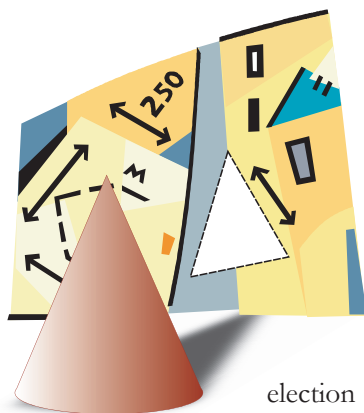


Higher Prices Prompt Rule Change in the Model Shadow Stock Portfolio

By James B. Cloonan



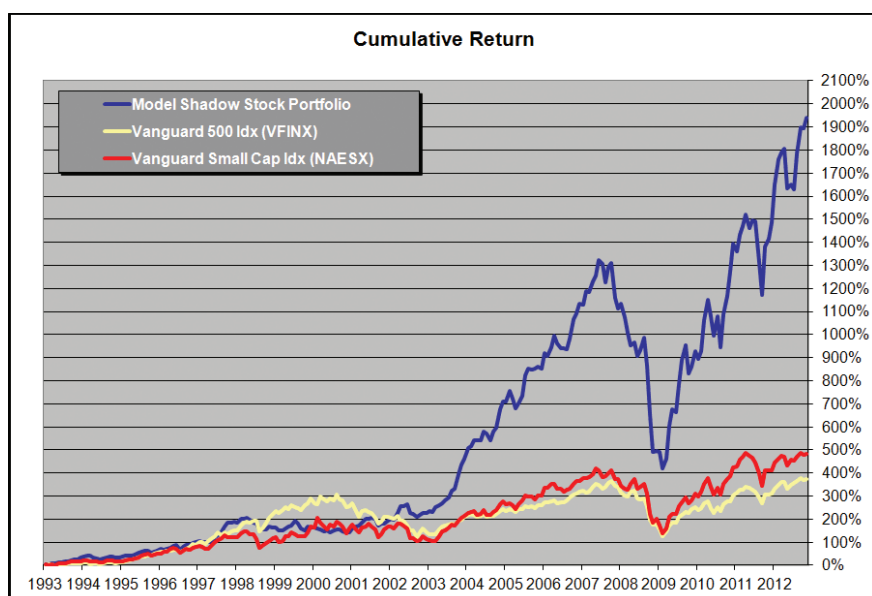
While the market in general keeps approaching and then backing off new highs, the Model Shadow Stock Portfolio has broken through and is now up 28.5% year-to-date as of November 30, 2012. This compares to 14.8% for the S&P 500 index as measured by the Vanguard 500 Index fund (VFINX). The returns for longer periods can be seen in Figure 1 and Table 3.

The presidential election is over, and we are spared the media barrage of negative comments. We do have the fiscal cliff debates and speeches, which seem to be affecting the stock market for about an hour at a time. I hope that problem will be mostly resolved by the time you read this column, but who knows.

I am not a technician, but I certainly have the feeling that the market wants to go up. Even with the mess in Washington and the threat of a serious negative impact on the economy if something isn't done about taxes and spending, the market hangs in. With billions on the sidelines and in very

low yield bonds, there is certainly the scenario for a strong stock market even though post-election years have historically had the weakest average returns of the four-year presidential cycle.

Figure 1. Model Shadow Stock Portfolio vs. Benchmark (Through 11/30/2012)



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	28.5	34.6	28.5	20.1	23.6	19.7
Vanguard 500 Index (VFINX)	14.8	16.0	11.1	6.2	15.1	11.1
Vanguard Small Cap Index (NAESX)	14.5	14.8	15.3	9.9	20.1	12.5

*Relative to Vanguard Total Stock Market Index fund (VTSMX).
Data as of 11/30/2012.

