

Shadow Stock Gains Limited by Pause in Small-Cap Stocks

By James B. Cloonan

The Model Shadow Stock Portfolio is up 2.0% since our April column and up 4.7% for the year as of the end of May.

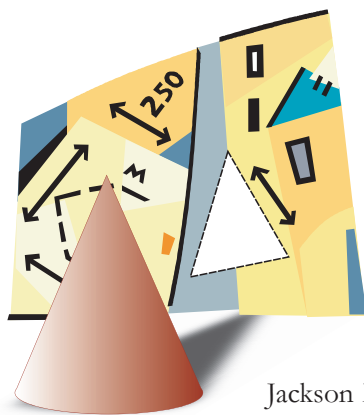
This lags the S&P 500 as represented by the Vanguard 500 Index fund (VFINX), which is up 7.8% year-to-date. It appears small-cap stocks are taking a breather after a very strong run, but they are still positive.

As I write this in early June, the entire market is dropping on unemployment figures and negative economic forecasts throughout the world. Next quarter's earnings reports will soon be in the mix, and it won't be long before political commentary ramps up for the primaries and the election. Despite the bad economic news and the growing civil unrest abroad, the stock market is still positive, but it is well behind the 20% return of a typical pre-election year.

Table 1 lists the current holdings of the Model Shadow Stock Portfolio, and Figure 1 and Table 2 report on the portfolio's performance.

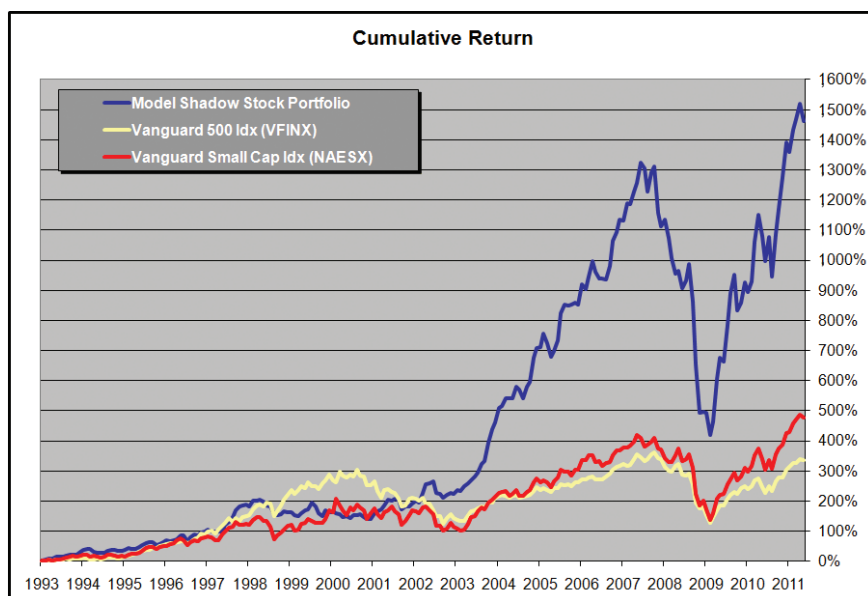
Portfolio Sells

Two stocks were dropped from the portfolio; both changes were forced on



us. Kendle International (KNDL) announced board approval of a buyout at \$15.25 and Jackson Hewitt Tax Service (JTX; now JHTXQ) agreed
(continued on page 36)

Figure 1. Model Shadow Stock Portfolio Vs. Benchmark (Through 5/31/2011)



Portfolio	Year-to-Date Return (%)	Annual Return (%)			Ann'l Std Dev (%)	3-Year Risk-Adjusted Return (%)*
		1-Year	3-Year	10-Year		
Model Shadow Stock Portfolio	4.7	32.5	13.7	17.8	34.4	10.2
Vanguard 500 Index (VFINX)	7.8	25.8	0.9	2.5	21.5	1.0
Vanguard Small Cap Index (NAESX)	9.7	31.4	6.6	7.9	28.0	6.1

*Relative to Vanguard Total Stock Market Index fund (VTSMX).
Data as of 5/31/2011.

