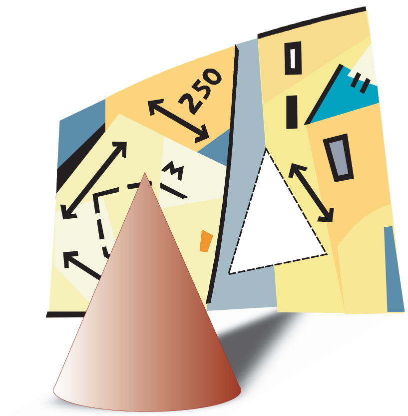
Model Shadow Stock Portfolio: Special Update and Rule Changes

By James B. Cloonan



As described in the Model Fund Portfolio column in this issue on page 26, the Model Fund Portfolio is being eliminated.

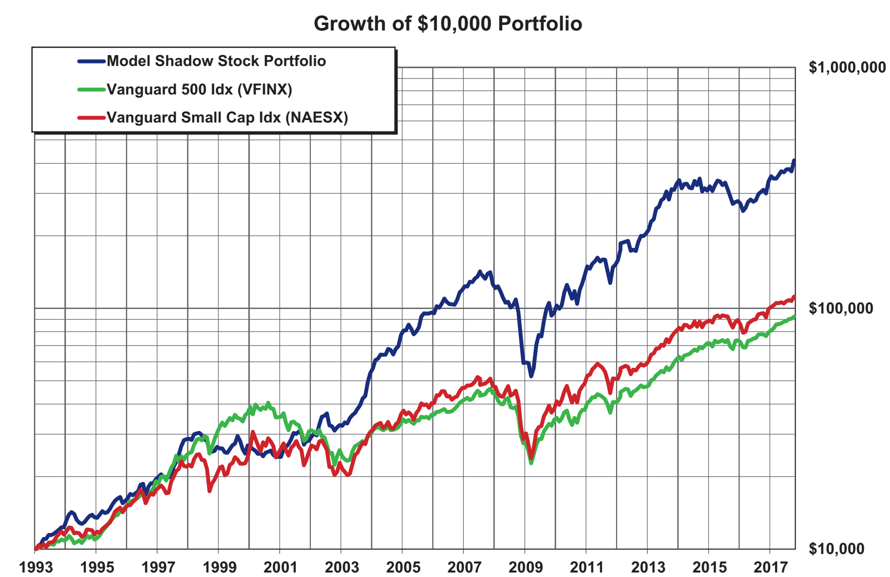
The Level3 Passive Portfolio of exchange-traded funds is being retained and will be presented with Model Shadow Stock Portfolio updates in the future.

The Model Shadow Stock Portfolio will now be covered in the *AAII Journal* every other month, or six times a year, rather than four times. This will begin with the January 2018 issue. Increasing the frequency will allow new followers of the portfolio to become familiar with it more quickly. However, portfolio reviews will still only take place on a quarterly basis and any changes reported in an email at the beginning of March, June, September and December. [Please be sure you are signed up for the Model Portfolios Update email to receive these notices and the regular monthly email with performance updates that is sent out on the 15th of each month.] A quarterly review schedule will maintain the low transaction and low time commitment characteristics of the Model Shadow Stock Portfolio.

The main purpose of this special article is to provide advance notice of these major rule changes that will be used for decisions starting on December 1. A special Model Portfolios email sent at the beginning of December and the January *AAII Journal* column will report on any changes made to the Model Shadow Stock Portfolio under the new rules.

(continued on page 25)

Figure 1. Model Shadow Stock Portfolio vs. Benchmarks (Through 9/30/2017)



		Annual Return (%)				
Portfolio	Year-to-Date Return (%)	1-Year	3-Year	10-Year	Since Inception	Ann'l Std Dev (%)
Model Shadow Stock Portfolio	16.4	32.3	10.4	11.4	16.2	15.7
Vanguard 500 Index (VFINX)	14.1	18.4	10.7	7.3	9.3	9.9
Vanguard Small Cap Index (NAESX)	10.5	17.2	10.3	8.4	10.2	12.2

