, in which case purchases are placed at the offer price and sales are placed at the bid price.
- Unfilled orders on exchange-listed stocks should be adjusted after a few days. In the over-the-counter market,
- If price changes cause a stock to become ineligible (due to changes in price-to-book-value ratio or market capitalization) when only part of the order has been filled, keep what is already purchased and cancel balance of order.

Portfolio Management Rules

- Decisions are made only at the end of each quarter. In order to react to the majority of earnings reports as early as possible, consider doing the quar-

The Beginner's Portfolio
Unrealized Capital Gains

Ticker Symbol	Company (Exchange*)	Sales ($)	Cost ($)	Gain (Loss) ($)
AI	Arrow Automotive Industries (AM)	26,875	25,400	1,475
AWS	Alba-Waldensian (AM)	25,470	19,913	5,557
ALGH	Allegheny & Western Energy (NM)	34,075	19,870	14,205
ASTR	Astrosystems (NM)	23,375	23,485	(110)
CAO	Carolina Freight (NY)	20,988	21,300	(312)
CIS	Concord Fabrics Cl A (AM)	26,400	18,600	7,800
CUO	Continental Materials (AM)	19,400	19,275	125
DRSA	Diagnostic Retrieval Cl A (AM)	24,750	22,073	2,677
DYA	Dynamics Corp. (NY)	34,500	19,213	15,287
EEI	Ecology & Environment (AM)	16,000	18,513	(2,513)
FSCR	Federal Screw Works (NM)	19,250	11,810	7,440
GBCT	GBC Technologies (NM)	13,475	17,660	(4,185)
LIBHA	Liberty Homes Cl A (NM)	20,938	23,810	(2,872)
MARSA	Marsh Supermarkets Cl A (NM)	19,125	21,210	(2,085)
METHB	Methode Electronics Cl B (NM)	21,600	21,060	540
MOGA	Moog Inc. Cl A (AM)	34,800	20,225	14,575
NOLD	Noland Co. (NM)	23,238	17,420	5,818
OHCA	Oriole Homes Cl A (AM)	14,700	21,338	(6,638)
OLGR	Oilgear Co. (NM)	24,000	19,270	4,730
PWRR	Providence & Worcester Rail (NM)	22,425	19,560	2,865
SBS	Salem Corp. (AM)	51,188	20,188	31,000
SCRB	Sea Containers (NY)	21,350	20,725	625
SEWY	Seaway Food Town (NM)	29,000	20,060	8,940
SNSTA	Sonesta Int'l Hotels Cl A (NM)	33,500	20,620	12,880
SWH	Spaghetti Warehouse (NY)	17,325	19,899	(2,574)
TCII	TCI International (NM)	19,250	19,758	(508)
TLX	Trans-Lux (AM)	23,288	25,731	(2,443)
TNZA	Tranzonic Co. Cl A (AM)	22,875	19,650	3,225
WSOB	Watsco Inc Cl B (AM)	29,200	24,875	4,325
		712,360	592,511	119,849

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terly reviews early in February, May, August, and November. Be consistent.

- 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. If over 10% of portfolio is in cash, move the market cap screen up a bit (for instance, from $60 million to $64 million) to find new qualifying stocks.
- 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.