MODEL SHADOW STOCK PORTFOLIO

May's Volatility Leads to More Choices for Shadow Stock Portfolio

After conducting the quarterly review of the Model Shadow Stock Portfolio in early June, two stocks were removed from the portfolio and one new stock was purchased.

BY JOHN BAJKOWSKI

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Expectations that the U.S. and China were close to reaching a trade deal were shattered in May, resulting in strong stock market sell-off and renewed concerns that the trade tariffs will result in reduced global economic growth. Expectations had been growing that the threat of a tariff increase was just a negotiation tactic that would not be implemented. As we know now, these expectations were proven wrong.

The market sell-off extended to commodities such as oil and pushed down the yield of bonds, as investors see a greater likelihood that the Federal Reserve will need to lower interest rates to offset some of the negative economic impact of the escalation of tariffs.

The S&P 500 index, as measured by the Vanguard 500 Index fund (VFINX), lost 6.4% during May, but the damage was even worse for the Model Shadow Stock Portfolio, which declined 13.7% during the month, pushing its performance into the red for the year. The Model Shadow Stock Portfolio is now down 0.2% year to date, while the Vanguard 500 Index fund is up 10.7%. The Vanguard Small-Cap Index fund (NAESX) was down 7.3% during May and has a year-to-date performance of 11.6%, while the DFA U.S. Micro Cap fund (DFSCX) was down 9.1% during the month and is up 4.9% for this year through the end of May. Figure 1 shows performance over longer periods.

Value-oriented stock indexes are lagging growth stocks on a year-to-date basis. Large-cap value stocks were down 7.6% during May, reducing their year-to-date performance to 8.0%, while large-cap growth stocks lost 5.3% during the month and are now up 13.2% through the first five months of the year.

In the mid-cap segment, value stocks are up 7.9% for the year after losing 9.7% during May. Mid-cap growth stocks are up 11.2% for the year after losing 9.7% during May.

Small-cap value stocks are up 6.7% year to date, while small-cap growth stocks are up 11.7%. Small-cap value stocks lost 8.2% during May, while small-cap growth stocks were down 7.4%.

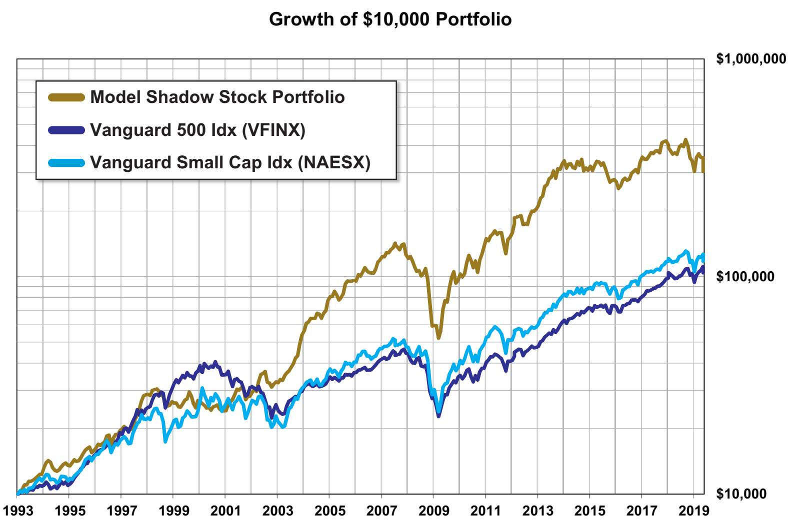
Stocks in the information technology (+16.5%), telecom services (+14.2%) and consumer discretionary (+13.0%) sectors are leading the market this year. Sectors that are lagging this year include pharmaceuticals (+0.2%), health care (+1.3%) and energy (+3.5%).

Since its inception in 1993, the AAII Model Shadow Stock Portfolio has a compound annual average return of 13.8%, versus the Vanguard 500 Index fund's gain of 9.2% per year on average. Over the same period, the Vanguard Small-Cap Index fund posted an average annual gain of 9.7%.

(continued on page 36)

FIGURE 1

Model Shadow Stock Portfolio vs. Benchmarks (Through 5/31/2019)



Portfolio	Year-to-Date Return (%)	Annual Return (%) 1-Year	3-Year	10-Year	Since Inception	Ann'l Std Dev (%)
Model Shadow Stock Portfolio	(0.2)	(22.7)	3.1	14.6	13.8	21.4
Vanguard 500 Index (VFINX)	10.7	3.7	11.6	13.8	9.2	11.5
Vanguard Small Cap Index (NAESX)	11.6	(5.0)	9.4	13.9	9.7	15.0

Data as of 5/31/2019.

