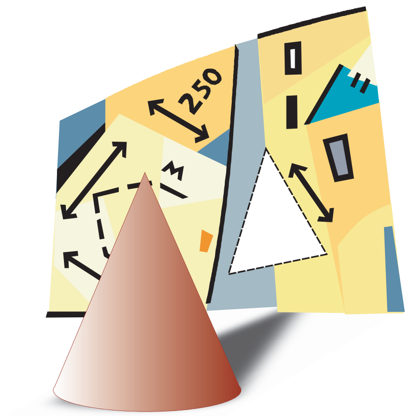
Model Shadow Stock Portfolio: Three New Stocks Added

By James B. Cloonan



Large growth stocks continue to lead the market.

As of August 31, the year-to-date return for the S&P 500 index, as measured by the Vanguard 500 Index fund (VFINX), leads that of the Model Shadow Stock portfolio, 11.8% to 4.8%.

The longer-term performance can be viewed in Figure 1 and Table 3.

Portfolio Changes

Table 1 lists the stocks currently in the Model Shadow Stock Portfolio, and Table 2 summarizes the changes made during the quarterly portfolio review.

Ultra Clean Holdings Inc. (UCTT) continued to exceed the 3.0 price-to-book limit. But this quarter there were qualifying stocks to replace it, so Ultra Clean Holdings was sold.

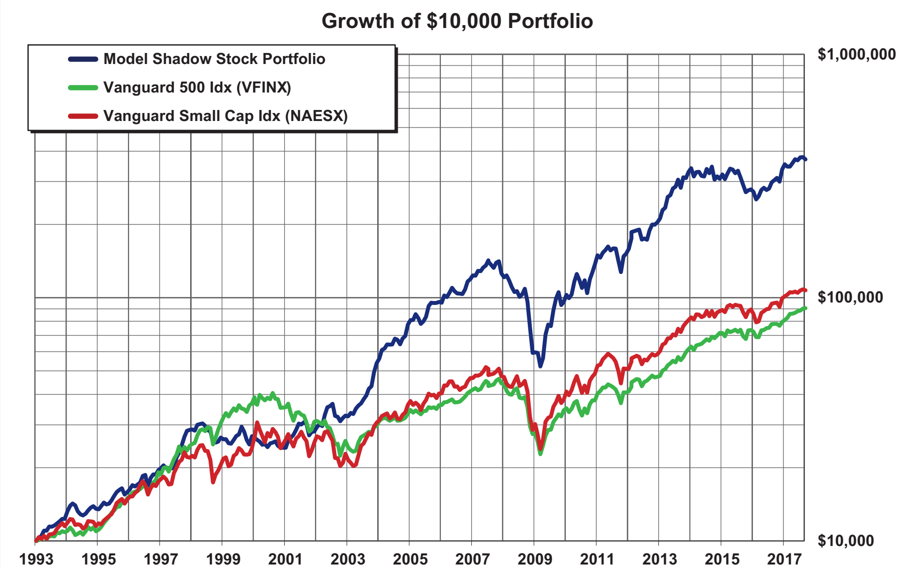
There were six non-Chinese stocks that passed our screen. Two of them were already held in the portfolio. Another one did not qualify since it is basically a lending facility and financial stocks are not purchased under the portfolio rules. That left three stocks. Fortunately, Ultra Clean Holdings had tripled in price since being added to the portfolio, so the funds to buy all three were available.

The three new additions are:

- Amira Nature Foods Ltd. (ANFI),
- Delta Apparel Inc. (DLA) and
- Strattec Security Corp. (STRT).

(continued on page 36)

Figure 1. Model Shadow Stock Portfolio vs. Benchmarks (Through 8/31/2017)



Portfolio	Year-to-Date Return (%)	Annual Return (%) 1-Year	3-Year	10-Year	Since Inception	Ann'l Std Dev (%)
Model Shadow Stock Portfolio	4.8	21.7	2.3	10.8	15.8	16.1
Vanguard 500 Index (VFINX)	11.8	16.1	9.4	7.5	9.3	10.0
Vanguard Small Cap Index (NAESX)	5.8	12.7	6.8	8.2	10.0	12.5

Data as of 8/31/2017.

