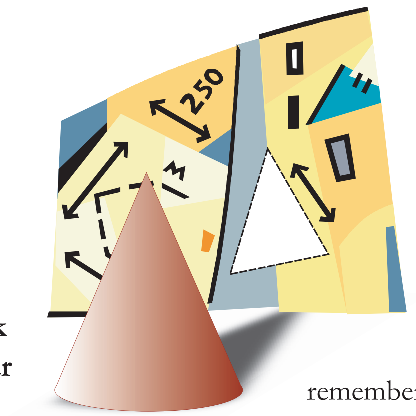
Record Market Volatility Affects Model Shadow Stock Portfolio

By James B. Cloonan



The Model Shadow Stock Portfolio is down 5.1% for the year as of the end of August.

This lags the S&P 500, as represented by Vanguard 500 Index fund (VFINX), which is down 1.9% year-to-date. Large-cap stocks have been catching up a bit after trailing significantly for several years.

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

Current Events

Market volatility has been at record levels this last quarter. The bulls and bears seem to be fighting it out, with each having big days. The market is still negative in a year that is usually the strongest in the four-year election cycle. As I mentioned before, the push for reduced government spending by both Democrats and Republicans has neutralized the usual "spend to get votes" impact of pre-election years.

Unemployment and negative economic forecasts throughout the world have weighed heavily on the market this year. Every time it seems that all the bad news possible is out, something new happens. As if politics and unemployment weren't enough, we have been hit by the worst natural disasters I can remember: Earthquakes, hurricanes, floods, forest fires

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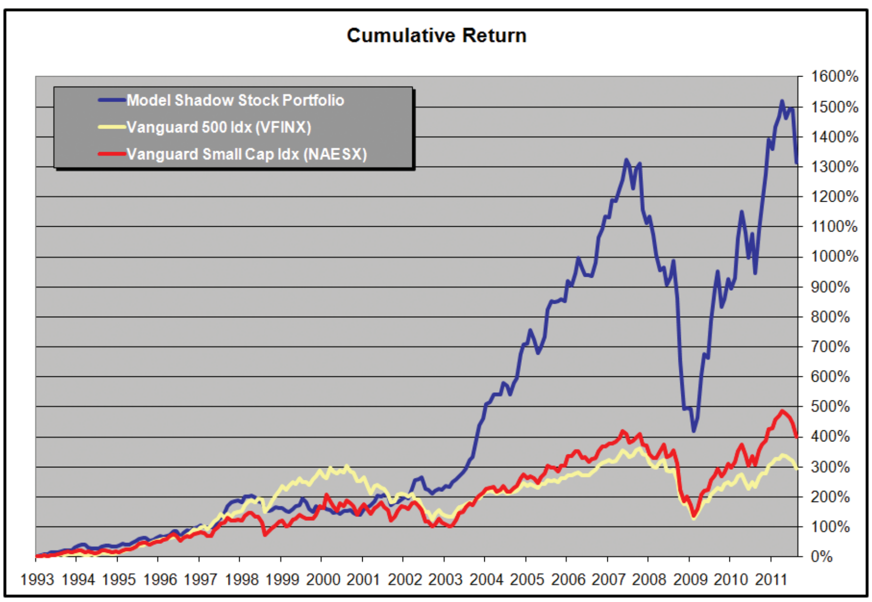
Figure 1. Model Shadow Stock Portfolio Vs. Benchmark (Through 8/31/2011)



Portfolio	Year-to-Date Return (%)	Annual Return (%) 1-Year	3-Year	10-Year	Ann'l Std Dev (%)	3-Year Risk-Adjusted Return (%)*
Model Shadow Stock Portfolio	(5.1)	35.6	9.2	16.7	34.9	7.1
Vanguard 500 Index (VFINX)	(1.9)	18.3	0.5	2.6	20.9	0.5
Vanguard Small Cap Index (NAESX)	(5.0)	22.9	3.1	6.8	28.1	2.9