Table 1. The Model Shadow Stock Portfolio

Company (Ticker)	Current Price (\$)	52-Week		Market Cap (\$ Mil)	P/E Ratio (X)	P/B Ratio (X)	Div Yield (%)	Notes
		High (\$)	Low (\$)					
Addus HomeCare Corp. (ADUS)*	5.61	6.25	2.80	60.4	10.8	0.68	0.0	qualified as of 6/10/2011
AeroCentury Corp. (ACY)	11.85	24.00	9.54	19.0	nmf	0.46	0.0	earnings probation (2011q1)
Alamo Group, Inc. (ALG)	21.84	29.27	18.68	259.5	11.4	0.98	1.1	
Audiovox Corp. (VOXX)	7.08	8.98	6.17	163.4	7.2	0.42	0.0	qualified as of 6/10/2011
Books-A-Million (BAMM)	3.38	7.26	3.35	53.2	15.4	0.47	5.9	
Capital Senior Living (CSU)	8.76	10.91	4.53	241.3	48.7	1.42	0.0	
CONN'S, Inc. (CONN)	5.68	6.91	2.94	180.5	nmf	0.50	0.0	earnings probation (2010q2)
CSS Industries (CSS)	18.21	21.55	14.87	177.2	30.9	0.75	3.3	
Ennis, Inc. (EBF)	17.22	20.25	14.33	448.5	10.0	1.28	3.6	
Flexsteel Industries (FLXS)	14.78	19.69	10.08	99.2	9.2	0.80	2.0	
Gilat Satellite Networks Ltd. (GILT)*	4.51	6.20	4.15	184.1	6.3	0.69	0.0	qualified as of 6/10/2011
Hastings Entertainment (HAST)	4.23	8.02	4.08	36.4	35.3	0.35	0.0	qualified as of 6/10/2011
Key Tronic Corp. (KTCC)	4.43	6.84	4.31	45.9	7.0	0.69	0.0	qualified as of 6/10/2011
Kimball International (KBALB)	5.98	7.89	4.81	163.2	42.7	0.58	3.3	qualified as of 6/10/2011
Lithia Motors, Inc. (LAD)	17.42	19.09	5.87	459.8	27.2	1.39	1.6	
Marlin Business Servs (MRLN)	12.23	13.74	9.24	159.2	30.6	0.98	0.0	
Mitcham Industries, Inc. (MIND)	15.62	16.44	5.98	156.6	19.3	1.49	0.0	
Paragon Shipping Inc. (PRGN)	2.03	4.32	1.87	120.2	5.6	0.23	0.0	
PC Connection, Inc. (PCCC)	8.40	9.91	5.75	225.9	9.0	0.86	0.0	
PC Mall, Inc. (MALL)	8.00	10.98	3.20	99.2	12.3	0.89	0.0	
RCM Technologies (RCMT)	5.21	5.93	4.23	68.1	13.4	0.97	0.0	
Rex American Resources (REX)	15.98	19.30	12.96	152.4	44.4	0.60	0.0	qualified as of 6/10/2011
Rocky Brands, Inc. (RCKY)	11.03	16.47	5.68	82.6	9.3	0.78	0.0	qualified as of 6/10/2011
Saga Communications (SGA)	35.97	39.51	16.53	153.0	11.3	1.86	0.0	
Shoe Carnival, Inc. (SCVL)	27.00	30.09	16.24	357.8	12.9	1.32	0.0	
Standard Motor Products (SMP)	14.19	15.20	7.38	324.2	11.2	1.48	2.0	
Standex Int'l Corp. (SXI)	31.16	39.11	22.27	389.2	11.6	1.74	0.8	
SureWest Communications (SURW)	15.04	17.83	5.61	211.5	167.1	0.77	2.1	
Willis Lease Finance (WLFC)	13.03	14.20	8.12	154.0	10.9	0.57	0.0	qualified as of 6/10/2011

*Company is new to the model portfolio (added 6/2/2011).

Source: AAIL's Stock Investor Pro/Thomson Reuters. Data as of 6/10/2011.

Explanation of Notes

Approaching Size Limit: Stocks are sold if their market capitalization goes above three times the initial maximum criterion. The current market capitalization maximum for initial screening is \$200 million. Stocks are marked "approaching size limit" if their current market cap exceeds 2½ times the initial criterion, or \$500 million.

Approaching Value Limit: Stocks are sold once their price-to-book-value ratio goes above three times the initial criterion. The current initial price-to-book ceiling is 0.80. Stocks are marked "approaching value limit" if their current price-to-book-value ratio exceeds 2½ times the initial criterion, or 2.00.

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 within the parentheses lists 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 Shadow Stock Portfolio area of AAIL.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 0.80. (Figure will change gradually with changes in overall market values.)
- Market capitalization must be between \$17 million and \$200 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.
- No financial stocks or limited partnerships will be purchased.
- No stocks on foreign exchanges or ADRs will be purchased because of different accounting and/or withholding tax on dividends.
- 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.
- Market capitalization goes above three times the initial maximum criterion.

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.

