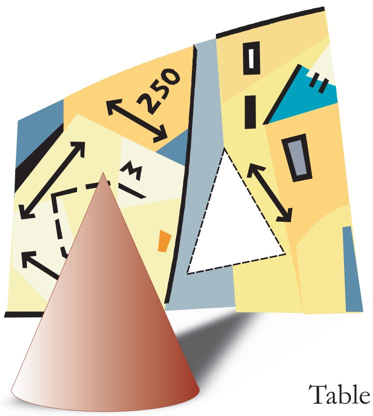
Despite Uncertainty, Model Shadow Stock Portfolio Still Positive for 2012

By James B. Cloonan



May has taken away much of the stock market gain of the first four months.

This pullback has impacted the Model Shadow Stock Portfolio as well as the general market. The portfolio was up 9.1% for the year as of May 31, 2012, compared to a 5.1% year-to-date return for the S&P 500 index, as measured by the Vanguard 500 Index fund (VFINX). But the Model Shadow Stock Portfolio had been up over 22% for the year in mid-March.

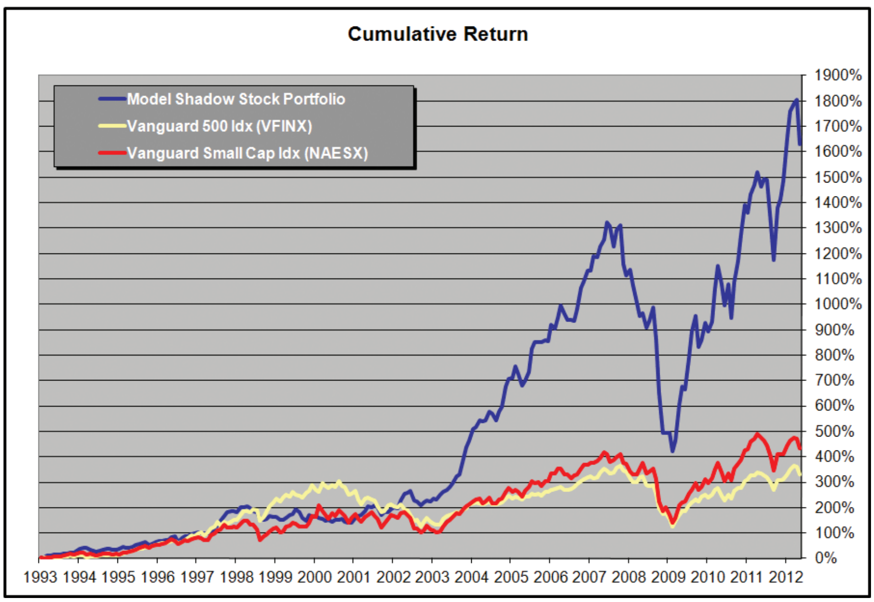
The stock market hates uncertainty, and uncertainty is with us. In addition to an extension of the eurozone problems because of the government transition in Greece, we have domestic uncertainty as well. The economic picture is not clear. No one knows what the Federal Reserve will do. And election debating points seem to be more important to our government than making decisions about taxes, budgets, Social Security, and Medicare.

Longer-term results and comparisons can be seen in Figure 1 and Table 3. While the pullback in May was disappointing, the portfolio movement for the year-to-date is still upward, and a bit above our average results.

No Changes to Portfolio

Table 1 lists the current holdings in the Model Shadow Stock Portfolio.

Figure 1. Model Shadow Stock Portfolio Vs. Benchmark (Through 5/31/2012)



Portfolio	Year-to-Date Return (%)	Annual Return (%) 1-Year	3-Year	5-Year	10-Year	Ann'l Std Dev (%)	3-Year Risk-Adjusted Return (%)*
Model Shadow Stock Portfolio	9.1	10.8	30.7	5.0	17.1	26.4	20.0
Vanguard 500 Index (VFINX)	5.1	(0.6)	14.8	(1.0)	4.0	15.8	14.8
Vanguard Small Cap Index (NAESX)	4.3	(7.6)	18.4	0.5	7.0	21.2	14.7

