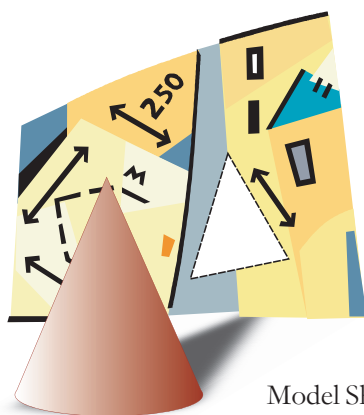


The Model Shadow Stock Portfolio and Micro-Cap Stock Spreads

By James B. Cloonan



Even with the pullback in August, it continues to be a very strong year for the Model Shadow Stock Portfolio. The portfolio is up 33.6% year-to-date as of August 31, 2013, compared to a gain of 16.0% for the S&P 500 index as measured by the Vanguard 500 Index fund (VFINX).

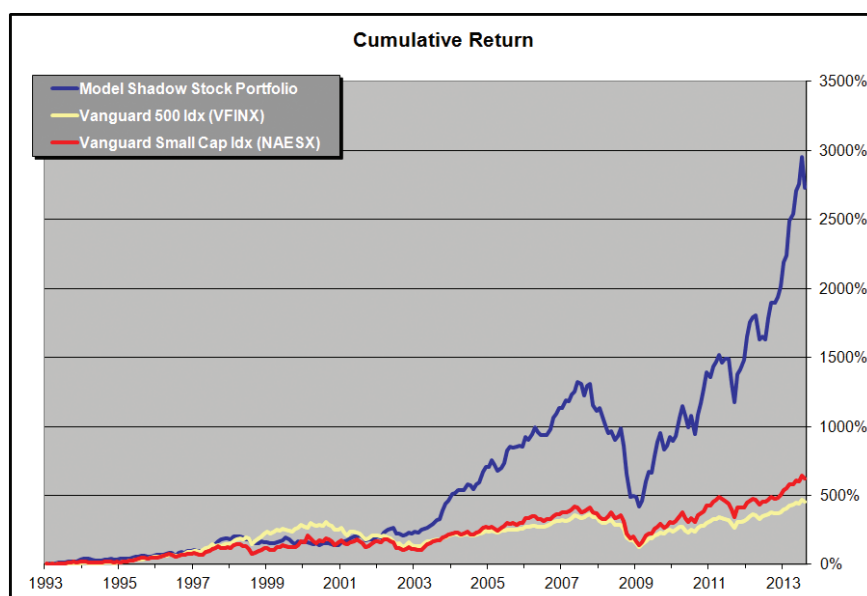
These results, as well as results for longer periods, can be seen in Figure 1 and Table 3. Almost every segment of the stock market seems very strong despite lots of disquieting events. I mentioned last quarter that although some of the economic concerns had lessened, we would probably find a new problem by the time this article was written. Sure enough, we got Syria and the problem of how to respond to their use of chemical weapons.

While the decision of what to do about Syria will be made before my January column, the budget crisis will be coming back into play over the next three months. So far, the market has taken a little step back with each negative event or prediction and then come bouncing back.

Interest rates keep going up. While this mainly affects bonds, there is an

impact on those stocks whose price levels are maintained based on dividend yield. The Model Shadow Stock Portfolio does not include any such stocks. There is some feeling that as interest rates rise inves-

Figure 1. Model Shadow Stock Portfolio vs. Benchmark (Through 8/31/2013)



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	33.6	49.8	39.4	20.9	21.2	25.6
Vanguard 500 Index (VFINX)	16.0	18.5	18.2	7.0	12.9	18.2
Vanguard Small Cap Index (NAESX)	19.7	26.3	21.1	10.0	17.4	16.8

*Relative to Vanguard Total Stock Market Index fund (VTSMX).
Data as of 8/31/2013.