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
Beazer Homes USA, Inc. (BZH)	9.08	16.08	8.16	293.2	nmf**	0.53	0.0	
Big 5 Sporting Goods Corp. (BGFV)	2.00	9.75	2.00	44.8	nmf**	0.24	10.0	
Container Store Group Inc. (TCS)	7.03	12.42	4.21	347.8	16.4	1.28	0.0	
CPI Aerostructures, Inc. (CVU)	7.06	11.75	5.83	86.5	26.5	0.87	0.0	qualifies as of 5/31/2019
Delta Apparel, Inc. (DLA)	21.56	24.99	16.11	149.4	22.1	1.03	0.0	
Ducommun Incorporated (DCO)	45.13	52.04	31.05	532.2	38.0	1.96	0.0	
Ennis, Inc. (EBF)	18.52	22.98	17.36	486.2	12.8	1.67	4.9	
Flexsteel Industries, Inc. (FLXS)	17.15	40.87	17.05	137.8	nmf**	0.60	5.1	
Hallador Energy Co. (HNRG)	5.66	7.98	4.75	172.4	14.0	0.66	2.8	qualifies as of 5/31/2019
Hooker Furniture Corp. (HOFT)	26.83	49.85	24.85	321.1	7.9	1.20	2.2	
Kimball Electronics Inc. (KE)	14.25	20.90	13.51	381.3	8.7	1.01	0.0	
Mesa Air Group (MESA)*	9.12	16.41	6.36	266.6	13.2	0.77	0.0	qualifies as of 5/31/2019
New Home Company Inc. (NWHM)	3.95	10.59	3.90	82.4	nmf**	0.33	0.0	
Olympic Steel, Inc. (ZEUS)	12.38	24.23	12.09	140.7	5.0	0.46	0.6	qualifies as of 5/31/2019
PC Connection, Inc. (CNXN)	31.74	43.05	27.04	867.0	12.9	1.56	0.0	
PCM Inc. (PCMI)	25.55	39.69	12.10	316.5	13.0	1.96	0.0	
R C M Technologies Inc. (RCMT)	3.30	5.33	2.54	41.5	10.9	1.46	0.0	
RCI Hospitality Holdings (RICK)	16.26	34.84	16.15	161.5	10.7	0.99	0.7	qualifies as of 5/31/2019
Renewable Energy Group (REGI)	15.64	32.52	15.15	586.1	98.6	0.82	0.0	
REX American Resources (REX)	67.47	89.80	61.71	443.0	17.3	1.09	0.0	
Rocky Brands Inc. (RCKY)	24.46	33.45	22.44	186.2	12.7	1.17	2.3	
Strattec Security Corp. (STRT)	24.99	40.40	23.25	91.5	nmf**	0.56	2.2	
Townsquare Media Inc. (TSQ)	5.50	9.79	3.95	95.8	nmf**	0.31	5.5	
Universal Stainless & Alloy (USAP)	12.70	30.91	12.53	113.0	11.1	0.47	0.0	qualifies as of 5/31/2019
Vishay Precision Group Inc. (VPG)	35.82	45.00	26.34	492.2	18.0	2.12	0.0	
VSE Corp. (VSEC)	24.11	51.09	24.06	276.1	7.8	0.78	1.5	qualifies as of 5/31/2019

na = not available
nmf = no meaningful figure
**Company is new to the Model Shadow Stock Portfolio. Added 6/4/2019. Amira Nature Foods Ltd. (ANFI) and CSS Industries Inc. (CSS) were removed on 6/4/2019.*
***Trailing four-quarter GAAP earnings negative, but adjusted earnings positive.*
Source: AAII's Stock Investor Pro*/Refinitiv. Data as of 5/31/2019.*

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 Shadow Stocks area of AAII.com for more information.

Shadow Stock Portfolio Rules

Purchase & 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. (This figure will change gradually with changes in overall market values.)
» Market capitalization must be between $30 million and $400 million. (This 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 or limited partnerships will be purchased.
» No stocks in the utility sector will be purchased.
» No stocks in the rental and leasing industry will be purchased.
» No stock on foreign exchanges or ADRs will be purchased because of different accounting and/or withholding tax on dividends. Foreign stocks traded 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. (This 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.
» Momentum is used as a tie-breaker among qualifying stocks. A ranking on four-week relative strength is 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 from continuing operations becoming positive, the stock is sold. When available, adjusted (non-GAAP) earnings are used to put stocks on probation or sell them. These are earnings that have been adjusted to eliminate the impact of non-recurring events such as markdown of inventory or goodwill. These are earnings reported in the media, in press releases and used in estimates of future earnings. Adjusted earnings are used because the information appears much sooner than official filing data. Otherwise, earnings from continuing operations are used.
» The stock's price-to-book-value ratio goes above three times the initial criterion.
» Market capitalization goes above three times the initial maximum criterion.
» Stocks that have been held for four years can be sold unless:
- they currently qualify,
- they are up more than 40% from their purchase, or
- there is no qualifying stock to replace them.