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)	6.78	6.90	3.00	73.3	11.5	0.81	0.0	
Alamo Group, Inc. (ALG)	33.12	34.63	25.51	396.3	12.4	1.29	0.7	
Capital Senior Living Corp. (CSU)	17.81	18.00	6.70	501.8	nmf	2.87	0.0	approaching value limit
CSS Industries, Inc. (CSS)	20.52	22.40	17.86	196.5	13.0	0.81	2.9	
Ducommun Incorporated (DCO)	15.67	15.89	7.71	166.0	nmf	0.76	0.0	
Ennis, Inc. (EBF)	15.22	17.74	12.80	398.1	18.3	1.09	4.6	
Flexsteel Industries (FLXS)	19.89	23.28	13.26	139.4	10.4	0.97	3.0	
Gilat Satellite Networks (GILT)	5.26	5.60	2.31	217.2	nmf	0.82	0.0	
Hardinge Inc. (HDNG)	9.59	11.65	7.61	112.1	8.4	0.70	0.8	qualified as of 11/30/2012
Hooker Furniture Corp. (HOFT)	13.89	14.25	9.30	149.3	27.8	1.18	2.9	
Key Tronic Corp. (KTCC)	10.14	13.16	4.40	106.4	7.7	1.27	0.0	
Kimball International (KBALB)	12.48	13.25	5.03	475.2	28.4	1.21	1.6	
Marlin Business Services (MRLN)	17.30	23.08	12.39	220.4	21.9	1.23	1.8	
Medical Action Industries (MDCI)	2.69	6.36	2.25	44.1	nmf	0.30	0.0	
Mitcham Industries (MIND)	14.49	26.76	12.39	186.1	6.0	1.07	0.0	
Olympic Steel, Inc. (ZEUS)	19.77	28.31	14.77	215.8	16.8	0.72	0.4	
PC Connection, Inc. (PCCC)	10.60	12.92	7.34	281.0	8.9	0.94	0.0	
PC Mall, Inc. (MALL)	5.93	6.70	5.06	71.1	31.2	0.62	0.0	qualified as of 11/30/2012
RCM Technologies, Inc. (RCMT)	5.75	6.16	4.89	69.2	22.1	0.99	0.0	
Renewable Energy Gp (REGI)	5.92	10.65	4.28	180.7	2.2	0.53	0.0	
REX American Resources (REX)	18.84	33.95	14.43	155.2	8.1	0.62	0.0	qualified as of 11/30/2012
Rocky Brands, Inc. (RCKY)	13.31	14.33	8.75	99.9	15.1	0.81	0.0	
Saga Communications (SGA)	45.35	47.98	33.53	192.7	11.8	1.83	0.0	
Shoe Carnival, Inc. (SCVL)	22.11	24.66	14.97	452.4	15.2	1.41	0.9	
Standard Motor Products (SMP)	19.56	25.91	11.94	446.3	6.8	1.46	1.8	
Standex Int'l Corp. (SXI)	49.26	52.14	31.60	626.9	13.4	2.42	0.6	approaching size & value limits
Sterling Construction (STRL)	9.23	12.42	7.12	152.3	nmf	0.72	0.0	earnings probation (2012 Q2)
VOXX International (VOXX)	6.74	14.56	5.55	157.7	8.4	0.38	0.0	qualified as of 11/30/2012
Willis Lease Finance (WLFC)	14.33	14.82	10.75	127.0	nmf	0.59	0.0	

Source: AAI's Stock Investor Pro/Thomson Reuters. Data as of 11/30/2012.

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 \$240 million. Stocks are marked "approaching size limit" if their current market cap exceeds 2½ times the initial criterion, or \$600 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 Model Shadow Stock Portfolio area of AAI.com for more information.

Portfolio Rule Change

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

Standex International Corp. (SXI) would have been sold based on its market capitalization being over \$600 million, but we have raised the market-cap criterion. Stocks must now have a market cap between \$30 million and \$240 million to be considered for purchase. Therefore, the sell requirement of three times the initial maximum market cap moves up

to \$720 million. Stocks will be marked as approaching the size limit if they reach \$600 million, 2½ times the initial maximum market cap. The increase in the price of micro-cap stocks required this adjustment.

Since we had no stocks that needed to be sold in our fourth-quarter review, there are no buy transactions this period, as shown in Table 2.

