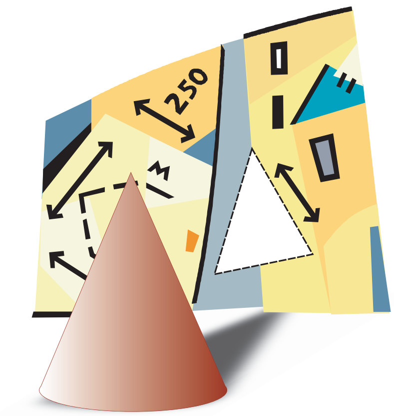
The Model Shadow Stock Portfolio's Origins and Newest Stock

By John Bajkowski



James Cloonan came up with the term "shadow stock" back in 1983 to help describe a class of stock that possesses several desirable characteristics identified through intensive studies of the stock market.

It had come to light that certain approaches for selecting stocks tend to produce better results and do so over long periods of time. When we first defined Shadow Stocks, the focus was primarily on size and neglect. We looked for the following characteristics:

- Relatively small compared to large corporations, but large enough to be developed and exchange-traded.
- Relatively neglected. Not well researched by professional analysts as measured by the number of analysts providing estimates and the number of institutional holdings.
- Underpriced rather than overpriced securities that highlight inefficiencies in market pricing.

As originally defined, "Shadow Stocks are those whose companies are of a size that permits dramatic growth, those that are not well researched by the professionals and those whose neglect has led to underpricing."

The rules used to define and capture Shadow Stocks have evolved over time as new research continues to highlight promising techniques individuals can use to select and build stock portfolios. Notably, relative price strength has been introduced to help select Shadow Stock candidates. See page 35 for the current

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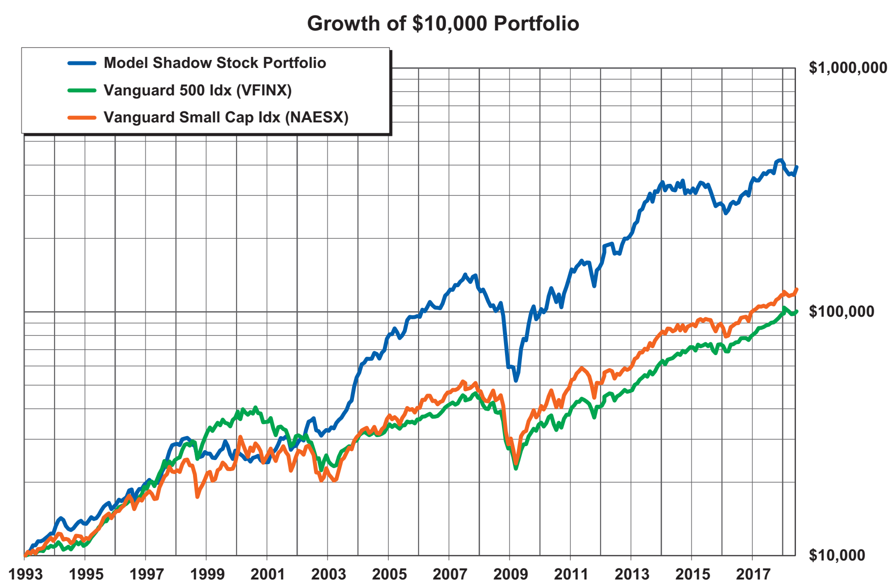
Figure 1. Model Shadow Stock Portfolio vs. Benchmarks (Through 5/31/2018)



Portfolio	Year-to-Date Return (%)	Annual Return (%) 1-Year	3-Year	10-Year	Since Inception	Ann'l Std Dev (%)
Model Shadow Stock Portfolio	(2.5)	7.1	6.5	13.9	15.5	16.1
Vanguard 500 Index (VFINX)	1.9	14.2	10.8	9.0	9.4	10.2
Vanguard Small Cap Index (NAESX)	5.2	18.1	9.7	10.0	10.4	12.1

Data as of 5/31/2018.