Table 1. Model Shadow Stock Portfolio

Company (Ticker)	Current Price ($)	52-Week High ($)	52-Week Low ($)	Market Cap ($ Mil)	P/E Ratio (X)	P/B Ratio (X)	Div Yield (%)	Notes
Alamo Group, Inc. (ALG)	91.76	95.62	58.30	1,044.8	23.5	2.51	0.4	approaching size & value limit
Amira Nature Foods Ltd. (ANFI)*	5.33	8.60	4.50	209.1	6.4	1.02	0.0	
AV Homes Inc. (AVHI)	15.45	20.50	14.65	338.0	12.1	0.76	0.0	
Beazer Homes USA Inc. (BZH)	14.91	16.47	9.67	494.7	nmf**	0.74	0.0	
CPI Aerostructures Inc. (CVU)	8.70	10.15	5.55	76.1	13.1	1.09	0.0	
CSS Industries Inc. (CSS)	26.78	29.18	23.16	244.7	9.9	0.85	3.0	
Delta Apparel, Inc. (DLA)*	19.62	23.47	14.85	145.7	14.5	0.94	0.0	qualified as of 8/31/2017
Ducommun Incorporated (DCO)	27.50	35.58	18.70	313.8	22.8	1.41	0.0	
Ennis, Inc. (EBF)	19.10	19.85	14.40	484.2	17.8	1.93	4.2	
Flexsteel Industries Inc. (FLXS)	45.50	62.99	39.98	356.1	15.1	1.54	1.8	
Global Power Equip*** (GLPW)	2.75	5.40	1.85	49.0	nmf	nmf	nmf	no longer exchange listed
Hallador Energy Co. (HNRG)	5.80	10.40	5.35	170.8	21.3	0.76	2.8	
Hardinge Inc. (HDNG)	13.69	14.85	8.24	177.0	65.4	1.07	0.6	
Hooker Furniture Corp. (HOFT)	40.25	46.60	23.17	459.6	17.0	2.30	1.2	
Key Tronic Corp. (KTCC)	7.11	8.20	6.69	75.4	13.8	0.66	0.0	
Kimball Electronics Inc. (KE)	19.05	20.30	11.54	506.8	15.4	1.50	0.0	
PC Connection, Inc. (CNXN)	25.51	30.48	22.31	672.6	14.4	1.49	0.0	
PCM Inc. (PCMI)	13.15	31.20	11.80	161.2	10.3	1.18	0.0	
R C M Technologies (RCMT)	5.39	7.23	4.51	66.1	103.1	2.00	0.0	
RCI Hospitality Holdings (RICK)	23.30	26.85	10.75	222.9	20.9	1.66	0.5	
Renewable Energy Group (REGI)	12.10	13.39	7.91	468.1	nmf**	0.83	0.0	
REX American Resources (REX)	86.62	107.87	76.10	593.0	16.8	1.66	0.0	
Roadrunner Transportation (RRTS)	7.47	11.88	6.05	282.6	11.4	0.46	0.0	
Rocky Brands Inc. (RCKY)	12.90	15.70	9.95	97.9	34.8	0.70	3.4	qualified as of 8/31/2017
Salem Media Group Inc. (SALM)	6.05	8.25	5.00	160.6	21.2	0.73	4.3	
Seneca Foods Corp. (SENEA)	29.80	42.65	27.03	288.0	25.0	0.68	0.0	
Shoe Carnival, Inc. (SCVL)	20.10	31.79	15.08	283.4	16.9	na	1.5	
SigmaTron International (SGMA)	8.42	8.65	4.01	35.7	25.3	0.57	0.0	qualified as of 8/31/2017
Strattec Security Corp. (STRT)*	31.40	44.43	23.00	112.8	16.0	0.75	1.8	qualified as of 8/31/2017
Townsquare Media Inc. (TSQ)	9.98	13.01	8.12	184.8	14.0	0.47	0.0	
Vishay Precision Group Inc. (VPG)	21.85	22.80	15.10	279.8	30.3	1.59	0.0	
VOXX International Corp. (VOXX)	8.10	9.00	2.50	189.7	34.4	0.50	0.0	

nmf = no meaningful figure.
**Added to the portfolio on 8/31/2017.*
***Trailing four-quarter GAAP earnings negative, but adjusted earnings positive.*
****Global Power was delisted on 3/31/2016 after failing to meet the NYSE deadline for restating its 2013 and 2014 financial statements.*
Source: AAII's Stock Investor Pro*/Thomson Reuters. Data as of 8/31/2017.*

Explanation of Notes

Approaching Size Limit: Stocks are sold if their market capitalization goes above three times the initial maximum criterion and there is a stock to replace it. The current market capitalization maximum for initial screening is $400 million. Stocks are marked "approaching size limit" if their current market cap exceeds 2½ times the initial criterion, or $1 billion.