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)	21.18	23.71	4.70	231.1	21.0	2.07	0.0	approaching value limit
Alamo Group, Inc. (ALG)	45.36	47.61	28.59	549.2	17.4	1.69	0.6	
Alpha & Omega Semicon (AOSL)	7.08	9.90	6.64	180.6	nmf	0.64	0.0	earnings probation (2013 Q4)
CSS Industries Inc. (CSS)	21.82	31.50	18.79	207.6	14.2	0.85	2.7	
Ducommun Incorporated (DCO)	26.15	29.37	12.86	279.3	15.8	1.19	0.0	
Ennis, Inc. (EBF)	17.81	19.42	13.90	466.9	15.8	1.25	3.9	
Fab Universal Corp. (FU)*	4.04	5.70	2.25	84.1	16.2	0.58	0.0	qualified as of 8/31/2013
Flexsteel Industries (FLXS)	22.49	26.29	18.56	159.9	12.6	1.06	2.7	
Gilat Satellite Networks (GILT)	4.75	6.20	3.06	199.6	nmf	0.84	0.0	
Hardinge Inc. (HDNG)	14.49	16.88	8.56	170.4	12.1	1.06	0.6	
Hooker Furniture Corp. (HOFT)	14.39	18.31	11.35	154.5	16.0	1.17	2.8	
International Shipholding (ISH)	23.85	28.13	13.00	172.9	10.8	0.60	4.2	qualified as of 8/31/2013
Key Tronic Corp. (KTCC)	9.91	12.28	8.69	103.9	8.6	1.10	0.0	
Kimball International (KBALB)	9.84	13.25	8.48	294.5	18.9	0.93	2.0	
LMI Aerospace, Inc. (LMIA)*	12.09	23.20	12.02	155.4	11.3	0.73	0.0	qualified as of 8/31/2013
Marlin Business Services (MRLN)	24.36	25.97	15.43	314.8	20.6	1.66	1.8	
Medical Action Industries (MDCI)	5.11	10.07	2.25	83.8	nmf	0.88	0.0	
Mitcham Industries, Inc. (MIND)	17.56	18.79	11.51	224.5	15.7	1.25	0.0	
Olympic Steel, Inc. (ZEUS)	25.98	29.48	15.43	284.5	nmf	0.96	0.3	
PC Connection, Inc. (PCCC)	14.85	17.65	9.82	388.5	11.6	1.26	0.0	
PCM Inc. (PCMI)	9.79	11.96	5.06	113.2	13.8	0.93	0.0	
RCM Technologies, Inc. (RCMT)	5.70	6.72	5.00	70.5	17.3	1.14	0.0	
Renewable Energy Group (REGI)	15.45	16.50	4.28	517.5	9.6	1.15	0.0	
REX American Resources (REX)	29.54	41.00	14.43	241.2	NA	0.96	0.0	
Rocky Brands, Inc. (RCKY)	15.89	19.37	10.84	119.4	11.3	0.94	2.5	
Salem Communications (SALM)	7.74	10.14	4.62	192.0	nmf	1.00	2.6	earnings probation (2013 Q1)
Shoe Carnival, Inc. (SCVL)	25.39	27.22	18.80	519.7	16.8	1.65	0.9	
Standard Motor Products (SMP)	30.66	38.05	16.57	704.9	14.2	2.13	1.4	approaching size & value limits
TravelCenters of America (TA)	7.61	12.50	4.18	225.0	10.9	0.59	0.0	qualified as of 8/31/2013
VOXX International (VOXX)	12.16	15.00	5.55	292.1	9.9	0.65	0.0	
Willis Lease Finance (WLFC)	14.04	16.28	11.70	124.4	40.1	0.54	0.0	qualified as of 8/31/2013

*Company is new to the portfolio. Added 9/3/2013.

Source: AII's Stock Investor Pro/Thomson Reuters. Data as of 8/31/2013.

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 AII.com for more information.

tors will switch from stocks to bonds, thereby putting downward pressure on stock prices. Interest rate increases, particularly at current low levels, are likely to signal continued economic recovery, which should be positive for stocks.

Portfolio Changes

Table 1 lists the current holdings in the Model Shadow Stock Portfolio. We sold Saga Communications Inc. (SGA) because it no longer comes close to

being a value stock. It may prosper in someone's growth portfolio. The August pull-back stopped Standard Motor Products (SMP) from breaking through the value or size limits, but it is quite close.

Table 2. Third-Quarter 2013 Transactions

Company	Reason
Buy	
Fab Universal Corp. (FU)	
LMI Aerospace, Inc. (LMIA)	
Sell	
Saga Communications, Inc. (SGA)	exceeded value limit

As shown in Figure 2, we were down to seven qualifying stocks this

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.