**Relative to Vanguard 500 Index fund (VFINX).*
Data as of 9/30/2017.

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)	107.37	107.75	58.30	1,244.5	27.5	2.93	0.4	exceeds size limit approaching value limit
Amira Nature Foods (ANFI)	6.02	8.60	4.50	241.5	7.2	1.15	0.0	
AV Homes Inc. (AVHI)	17.15	20.50	14.65	381.7	13.4	0.85	0.0	qualifies as of 9/29/2017
Beazer Homes USA (BZH)	18.74	18.75	9.67	617.7	nmf*	0.92	0.0	
CPI Aerostructures (CVU)	9.35	10.15	5.55	82.1	14.0	1.17	0.0	
CSS Industries Inc. (CSS)	28.82	29.43	23.16	263.5	10.6	0.92	2.8	
Delta Apparel, Inc. (DLA)	21.51	23.47	14.85	159.1	15.9	1.03	0.0	
Ducommun Incorporated (DCO)	32.05	35.58	18.70	365.8	26.5	1.64	0.0	
Ennis, Inc. (EBF)	19.65	19.96	14.40	503.3	17.1	1.95	4.1	
Flexsteel Industries (FLXS)	50.70	62.99	39.98	399.0	16.8	1.72	1.7	
Global Power Equipment (GLPW)	1.85	5.40	1.66	32.2	2.8	nmf	0.0	
Hallador Energy Co. (HNRG)	5.72	10.40	5.28	171.1	21.0	0.75	2.8	
Hardinge Inc. (HDNG)	15.27	15.64	8.24	199.9	72.9	1.19	0.5	
Hooker Furniture Corp. (HOFT)	47.75	48.10	24.06	555.6	18.5	2.65	1.0	approaching value limit
Key Tronic Corp. (KTCC)	7.21	8.20	6.69	75.5	14.0	0.67	0.0	
Kimball Electronics Inc. (KE)	21.65	22.05	13.17	587.6	17.5	1.71	0.0	
PC Connection, Inc. (CNXN)	28.19	30.48	22.31	742.5	15.9	1.65	0.0	
PCM Inc. (PCMI)	14.00	31.20	11.80	178.2	11.0	1.25	0.0	
RCM Technologies (RCMT)	5.72	7.23	4.51	69.2	109.5	2.12	0.0	
RCI Hospitality Holdings (RICK)	24.75	26.85	10.92	248.5	22.2	1.77	0.5	
Renewable Energy Group (REGI)	12.15	13.55	8.10	472.0	nmf*	0.84	0.0	
REX American Resources (REX)	93.83	107.87	76.10	606.4	21.4	1.77	0.0	
Roadrunner Transportation Sys. (RRTS)	9.53	11.88	6.05	361.2	14.5	0.58	0.0	qualifies as of 9/29/2017
Rocky Brands Inc. (RCKY)	13.40	15.70	9.95	97.5	36.1	0.73	3.3	qualifies as of 9/29/2017
Salem Media Group Inc. (SALM)	6.60	8.25	5.00	172.4	23.1	0.80	3.9	
Seneca Foods Corp. (SENEA)	34.50	42.65	27.75	338.3	28.9	0.78	0.0	
Shoe Carnival, Inc. (SCVL)	22.38	31.79	15.08	378.7	18.3	1.20	1.3	
SigmaTron International (SGMA)	8.37	8.70	4.01	35.1	21.7	0.56	0.0	qualifies as of 9/29/2017
Strattec Security Corp. (STRT)	40.90	44.43	23.00	151.7	20.9	0.97	1.4	qualifies as of 9/29/2017
Townsquare Media Inc. (TSQ)	10.00	13.01	8.12	193.8	14.0	0.47	0.0	
Vishay Precision Group Inc. (VPG)	24.40	24.45	15.10	319.7	33.9	1.77	0.0	
VOXX International Corp. (VOXX)	8.55	9.00	2.50	210.2	36.3	0.53	0.0	

nmf = no meaningful figure
**Trailing four-quarter GAAP earnings negative, but adjusted earnings positive.*
Source: AAII's Stock Investor Pro*/Thomson Reuters. Data as of 9/29/2017.*

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—As of November 1, 2017

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.
- 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.
- Relative price strength over the last four weeks will be used as a tie-breaker.

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.
- The stock has been held for four years—unless it currently qualifies, its price is up more than 40% from the purchase price, or there is no qualifying stock to preplace 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 review. If too much cash is accumulated, the rules will be adjusted.
- 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.

(continued from page 22)

YTD Performance

I am happy to report that, after a slow beginning this year, as of this writing the Model Shadow Stock Portfolio's returns have caught up with and passed the year-to-date returns of the S&P 500 index, as measured by the Vanguard 500 Index fund (VFINX). Though this is not a regular update for the portfolio, the current holdings and performance tables are shown here with data through September 30.

Rule Changes

Momentum

The rule that relative strength for the past 26 weeks must be in the top 50% is being eliminated. Relative strength changes too rapidly for this to be effective even with a two-month period between portfolio decisions.

Momentum will be retained as a criterion by using it as a tie breaker among qualifying stocks. A ranking on four-week relative strength will be used as the tie breaker.

Holding Period

Many years ago the portfolio had a "two-year rule." Stocks were dropped if they no longer qualified after two years and there were newly qualifying stocks to replace them. This rule was dropped because it created too much turnover, and it was decided that two years was not enough time to give a stock a chance. Many stocks were moving up and they failed to qualify only because of upward momentum that we didn't wish to interrupt.

It is important to get rid of stocks that are not going anywhere and that prevent the addition of newly qualifying stocks to the portfolio, so an approach that avoids the previous problems with the two-year rule is being instigated.

The new rule is called the "four-year rule" and requires selling all stocks that have been held over four years unless:

- they currently qualify,
- they are up more than 40% from their purchase price, or
- there is no qualifying stock to replace them.