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
Aceto Corp. (ACET)	2.64	17.10	2.22	91.4	nmf**	0.46	1.5	
Amira Nature Foods (ANFI)	2.37	7.05	1.62	95.6	na	0.45	0.0	
AutoWeb Inc. (AUTO)	3.63	14.30	2.88	46.8	nmf**	0.78	0.0	
Beazer Homes USA (BZH)	15.10	23.24	11.95	526.3	15.0	0.86	0.0	
Big 5 Sporting Goods (BGFV)	8.20	14.55	5.05	168.7	nmf**	0.94	7.3	
Container Store Group (TCS)	7.66	8.50	3.53	369.7	nmf**	1.46	0.0	
CPI Aerostructures (CVU)	10.20	10.80	7.80	92.1	16.3	1.19	0.0	
CSS Industries Inc. (CSS)	16.15	30.29	15.13	149.4	nmf**	0.50	5.0	
Delta Apparel, Inc. (DLA)	18.84	23.47	16.90	138.9	13.4	0.93	0.0	qualifies as of 5/31/2018
Ducommun Incorporated (DCO)	33.76	35.55	25.06	384.2	51.3	1.55	0.0	
Ennis, Inc. (EBF)	18.25	21.50	15.90	235.4	12.8	1.77	4.4	
Flexsteel Industries, Inc. (FLXS)	37.27	57.79	34.74	300.7	12.8	1.21	2.4	
Hallador Energy Co. (HNRG)	7.49	8.40	4.79	218.4	21.2	0.89	2.1	qualifies as of 5/31/2018
Hooker Furniture Corp. (HOFT)	37.30	52.75	35.90	451.1	14.5	1.91	1.5	
Kimball Electronics Inc. (KE)	18.70	22.45	15.75	499.2	14.2	1.40	0.0	
New Home Co. (NWHM)	10.09	13.55	9.53	214.9	11.3	0.81	0.0	
Olympic Steel, Inc. (ZEUS)	23.13	25.84	16.25	245.8	10.5	0.94	0.3	qualifies as of 5/31/2018
PC Connection, Inc. (CNXN)	29.59	30.35	22.66	792.8	15.6	1.61	0.0	
PCM Inc. (PCMI)	12.20	20.94	6.90	143.8	453.2	1.10	0.0	
RCM Technologies (RCMT)	5.25	6.55	4.24	61.1	17.0	2.76	0.0	approaching value limit
RCI Hospitality Holdings (RICK)	31.95	33.78	20.67	311.0	28.5	2.05	0.4	
Renewable Energy Group (REGI)	17.85	18.15	9.50	671.7	2.6	0.89	0.0	
REX American Resources (REX)	76.02	102.00	70.48	472.6	16.6	1.32	0.0	
Roadrunner Transportation (RRTS)	1.81	9.75	1.65	70.4	nmf**	0.52	0.0	
Rocky Brands Inc. (RCKY)	28.20	28.40	12.20	201.5	25.8	1.45	1.7	
Seneca Foods Corp. (SENEA)	27.10	36.60	27.00	279.9	37.4	0.61	0.0	qualifies as of 5/31/2018
SigmaTron International (SGMA)	6.84	11.61	5.26	28.7	11.8	0.46	0.0	
Strattec Security Corp. (STRT)	38.00	49.20	30.05	137.0	15.2	0.86	1.5	qualifies as of 5/31/2018
Townsquare Media Inc. (TSQ)	6.23	11.63	6.03	109.4	nmf**	0.33	4.8	
Universal Stainless & Alloy (USAP)*	24.20	31.20	17.10	174.4	66.9	0.90	0.0	qualifies as of 5/31/2018
Vishay Precision Group (VPG)	37.55	38.25	16.55	499.8	32.9	2.48	0.0	

na = not available
nmf = no meaningful figure
**new addition as of 5/31/2018.*
***Trailing four-quarter GAAP earnings negative, but adjusted earnings positive.*
Source: AAII's Stock Investor Pro*/Thomson Reuters. Data as of 5/31/2018.*

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 last 12 months' earnings 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. When available, adjusted (non-GAAP) earnings are used to put stocks on probation or sell them. Otherwise, earnings from continuing operations are used. The date is the fiscal quarter during which the company first reported negative trailing 12-month earnings.

Qualifies 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.
- 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 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. When available, adjusted (non-GAAP) earnings are used to put stocks on probation or sell them. Otherwise, earnings from continuing operations are used.
- 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 replace it. If a stock has been held for over four years, it needs to be up 10% per year held to avoid being sold (for example, a stock held six years needs to be up 60%). Time and return are based on the initial purchase for the portfolio.

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.

Table 2. Second-Quarter 2018 Transactions

Sell

Company (Ticker)	Reason
AV Homes Inc. (AVHI)	negative earnings

Buy

Company (Ticker)	Maximum Price to Pay
Universal Stainless & Alloy Products (USAP)	$26.88

(continued from page 33)
Shadow Stock portfolio rules.

Portfolio Performance

The AAII Model Shadow Stock Portfolio posted a strong gain in May, climbing 8.1%; however, it was not enough to bring the year-to-date return into positive territory. The Model Shadow Stock Portfolio is down 2.5% for the year as of May 31, while the Vanguard 500 Index fund (VFINX) is up 1.9%.

Since its inception in 1993, the AAII Model Shadow Stock Portfolio has a compound annual average return of 15.5% versus the Vanguard 500 Index fund's (VFINX) gain of 9.4% per year on average through May 31. Figure 1 and Table 3 detail the portfolio's returns.

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	14.0	21.7	16.1	402,716	98,495	117,542
2018 YTD	(2.5)	1.9	5.2	392,696	100,415	123,611
Since Incep	**15.5**	**9.4**	**10.4**	**392,696**	**100,415**	**123,611**

Data as of 5/31/2018.

Quarterly Portfolio Activity

Table 1 lists the stocks that currently make up the Model Shadow Stock Portfolio, and Table 2 summarizes the changes made during the quarterly update.

After conducting the quarterly review of the Model Shadow Stock Portfolio, AV Homes Inc. (AVHI) is being removed and Universal Stainless & Alloy Products Inc. (USAP) is being added.

AV Homes has been on earnings probation since its fourth-quarter 2017 earnings release on February 22. On April 26, the company reported an adjusted (non-GAAP) loss of $0.10 per share for its fiscal first quarter, expanding its trailing 12-month adjusted loss to $1.04 per share. Because the company went two quarters with trailing adjusted earnings being negative and it reported an adjusted loss for the latest fiscal quarter, AV Homes triggered the portfolio's earnings sell rule. The stock has been removed from the Model Shadow Stock Portfolio.

With the proceeds from the AV Homes sale and the existing cash position, there were enough funds to take a position in one company at roughly the average position size for the existing holdings in the model portfolio.

Twelve stocks met the initial selection criteria for the Model Shadow Stock Portfolio at the end of May and six are currently held in the Model Shadow Stock Portfolio. Qualifying companies are noted in the Notes column of Table 1. The liquidity requirements and four-week relative strength were used to select Universal Stainless & Alloy Products.

You can follow the Model Shadow Stock Portfolio in the Model Portfolios area on AAII.com. To receive monthly email updates along with alerts to any changes made to the portfolio, please go to www.aaii.com/email. ▲

John Bajkowski is president of AAII. Wayne A. Thorp, CFA, AAII's senior financial analyst, provided research.