

Model Shadow Stock Portfolio Reaches an All-Time High

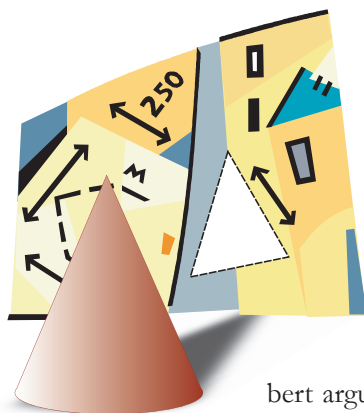
By James B. Cloonan

The run of strong performance in smaller-cap stocks that began in December 2011 has carried through January and February, and micro caps have led the way.

The Model Shadow Stock Portfolio is up 17.2% year to date compared to 9.0% for the S&P 500 as measured by the Vanguard 500 Index fund (VFINX). The model portfolio is now at an all-time high.

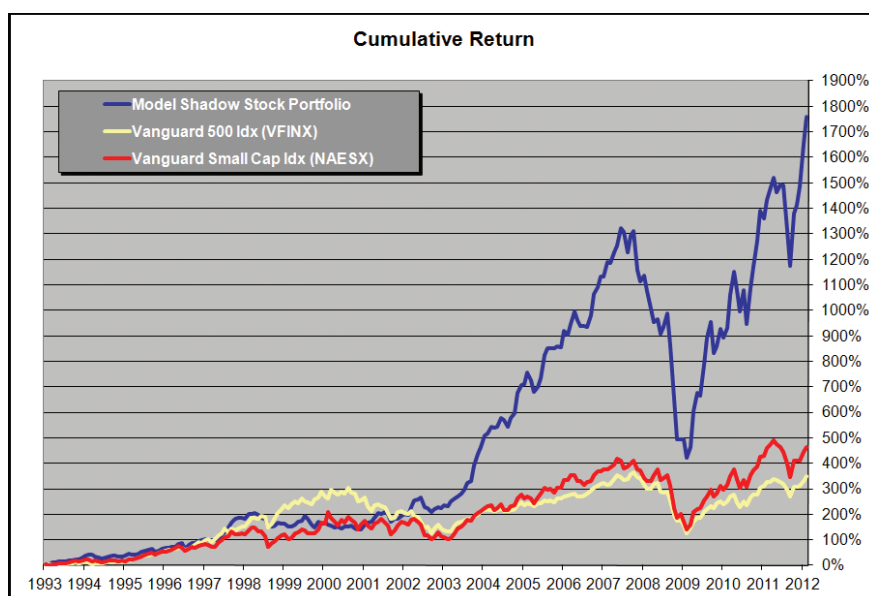
Other results and comparisons can be seen in Figure 1 and Table 3. We have added new columns to Table 3 to show the cumulative values of a \$10,000 investment since inception of the Model Shadow Stock Portfolio in 1993. Notice the difference between the \$185,923 present value of \$10,000 invested 19+ years ago in the Model Shadow Stock Portfolio compared to \$44,844 for VFINX and \$56,358 for the Vanguard Small Cap Index fund (NAESX). What seems like a modest annual difference compounds very significantly over the years.

The Model Shadow Stock Portfolio's 16.5% annual average return since inception almost 20 years ago underscores a point made in Mark Hulbert's article in the January 2012



AAll Journal ("Believing Performance Claims: A Triumph of Hope Over Experience"). Hulbert argued that 15% seems to be about the maximum long-term return possible without the additional techniques

Figure 1. Model Shadow Stock Portfolio Vs. Benchmark (Through 2/29/2012)



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	17.2	21.4	52.8	20.2	28.7	31.3
Vanguard 500 Index (VFINX)	9.0	5.0	25.4	4.1	20.9	20.9
Vanguard Small Cap Index (NAESX)	10.4	1.0	33.1	8.1	23.0	25.4

*Relative to Vanguard Total Stock Market Index fund (VTSMX).
Data as of 2/29/2012.