These changes should allow the addition of more highly qualified stocks, take more advantage of momentum and increase the return.

Table 2. 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	16.4	14.1	10.5	411,183	92,387	111,876
Since Incep	**16.2**	**9.3**	**10.2**	**411,183**	**92,387**	**111,876**

Data as of 9/30/2017.

Some Comments on Trading

Last quarter's portfolio changes posted online on September 1 and covered in the October *AAII Journal* created some fast run ups and, subsequently, questions from members. Here are some of my observations:

- Anytime an analyst, a brokerage firm, a TV prognosticator or someone like me makes a comment on or recommends a stock, it goes up. The usual pattern is for the price to go up immediately and then come back down part way or all of the way in a few days. That is why I continually advise being patient.
- The stocks in question all pulled back after the first day run-up. Except for Strattec Security Corp. (STRT), they have come back to levels close to where they were on September 1. Strattec appeared to be very underpriced and had recently been knocked down; that and the likelihood that momentum programs picked it up probably caused the price to push up again. It is still at a qualifying level.
- While a temporary impact from any news is expected, the impact may have been stronger this time because our changes were announced before

(continued on page 28)

at Level3" (www.level3investing.com).

Guggenheim S&P 500 Equal Weight ETF (RSP)

This exchange-traded fund has outperformed the cap-weighted S&P 500 index over the 14 years of its existence. Other indexes also indicate that equal weighting provides higher returns. Equal weighting gives more weight to value stocks and smaller-cap stocks in an index, which leads to superior performance over the long run.

This fund, because of its size and history, is given a portfolio weight of 40%.

PowerShares Russell 1000 Equal Weight ETF (EQAL)

This ETF includes the top 1,000 stocks by capitalization size and gives some exposure to mid-cap stocks. Mid-cap stocks historically have had higher returns than large caps. It is a new fund, however, and uses an innovative approach that needs some observation before comparing it to Guggenheim S&P 500 Equal Weight ETF.

It is weighted at 20% of the portfolio.

Vanguard Mid-Cap Value ETF (VOE)

Mid-cap value has had higher returns than large stocks or mid-cap growth stocks.

It is weighted at 20% of the portfolio.

Vanguard REIT Index ETF (VNQ)

The returns of real estate investment trusts (REITs) have exceeded the returns of the S&P 500 over the long run and provide diversification as well.

This ETF is weighted at 20%.

Table 3. Level3 Passive Portfolio

Fund (Ticker)	Initial Weight	YTD Return %	1-Yr Return %	Return (%) Since 5/31/16
Guggenheim S&P 500 Equal Weight (RSP)	40%	11.7	15.8	20.8
PowerShares Russell 1000 Equal Weight (EQAL)	20%	10.7	14.2	19.4
Vanguard Mid-Cap Value (VOE)	20%	10.3	15.2	22.0
Vanguard REIT Index (VNQ)	20%	3.5	0.4	5.8
Weighted Avg of ETFs in Portfolio*		**9.6**	**12.3**	**17.8**
Actual Level3 Passive Portfolio**		**9.5**	**12.3**	**17.7**
Comparison:				
SPDR S&P 500 (SPY)		14.2	18.5	23.3

**A weighted average return of the ETFs in the current Level3 Passive Portfolio.*
***Performance of actual Level3 Passive Portfolio, including reinvested dividends.*
Source: Morningstar, Inc. Data as of 9/30/2017.

For more on the Level3 approach, go to www.level3investing.com.

Portfolio Management Notes

For the Level3 Passive Portfolio, the initial weightings are as previously indicated and as shown in Table 3. The approach to rebalancing is to keep it to a minimum.

While momentum is less of a factor with funds than it might be with stocks, and transaction costs for funds are much less than for stocks, rebalancing frequently is a distraction and can make taxes a significant consideration.

You should be able to achieve almost all the rebalancing necessary when you add and withdraw funds or when changes are made in the holdings.

Rebalancing decisions will have to be made by the individual since every investor will have added assets at a different time, so everyone's weights will be different. But the following are some general guidelines:

- Don't rebalance any holding unless you have held it for over a year.
- If a holding is 25% below where it should be with the planned weight, bring it back to the appropriate level by selling some overweighted holdings to provide funds.
- If a holding is 33% above where it should be with the planned weight, bring it back to the appropriate level by selling the excess and using the funds to buy underweighted holdings. ➤

(continued from page 25)

a holiday weekend. As a result, many buyers were putting in their orders at the exact same time. Ordinarily, these orders might have been distributed over three days.

- I suspect that some stock orders were put in as "market at open" and this can create a rapid up market that quickly comes back. Please don't use this kind of order on small-cap stocks. See the portfolio rules on page 24 for more guidance on placing orders.

Next Portfolio Review

A full coverage of the Model Shadow Stock Portfolio will appear in the January issue and the portfolio changes based on the new rules will be available online and by email on December 1.

The January article will be the last one authored by me, but the Model Portfolios column will continue on a bimonthly basis. ➤

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).