There were 18 qualifying

Table 2. Fourth Quarter 2012 Transactions

Company (Ticker)	Reason
Buy	
<i>No buys for fourth quarter.</i>	
Sell	
<i>No sells for fourth quarter.</i>	

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 \$30 million and \$240 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.

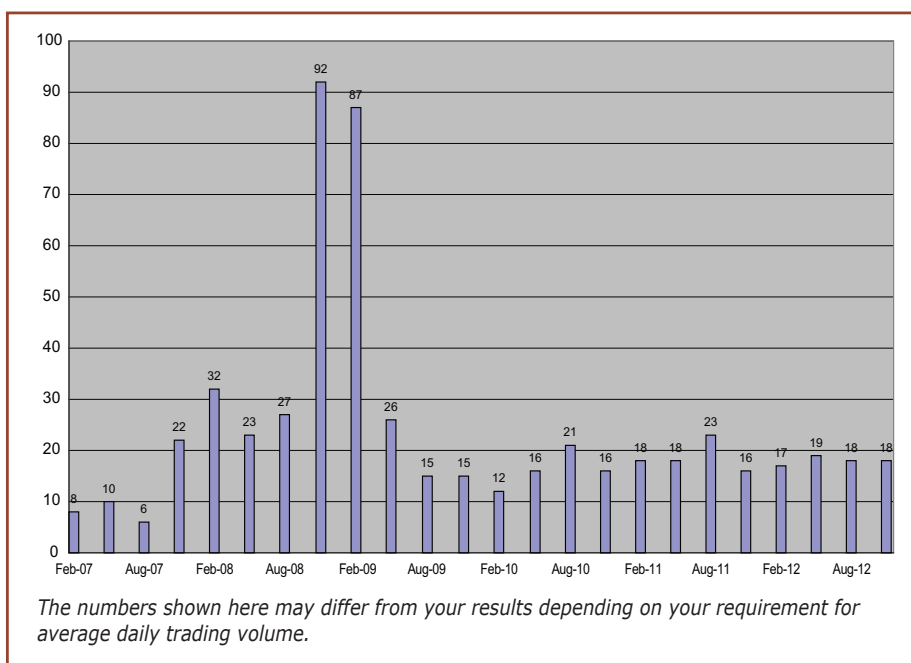
Management Rules

- 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

Year	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	28.5	14.8	14.5	203,895	47,241	58,479
Since Incep	16.3	8.1	9.3	203,895	47,241	58,479

Data as of 11/30/2012.

Figure 2. Number of First-Pass Qualifying Stocks

stocks under our liquidity criterion as well as the new market-cap criterion, as shown in Figure 2. Of these, two were already owned and three were Chinese stocks, which we continue to avoid.

Micro-Cap Performance

The Model Shadow Stock Portfolio has been doing extremely well since the 2007–2008 bear market, considerably better than the overall market and various subindexes.

It is a little perplexing that small stocks in general have not outperformed and value stocks have been lagging growth stocks this period. The only explanation I can think of is that micro caps as we have defined them are different than small caps, which many define as having market capitalization up to \$2 billion or more. Also, we have a rather strict definition of value (price-to-book-value ratio less than 0.80), while value stocks as defined in most indexes cover the half of all stocks in a category with the lowest price-to-book ratio. This often includes price-to-book levels of 2.0 or more.

Looking Ahead

As I mentioned, I have a slightly bullish bias, but would not suggest any deviations from a long-term allocation. While the average low return of post-election years since the 1930s is 6.7%, there have been some notable exceptions. In fact, four years ago the return on the S&P 500 was 26.5% and the return on this portfolio was 72.3%. In addition, all the major averages are below their all-time highs, which is certainly bullish for the long term, if not the short term.

If the fiscal cliff has been bridged by the time you read this, at least that variable will be put to rest. Of course, looking around the world we still have plenty of variables to be concerned about. We will review the portfolio again in the April 2013 *AAIL Journal*; until then, you can keep abreast at AAIL.com. ▲

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