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)	3.60	6.38	3.00	38.8	nmf	0.47	0.0	
Alamo Group, Inc. (ALG)	26.87	30.37	19.71	320.1	11.2	1.16	0.9	
Capital Senior Living (CSU)	8.57	10.91	5.44	237.2	53.6	1.37	0.0	
CONN'S, Inc. (CONN)	13.26	14.75	4.14	424.0	nmf	1.23	0.0	
CSS Industries (CSS)	19.60	22.40	14.98	190.6	21.3	0.76	3.1	qualified as of 2/29/2012
Ducommun Inc. (DCO)	15.27	26.08	10.84	160.9	32.5	0.63	0.0	qualified as of 2/29/2012
Ennis, Inc. (EBF)	16.76	20.25	12.08	436.7	11.5	1.20	3.7	
Flexsteel Industries (FLXS)	17.10	17.18	13.04	115.7	10.6	0.87	2.3	
Gilat Satellite Networks (GILT)	3.77	5.87	3.04	153.9	nmf	0.60	0.0	
Hooker Furniture Corp. (HOFT)	12.01	13.71	7.96	129.6	30.8	1.01	3.3	
Key Tronic Corp. (KTCC)	10.84	11.49	3.21	113.2	16.9	1.64	0.0	
Kimball International (KBALB)	6.16	7.89	4.61	169.3	34.2	0.61	3.2	qualified as of 2/29/2012
Marlin Business Services (MRLN)	15.70	16.58	9.37	201.1	32.0	1.14	1.5	
Medical Action Industries (MDCI)	5.42	9.85	4.31	88.8	27.1	0.59	0.0	qualified as of 2/29/2012
Mitcham Industries (MIND)	23.37	26.76	9.52	290.3	16.9	2.03	0.0	approaching value limit
PC Connection, Inc. (PCCC)	8.94	12.92	6.73	236.4	8.3	0.86	0.0	
PC Mall, Inc. (MALL)	6.05	10.98	4.80	72.8	10.1	0.67	0.0	qualified as of 2/29/2012
RCM Technologies (RCMT)	5.48	5.93	3.98	70.0	16.6	0.98	0.0	
Rex American Resources (REX)	30.67	31.83	13.36	255.2	39.8	1.19	0.0	
Rocky Brands, Inc. (RCKY)	11.75	16.47	8.75	88.2	10.6	0.75	0.0	qualified as of 2/29/2012
Saga Communications (SGA)	37.52	47.98	26.65	159.5	12.1	1.79	0.0	
Shoe Carnival, Inc. (SCVL)	26.18	34.05	19.19	349.6	12.7	1.22	0.0	
Standard Motor Products (SMP)	22.72	25.91	10.25	514.2	13.9	2.14	1.6	approaching size & value limit
Standex Int'l Corp. (SXI)	38.21	43.92	25.11	483.6	13.0	1.96	0.7	
Sterling Construction (STRL)	10.37	17.00	9.50	169.2	10.1	0.67	0.0	qualified as of 2/29/2012
VOXX International* (VOXX)	12.79	14.56	4.69	295.1	9.3	0.72	0.0	
Willis Lease Finance (WLFC)	14.47	14.82	9.91	170.8	11.0	0.61	0.0	qualified as of 2/29/2012

*formerly Audiovox Corp.

Source: AAI's Stock Investor Pro/Thomson Reuters. Data as of 2/29/2012.

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.

and leverage of hedge funds, which are not available to individual investors, or the ability to influence management behavior, which an investor like Warren Buffett has.

Portfolio Changes

Table 1 lists the current holdings in the Shadow Stock Portfolio. As shown in Table 2, we sold three stocks. Lithia Motors, Inc. (LAD) was sold because it violated our size limit of \$600 mil-

Table 2. First Quarter 2012 Transactions

Company (Ticker)	Reason
Buy	
Ducommun Inc. (DCO)	
Medical Action Industries (MDCI)	
Sterling Construction (STRL)	
Sell	
Lithia Motors, Inc. (LAD)	exceeded size limit
Paragon Shipping Inc. (PRGN)	negative earnings
SureWest Communications (SURW)	acquired by Consolidated Communications

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 3. Model Shadow Stock Portfolio: Annual Performance

	Average Annual Return (%)			Cumulative Value of \$10,000 (\$)		
	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
YTD	17.2	9.0	10.4	185,923	44,844	56,358
Since Incep	16.5	8.1	9.4	185,923	44,844	56,358

Data as of 2/29/2012.

lion market capitalization. It almost quadrupled for us, and we wish it happened in someone's mid-cap portfolio. Paragon Shipping Inc. (PRGN) was sold because it violated earnings probation. SureWest Communications (SURW) has agreed to a buyout by Consolidated Communications. Current shareholders will have to choose between cash and new stock, but our general rule is to sell when the board of a company agrees to a takeover.

The proceeds from these sales were used to make three purchases, listed in Table 2. We bought Ducommun Inc. (DCO), Medical Action Industries (MDCI) and Sterling Construction (STRL).

Our first pass of stocks meeting the purchase criteria showed 17 qualifying stocks (Figure 2). Three of these were Chinese stocks, which we continue to eliminate because of data uncertainty,

and three were stocks we currently own. The final selection was based on a combination of low price-to-book-value ratio, low market capitalization, and high liquidity.

Outlook

Since the 1930s, the third year in the elec-

tion cycle had always been a slightly above-average 12% for the stock market. But four years ago the election year was one of the worst in history—down 37%. While the average election-year return since the Great Depression is still 10.3%, the recent behavior of stocks has departed from previous history, and the election cycle may not be much of a guide. One reason for this might be the growing importance of foreign factors: The election cycle has always been explained in terms of domestic spending activities, but other countries have different political and economic cycles.

I feel a bit more bullish than average, but not enough to change basic asset allocations. There is still a lot of uncertainty in the stock market. The election poses much uncertainty—not just about who will be nominated and/or elected, but about what the candidates' plans really are. And the uncertainty extends beyond the presidential election to who will control the U.S. House and Senate.

We will examine the Model Shadow Stock Portfolio again in the July *AAIL Journal*, and you can follow any changes at AAIL.com. ▲

Figure 2. Number of First-Pass Qualifying Stocks