» 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. Sells are made only if there are suitable replacements.

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, stocks 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 done at the end of 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 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

Second-Quarter 2019 Transactions

Sells

Company (Ticker)	Reason
Amira Nature Foods Ltd. (ANFI)	negative earnings
CSS Industries Inc. (CSS)	negative earnings

Buy

Company (Ticker)	Maximum Price to Pay
Mesa Air Group (MESA)	$11.84

(continued from page 33)

Portfolio Changes

Table 1 shows the current holdings in the Model Shadow Stock Portfolio. After conducting the quarterly review of the Model Shadow Stock Portfolio in early June, two stocks were removed from the portfolio—Amira Nature Foods Ltd. (ANFI) and CSS Industries Inc. (CSS).

With the cash on hand and the proceeds from the two sells, there was enough to purchase one new stock with a position size roughly equal to the average position size for the portfolio holdings: Mesa Air Group (MESA).

Table 2 summarizes the changes. The detailed Model Shadow Stock Portfolio Rules on page 35 note the purchase and sell rules, provide some of the portfolio management rules and illustrate tips to consider when buying and selling micro-cap stocks.

Sold: Amira Nature Foods Ltd. (ANFI)

Amira Nature Foods has been on earnings probation since it announced its second-quarter 2018 earnings. At that time, the company's trailing 12-month earnings per share turned negative. In August of last year, the company announced it would be late in filing its Form 20-F for the year ended March 31, 2018. The company filed its Form 20-F in mid-March, at which time it was shown that its six-month results for the period ended September 30, 2018, were negative. If a Shadow Stock that is on earnings probation reports a subsequent quarterly loss (or in this case a subsequent six-month loss), it is removed from the portfolio.

Sold: CSS Industries Inc. (CSS)

CSS Industries has been on earnings probation since it announced its second-quarter 2019 earnings on November 1, 2018. At that time, the company's trailing 12-month earnings per share turned negative. On May 30, the company reported a quarterly loss. If a Shadow Stock that is on earnings probation reports a subsequent quarterly loss, it is removed from the portfolio.

Purchased: Mesa Air Group (MESA)

With the proceeds from the Amira Nature Foods and CSS Industries sales and the existing cash position of the Model Shadow Stock Portfolio, there were enough funds to take a position in one company at roughly the average position size for the existing holdings in the tracking portfolio.

The market downturn in May opened the door to a larger number of stocks falling below the maximum market-cap size filter of $400 million and the price-to-book-value ceiling of 1.00. As of the end of May, 25 stocks met the initial selection criteria. Applying the liquidity requirements to the remaining stocks reduced the number to 16 candidates. Looking at the price-to-book-value ratio and the four-week relative price strength led to Mesa Air Group.

Mesa Air Group is the holding company for Mesa Airlines, a regional carrier. Mesa Airlines provides regional air service for American Airlines under the American Eagle banner and for United Airlines under the United Express brand. Mesa Air Group operates 145 aircraft with approximately 610 daily departures. The company's agreements with its partners extend to 2025 with American Airlines and 2028 with United Airlines.

Based on Mesa Air Group's closing price of $9.00 on June 3, we suggest paying no more than $11.84. To calculate the maximum buy price based on the price-to-book-value ratio, multiply the current share price by the ratio of the maximum price-to-book ratio to be considered for the Model Shadow Stock Portfolio (currently 1.00) to the current price-to-book ratio of the stock. The price-to-book ratio for Mesa Air Group as of June 3 was 0.76, so the calculation is:

$\$11.84 = [\$9.00 \times (1.0 \div 0.76)]$

Next Portfolio Review

The next quarterly review of the Model Shadow Stock Portfolio will take place at the end of August. In the meantime, you can follow the portfolio in the AAII Shadow Stocks area on AAII.com (www.aaii.com/model-portfolios). To receive monthly email updates along with alerts to any changes made to the portfolio, please sign up at www.aaii.com/email. ■

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The Impact of Winter's Volatility on the Shadow Stock's Rules by John Bajkowski, April 2019
Model Shadow Stock Portfolio: Why Quarterly Reviews Still Make Sense by John Bajkowski, October 2018
Why Value Beats Growth: A Brief Explanation by Peter Berezin, September 2016