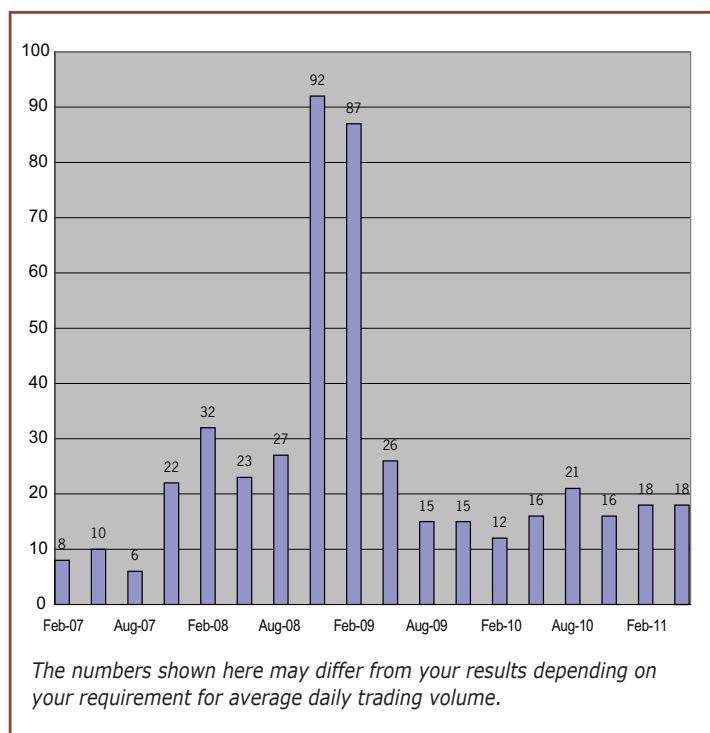
- The average daily dollar volume should be at least four times the amount needed for your position. This will ensure liquidity to get in and out of the position, even if you need to grow the position gradually and sell gradually. This will result in a varying number of qualifying stocks for each investor.
- For NASDAQ stocks, it appears to be better to use day orders. If the order is not filled, it is placed again with a slight adjustment. For NYSE and Amex stocks, good-till-canceled (GTC) orders are used to keep a place in line in the specialists' books. If the market isn't close to the desired price, the price is adjusted in a few days with a new GTC order.
- 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 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 new purchases, the excess receipts—up to 5% of the portfolio's value—are kept in cash until the next quarter. If the excess receipts are greater than 5% of the total portfolio value, the amount above 5% is distributed to smaller holdings that still qualify as buys. Efficient quantities are purchased: If over 10% of the portfolio is in cash, the price-to-book-value ratio can be moved up, but never over 0.90.
- At the end of a quarter, if receipts from stock sales are insufficient to buy all newly qualifying stocks, purchases are made in order of lowest bid/ask spreads.
- 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. Model Shadow Stock Portfolio: Annual Performance Since Inception

	Avg An'l Ret Since Incep (%)	2011 YTD Ret (%)	Annual Rate of Return																	
			2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993
Model Shadow Stock Portfolio	16.1	4.7	45.4	72.3	(50.8)	(1.8)	29.4	17.9	43.7	73.1	10.8	21.4	(7.7)	(0.0)	(8.9)	44.3	22.3	20.7	2.0	32.3
Vanguard 500 Index (VFINX)	8.3	7.8	14.9	26.5	(37.0)	5.4	15.6	4.8	10.8	28.5	(22.1)	(12.0)	(9.1)	21.1	28.6	33.2	22.9	37.4	1.2	9.9
Vanguard Small Cap Idx (NAESX)	10.0	9.7	27.7	36.1	(36.0)	1.2	15.6	7.4	19.9	45.6	(20.0)	3.1	(2.7)	23.1	(2.6)	24.6	18.1	28.7	(0.5)	18.7
DFA US Micro Cap (DFSCX)	11.6	7.8	31.3	28.1	(36.7)	(5.2)	16.2	5.7	18.4	60.7	(13.3)	22.8	(3.6)	29.8	(7.3)	22.8	17.6	34.5	3.1	21.0
Data as of 5/31/2011.																				

Figure 2. Number of First-Pass Qualifying Stocks**Table 3. Second Quarter 2011 Transactions**

Company (Ticker)	Reason
Sell	
Kendle International (KNDL)	acquired by INC Research bankruptcy filing
Jackson Hewitt Tax Service (JHTXQ)	
Buy	
Addus HomeCare Corp. (ADUS)	
Gilat Satellite Networks Ltd. (GILT)	

(continued from page 33)

to a bankruptcy filing with its creditors in

My general rule is to sell at the first selling period after general agreement

which the current common stock shareholders would receive nothing. This is the first time in 18 years we have had a bankruptcy in the portfolio, since companies generally get sold because of negative earnings long before they go bankrupt.

In both cases, we sold the shares when the actions had board approval. We sold Kendle for a bit less than the buy-out price, and we received a few cents for Jackson Hewitt even though the shares seem worthless (some arbitrage funds take positions in these kinds of situations).

of the company's board and any other parties involved. Another of my principles came up this month when I made a purchase error: that is, to immediately reverse a mistake, even though it may cost a commission and a bid/ask spread. Holding on to an unwanted position in the hopes of overcoming the commission and spread distracts your attention, and if the position gets worse you have no rules for what to do next.

Portfolio Purchases

There were 18 stocks that passed the initial screen this quarter, as shown in Figure 2. Eight of these companies were Chinese, and I eliminated them as I have done previously because I don't know whether or not to believe the figures. I am sure some of these China-based stocks are excellent opportunities, but there are many cases of manipulation and I don't have the resources to check extensively.

We made two purchases: Addus HomeCare Corp. (ADUS) and Gilat Satellite Networks Ltd. (GILT).

Portfolio transactions for the second quarter are summarized in Table 3.

Outlook

I still have a slightly bullish bias, mostly because everything looks so bleak. However, I continue to advocate long-term allocations. I hope that by my October column, we will have extended the national debt limit and avoided bond default. In the meantime, you can follow the portfolio at AAII.com. ▲

James B. Cloonan is founder and chairman of AAII.