**Relative to Vanguard Total Stock Market Index fund (VTSMX).*
Data as of 5/31/2012.

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)	3.99	6.38	3.00	43.0	nmf	0.49	0.0	
Alamo Group, Inc. (ALG)	30.97	34.23	19.71	369.2	11.2	1.33	0.8	
Capital Senior Living (CSU)	9.88	10.40	5.44	278.2	141.1	1.58	0.0	
CONN'S, Inc. (CONN)	17.49	19.83	4.97	564.6	nmf	1.58	0.0	approaching size limit
CSS Industries (CSS)	19.04	22.40	14.98	185.2	11.4	0.76	3.2	
Ducommun Inc. (DCO)	9.03	23.54	8.43	95.3	nmf	0.46	0.0	
Ennis, Inc. (EBF)	14.22	18.90	12.08	371.9	11.8	1.01	4.9	
Flexsteel Industries (FLXS)	20.11	22.00	13.04	136.7	11.6	1.00	2.0	
Gilat Satellite Networks (GILT)	3.19	5.20	3.04	131.7	nmf	0.51	0.0	
Hooker Furniture Corp. (HOFT)	10.98	13.99	7.96	118.5	23.4	0.93	3.6	
Key Tronic Corp. (KTCC)	9.69	13.16	3.21	101.4	11.0	1.36	0.0	
Kimball International (KBALB)	6.88	7.19	4.61	260.8	45.9	0.68	2.9	
Marlin Business Services (MRLN)	14.41	16.58	9.37	183.3	26.2	1.05	1.7	
Medical Action Industries (MDCI)	4.31	9.80	4.25	70.6	21.6	0.47	0.0	qualified as of 5/31/2012
Mitcham Industries (MIND)	18.90	26.76	9.52	240.4	9.5	1.51	0.0	
PC Connection, Inc. (PCCC)	8.98	12.92	6.73	237.1	8.1	0.85	0.0	
PC Mall, Inc. (MALL)	5.32	8.40	4.80	64.0	38.0	0.57	0.0	
RCM Technologies (RCMT)	5.68	6.16	3.98	72.2	17.8	1.00	0.0	
Rex American Resources (REX)	18.42	33.95	14.15	154.6	7.3	0.61	0.0	qualified as of 5/31/2012
Rocky Brands, Inc. (RCKY)	13.23	14.33	8.75	99.3	11.7	0.84	0.0	
Saga Communications (SGA)	34.90	47.98	26.65	148.3	10.8	1.55	0.0	
Shoe Carnival, Inc. (SCVL)	21.18	22.70	12.79	432.6	15.7	1.45	0.0	
Standard Motor Products (SMP)	13.51	25.91	10.25	311.1	4.9	1.10	2.7	
Standex Int'l Corp. (SXI)	40.69	46.05	25.11	513.7	11.9	1.98	0.7	approaching size limit
Sterling Construction (STRL)	9.00	14.60	8.54	146.9	nmf	0.71	0.0	earnings probation (2012 Q1)
VOXX International (VOXX)	9.86	14.56	4.69	230.8	9.0	0.54	0.0	
Willis Lease Finance (WLFC)	12.74	14.82	9.91	118.4	11.7	0.52	0.0	qualified as of 5/31/2012

Source: AAII's Stock Investor Pro*/Thomson Reuters. Data as of 5/31/2012.*

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.

Table 2 shows that there were no transactions for the second quarter of 2012. We had no sales of holdings this period, and as a result there were no purchases. Remember this is a real portfolio, and we can't buy if we don't sell.

Nineteen stocks passed the initial screen, which is about the average number of passing companies since 2008, as shown in Figure 2. Of the 19, four were Chinese stocks and three were already in our portfolio.

The number of Chinese stocks

Table 2. Second Quarter 2012 Transactions

Company (Ticker)	Reason
Buy	
No buys for second quarter.	
Sell	
No sells for second quarter.	

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

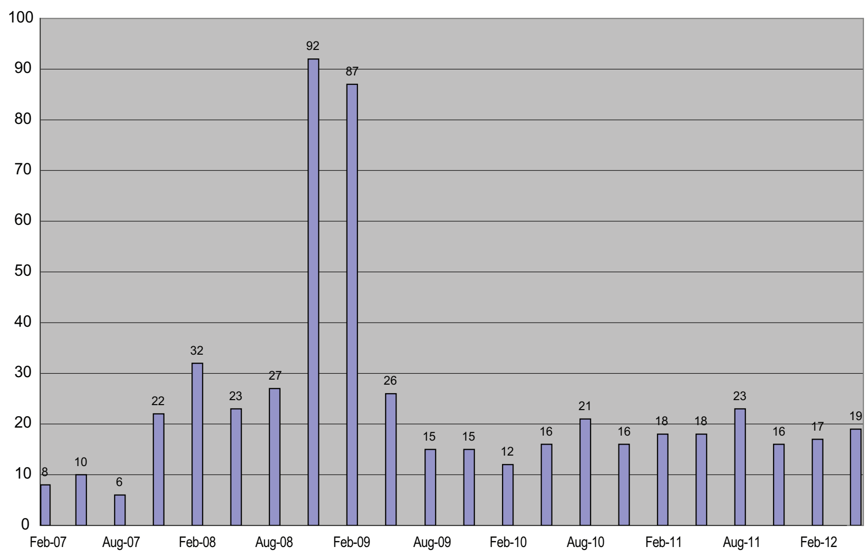
- Equal dollar amounts are invested in each stock initially.
- Decisions are made only at the end of each quarter. In order to react to the majority of earnings reports as soon as possible, quarterly reviews are made in February, May, August, and November.
- Best judgment is used for tenders or mergers, 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	9.1	5.1	4.3	173,189	43,248	53,246
Since Incep	15.8	7.8	9.0	173,189	43,248	53,246

Data as of 5/31/2012.

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.

appearing in our screen dropped in the past two quarters, and I wondered what had happened to them. They appeared when I eliminated the minimum $4.00 share price constraint. Not all, but a significant number of the Chinese passing companies from a year ago or so have dropped below $4.00 in price in recent quarters.

Remember, the number of qualifying stocks will change based on your liquidity requirements. In our initial screen, we may require more liquidity than you would need, and so you might find more than 19 stocks. The Stock Order Guidance section of the Model Shadow Stock Portfolio Rules box on page 35 discusses this issue.

Stock Split

Model Shadow Stock Portfolio holding Shoe Carnival, Inc. (SCVL) split 3-for-2.

You need to adjust the purchase price and the number of shares in your records if you hold this stock.

Your broker should have made the adjustments on your account records.

Looking Ahead

Over the next few months, we will be treated to what seems destined to be one of the bitterest election campaigns in recent history. Both parties have record campaign funds to give the fight maximum exposure. Remember that it is a campaign, and that not all the bad things are true. Our economy and the equities market will survive the battle, and the results, no matter what the outcome is.

We will be examining the Model Shadow Stock Portfolio in the October 2012 *AAII Journal*; in the meantime you can follow updates at AAII.com. ➤

James B. Cloonan is founder and chairman of AAII.