Approaching Value Limit: Stocks are sold once their price-to-book-value ratio goes above three times the initial criterion and there is a stock to replace it. The current initial price-to-book ceiling is 1.00. Stocks are marked "approaching value limit" if their current price-to-book-value ratio exceeds 2½ times the initial criterion, or 2.50.

Earnings Probation: If the last 12 months' earnings from continuing operations are negative, the stock is put on probation; if a subsequent quarter has negative earnings prior to 12-month earnings becoming positive, the stock is sold. The date in parentheses is the fiscal quarter during which the company first reported negative trailing 12-month earnings.

Qualified as of: Stock still qualified as a buy when the screen was run with current data. Stocks that don't currently qualify as a buy are held until they meet one of the sell rules.

See the Model Shadow Stock Portfolio area of AAII.com for more information.

Model Shadow Stock Portfolio Rules

Purchase and Sales Rules

Stock purchases must meet these criteria:

- No bulletin board or pink sheet stocks will be purchased.
- Price-to-book-value ratio must be less than or equal to 1.00. (Figure will change gradually with changes in overall market values.)
- Market capitalization must be between $30 million and $400 million. (Figure will change gradually with changes in overall market values.)
- The firm's last quarter and last 12 months' earnings from continuing operations must be positive and, if there are earnings estimates, the estimates must be positive for the current quarter and year.
- Relative price strength over the last 26 weeks must rank in the top 50% of the stock universe.
- No financial stocks, including those in the rental & leasing industry, or limited partnerships will be purchased.
- No utility stocks will be purchased.
- No stocks on foreign exchanges or ADRs will be purchased due to different accounting and/or withholding tax on dividends. Foreign stocks traded primarily on U.S. exchanges are OK with one exception: The stock of any company whose primary business is in China will not be purchased.
- The share price must be greater than $4.
- In order to reduce trading by avoiding stocks that are forever marginal, any stock that was sold within two years will not be rebought.
- Note second item under Stock Order Guidance concerning spreads when buying shares.
- Price-to-sales ratio must be less than 1.2. (Figure may change gradually with changes in overall market values.)
- Eliminate any company that failed to file a 10-Q (quarterly) report in the last six months.

Stocks are sold if any of the following occur:

- If last 12 months' earnings from continuing operations are negative, the stock is put on probation; if a subsequent quarter has negative earnings prior to 12-month earnings from continuing operations becoming positive, the stock is sold.
- The stock's price-to-book-value ratio goes above three times the initial criterion and there is a stock to replace it.
- Market capitalization goes above three times the initial maximum criterion and there is a stock to replace it.

Stock Order Guidance

- These rules are for general guidance. Your own experience, market conditions and the size of the position will impact your own decisions. The results in the model portfolio were obtained while sometimes paying more.
- Market orders are not used. Instead, if the quoted bid-ask spread is less than 2% (ask price minus bid price, divided by ask price), place a limit order at the ask price for a buy and at the bid price for a sell. If the bid-ask spread is more than 2%, try to place a limit order between the bid and ask prices to keep transaction costs low. If necessary, build a position gradually. With low commissions, it is often better to place partial orders than to try to establish a large position all at once. Be patient.
- The average daily dollar volume should be at least 10 times the amount needed for your position. This will ensure liquidity to get in and out of the position, even if you need to grow the position gradually and sell gradually. This will result in a varying number of qualifying stocks for each investor.
- 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, shares already purchased are kept but the balance of the order is canceled.

Management Rules

- Equal dollar amounts are invested in each stock initially.
- Decisions are made only at the end of each quarter. In order to react to the majority of earnings reports as soon as possible, quarterly reviews are made in February, May, August, and November.
- Best judgment is used for tenders or mergers, but all criteria must be obeyed.
- At the end of a quarter, if receipts from stocks sold exceed requirements for available new purchases, the excess receipts are kept in cash until the next quarter. If too much cash is accumulated, the rules will be adjusted.
- At the end of a quarter, if receipts from stock sales are insufficient to buy all newly qualifying stocks, purchases are made based on the width of the bid-ask spread and the number of shares at bid or ask price.
- Note that if you are managing your own portfolio, it should consist of at least 10 stocks. If you are developing the portfolio gradually, you can do it stock by stock, but don't put more than 10% of your funds in each additional stock. More than 20 stocks is not needed until the portfolio exceeds $1 million.