**Relative to Vanguard Total Stock Market Index fund (VTSMX). Data as of 8/31/2011.*

Table 1. The 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
Addus Homecare Corp. (ADUS)	4.90	6.38	2.80	52.8	10.2	0.58	0.0	qualified as of 9/9/2011
Alamo Group, Inc. (ALG)	21.69	29.27	20.37	258.3	9.6	0.94	1.1	
Audiovox Corp. (VOXX)	6.08	8.98	5.65	140.9	5.8	0.35	0.0	qualified as of 9/9/2011
Books-A-Million (BAMM)	2.60	6.94	2.32	41.1	nmf	0.37	7.7	earnings probation (2011q3)
Capital Senior Living (CSU)	6.15	10.91	5.00	169.9	41.0	0.99	0.0	
CONN'S, Inc. (CONN)	8.02	9.98	2.94	254.8	nmf	0.71	0.0	earnings probation (2010q2)
CSS Industries (CSS)	15.58	21.55	14.98	151.8	39.0	0.67	3.9	
Ennis, Inc. (EBF)	14.93	20.25	13.61	389.0	9.0	1.08	4.2	
Flexsteel Industries (FLXS)	14.82	19.69	13.04	99.5	9.9	0.77	2.0	qualified as of 9/9/2011
Gilat Satellite Networks Ltd. (GILT)	3.41	6.20	3.28	139.2	4.4	0.52	0.0	
Hastings Entertainment (HAST)	2.90	7.49	2.77	25.0	nmf	0.25	0.0	earnings probation (2011q3)
Hooker Furniture Corp. (HOFT)*	9.19	14.75	7.96	99.2	31.7	0.78	4.4	qualified as of 9/9/2011
Key Tronic Corp. (KTCC)	3.68	6.84	3.37	38.1	6.7	0.56	0.0	
Kimball International (KBALB)	4.94	7.89	4.83	135.5	38.0	0.48	4.0	qualified as of 9/9/2011
Lithia Motors, Inc. (LAD)	14.93	23.84	8.04	395.9	12.8	1.15	1.9	
Marlin Business Services (MRLN)	10.45	13.74	9.37	134.0	26.1	0.84	0.0	
Mitcham Industries, Inc. (MIND)	13.55	20.00	6.75	168.2	14.6	1.08	0.0	
Paragon Shipping Inc. (PRGN)	1.25	4.04	1.17	74.0	nmf	0.15	0.0	earnings probation (2011q3)
PC Connection, Inc. (PCCC)	8.69	9.91	6.56	232.4	8.5	0.87	0.0	
PC Mall, Inc. (MALL)	6.36	10.98	4.10	78.9	10.1	0.71	0.0	qualified as of 9/9/2011
RCM Technologies (RCMT)	4.33	5.93	4.15	56.5	12.0	0.79	0.0	qualified as of 9/9/2011
Rex American Resources (REX)	15.63	18.00	12.96	147.3	31.9	0.60	0.0	qualified as of 9/9/2011
Rocky Brands, Inc. (RCKY)	11.02	16.47	6.88	82.5	7.8	0.76	0.0	qualified as of 9/9/2011
Saga Communications (SGA)	27.25	40.45	17.94	115.9	8.9	1.36	0.0	
Shoe Carnival, Inc. (SCVL)	22.17	34.05	16.63	294.3	11.1	1.08	0.0	
Standard Motor Products (SMP)	12.70	16.34	9.04	290.7	8.4	1.22	2.2	
Standex Int'l Corp. (SXI)	31.79	39.11	22.27	401.4	11.2	1.60	0.8	
SureWest Communications (SURW)	10.66	17.83	5.61	150.2	48.5	0.54	3.0	qualified as of 9/9/2011
Willis Lease Finance (WLFC)	12.49	14.20	9.42	149.7	9.1	0.52	0.0	

**Company is new to the model portfolio. Added 9/1/2011.*
Source: AAII's Stock Investor Pro*/Thomson Reuters. Data as of 9/9/2011.*

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 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 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	15.3	(5.1)	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)	7.7	(1.9)	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)	9.0	(5.0)	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)	10.6	(6.5)	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 8/31/201.

(continued from page 33)

and drought all arrived at virtually the same time.

On the other hand, there is a lot of cash out there looking for a home. I have the feeling that if the stock market could get moving at all, it could be a significant move.

Portfolio Changes

AeroCentury Corp. (ACY) was sold because it violated probation with a quarterly loss.

An unusual event happened to one of the stocks in the Model Shadow Stock Portfolio in relation to our portfolio rules. Conn's Inc. (CONN) violated probation and went off probation at the same time. This occurred because it had a loss in the most recent quarter while on probation, but the loss replaced a huge year-earlier loss that made its earnings positive for the year. The stock was retained because the recent loss was a seasonal one that usually occurs and because the general guide is to keep transactions to a minimum. In addition, analysts' earnings estimate revisions were positive.

One stock was added to the Shadow Stock Portfolio this quarter: Hooker Furniture (HOFT). Twenty-three stocks passed my first screen in August; a higher number than passed in July, as shown in Figure 2. Five of these were Chinese companies and, as I have done previously, I eliminated them because I do not know whether to believe their figures or not. Out of the passing companies not already in the portfolio, Hooker was chosen because of its dividend, a criterion we have used as a tie-breaker in the past.

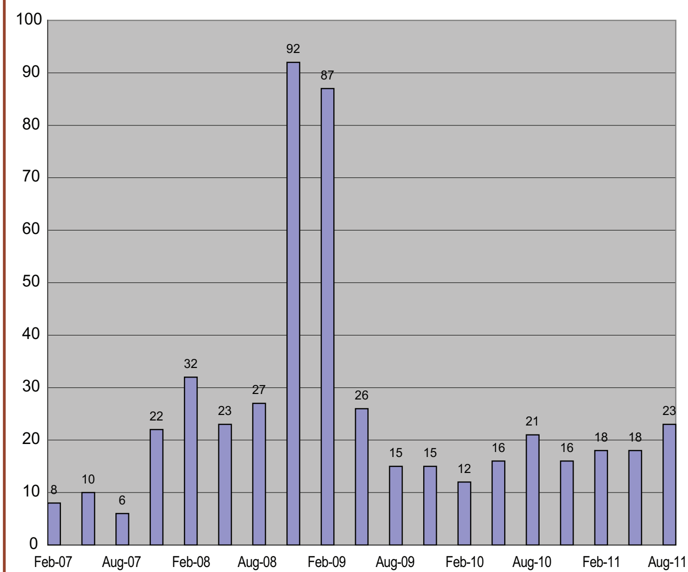
Third-quarter transactions are summarized in Table 3.

Outlook

As I felt in July, I have a slightly bullish bias, mostly because everything looks so bleak. We got out of the debt limit crisis, but not without damage. I continue to feel long-term allocations are appropriate.

We have lots of presidential primary speeches with programs and promises to hear before the next update on the Model Shadow Stock Portfolio in my January column. In the meantime you can follow the portfolio at AAII.com. ➤

Figure 2. Number of First-Pass Qualifying Stocks



The numbers shown here may differ from your results depending on your requirement for average daily trading volume.

Table 3. Third Quarter 2011 Transactions

Company (Ticker)	Reason
Sell	
AeroCentury Corp. (ACY)	negative earnings
Buy	
Hooker Furniture Corporation (HOFT)	

James B. Cloonan is founder and chairman of AAII.