Table 2. Third-Quarter 2017 Transactions

Sell	
Company (Ticker)	Reason
Ultra Clean Holdings Inc. (UCTT)	exceeded value limit
Buy	
Company (Ticker)	Maximum Price to Pay
Amira Nature Foods Ltd. (ANFI)	$5.93
Delta Apparel, Inc. (DLA)	$22.30
Strattec Security Corp. (STRT)	$50.60

(continued from page 33)

Along with summarizing these transactions, Table 2 shows the maximum price at which each would still qualify under the price-to-book requirement of 1.00. I would like to point out that in buying these stocks a bit of patience is usually rewarded.

I should also point out that while Ultra Clean Holdings is no longer a micro-cap stock, it has not violated any earnings requirement. Those of you who have the funds and invest in stocks other than micro-caps might wish to keep it.

Table 3. Model Shadow Stock Portfolio: Annual Performance

	Average Annual Return (%)			Cumulative Growth of $10,000 ($)		
Year	Model Shadow Stock Portfolio	Vanguard 500 Index (VFINX)	Vanguard Small Cap Index (NAESX)	Model Shadow Stock Portfolio	Vanguard 500 Index (VFINX)	Vanguard Small Cap Index (NAESX)
1993	32.3	9.9	18.7	13,230	10,989	11,870
1994	2.0	1.2	(0.5)	13,492	11,118	11,810
1995	20.7	37.4	28.7	16,291	15,282	15,204
1996	22.3	22.9	18.1	19,927	18,775	17,959
1997	44.3	33.2	24.6	28,756	25,010	22,375
1998	(8.9)	28.6	(2.6)	26,188	32,168	21,790
1999	(0.0)	21.1	23.1	26,187	38,945	26,831
2000	(7.7)	(9.1)	(2.7)	24,163	35,418	26,116
2001	21.4	(12.0)	3.1	29,325	31,160	26,926
2002	10.8	(22.1)	(20.0)	32,506	24,259	21,535
2003	73.1	28.5	45.6	56,268	31,174	31,360
2004	43.7	10.8	19.9	80,843	34,530	37,587
2005	17.9	4.8	7.4	95,353	36,180	40,376
2006	29.4	15.6	15.6	123,363	41,832	46,687
2007	(1.8)	5.4	1.2	121,166	44,083	47,227
2008	(50.8)	(37.0)	(36.0)	59,582	27,764	30,217
2009	72.3	26.5	36.1	102,665	35,120	41,130
2010	45.4	14.9	27.7	149,238	40,358	52,529
2011	6.3	2.0	(2.8)	158,701	41,155	51,067
2012	33.3	15.8	18.0	211,588	47,666	60,274
2013	61.0	32.2	37.6	340,599	63,009	82,966
2014	(5.8)	13.5	7.4	320,844	71,516	89,105
2015	(15.2)	1.3	(3.8)	272,161	72,410	85,693
2016	29.8	11.8	18.2	353,261	80,964	101,248
2017 YTD	4.8	11.8	5.8	370,319	90,522	107,160
Since Incep	**15.8**	**9.3**	**10.0**	**370,319**	**90,522**	**107,160**

Data as of 8/31/2017.

Special Situations

Global Power Equipment Group (GLPW) has not provided the anticipated earnings update as of this writing, but their new loan agreement requires restatement to be completed by the time you read this. Once the impact is known, as well as whether the stock will be relisted on Nasdaq, a decision will be made about holding or selling.

Roadrunner Transportation Systems (RRTS) still has not completed all past earnings adjustments, but the company appears to have current positive earnings. It will continue to be held unless it violates a rule.

Looking Ahead

The large contingent of individual investors and pundits who feel that the market is significantly overpriced keeps growing as the market continues upward. In the face of political warfare, nuclear threats and disastrous weather the stock market hangs in. While there certainly could be a pullback now or after another 20% rise, absent a major catastrophe I don't feel there is likely to be a major pullback (over 20%) for quite some time. I want to repeat the viewpoint I have previously expressed:

> "Downside portfolio risk of loss is limited and temporary. Upside risk of loss from being out of the market can be infinite and is permanent."

The Model Shadow Stock Portfolio will be reviewed again in the January issue. In the meantime, please keep up with portfolio news at AAII.com. ▲

James B. Cloonan is founder and chairman of AAII. He is author of the book "Investing at Level3: Higher Returns With Minimal Risk for the Long-Term Individual Investor" (www.level3investing.com).