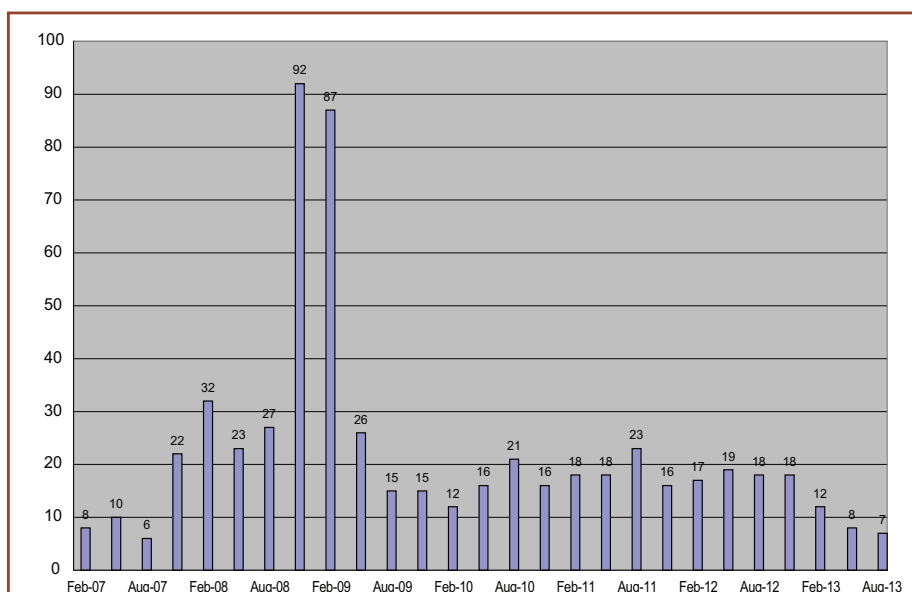
Management Rules

- 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
2012	33.3	15.8	18.0	211,588	47,666	60,274
YTD	33.6	16.0	19.7	282,712	55,315	72,153
Since Incep	17.6	8.6	10.0	282,712	55,315	72,153

Data as of 8/31/2013.

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.

quarter using the liquidity requirements as described in the portfolio rules. We already owned three of the stocks. Two were Chinese, which we avoid, and we bought the other two.

With the proceeds from selling SGA, we purchased Fab Universal Corp. (FU) and LMI Aerospace Inc. (LMIA). The summary of actions can be seen in Table 2.

Spreads

I receive quite a few questions about spread, which is the difference between the bid and ask (offer) prices. The spreads on many micro-cap stocks are quite high. To a certain extent, the high spreads and lack of liquidity are why we get paid higher returns, but reducing the spread effect is still desirable. A 5% or higher spread digs into the eventual return significantly. The results that the Model Shadow Stock Portfolio has achieved over the years were accomplished while paying high spreads, but we do try to reduce the impact.

The most important approach to reducing the negative impact of the spread is to minimize turnover. Our turnover ratio for the past 12 months was 13%, which really helps. This is why whenever there is a close decision about selling a stock, I avoid the transaction. When there are numerous stocks that qualify for purchase, the lower spread becomes a major tie-breaker.

There are also approaches to take when executing trades. It is important to realize that after you have done all the things recommended above, you still must pay a spread. Market makers are not going to make an efficient market without compensation that relates to the stock's liquidity. If you place a buy order at a price between the bid and ask, there is a small chance that another investor will do the same thing on the sell side of the trade before the market moves. Generally, however, when you get an execution between the bid and ask it means that the market moved and you paid the new spread. If the market moved in the opposite direction, you won't get a fill and may have to pay

more than the old ask.

Given that you must pay a spread, most of the time you don't want to give anyone a free lunch. Never enter a market order. If you are willing to pay the ask price, and that is often wise, use that price as your limit price. A market order to buy is likely to get you 100 shares at the offer price and subsequently higher prices for additional shares. Also, you should have patience. Commissions are so low that it is often wiser to place

multiple orders over time than a larger trade all at once.

Looking Ahead

We will see another earnings season before my next column, and this should impact stock prices more than most world events. General feelings about longer-term earnings also count, but they are strongly influenced, for right or wrong, by the most recent earnings

trend.

President Obama's choice of a new Federal Reserve chairman should take place soon and will have a short-term impact on interest rates and the stock market. The impact will be based on assumptions about future quantitative easing under the likely candidates. I hope it will be resolved before my next Model Shadow Stock Portfolio column in January 2014. In the meantime, you can follow portfolio news at AAIL.com. ▲

James B. Cloonan is founder and chairman of AAIL.

Portfolio Strategies

(continued from page 31)

decide how you will design and manage your investment program for success over the very long term.

Your loving grandfather, Charley

Advice I Wish I Had

Any grandmother or grandfather

reading my letter will understand exactly how I chose my 12 investment guidelines, and they'd be right. The guidelines are what I most wish I'd been given when I started out 50 years ago. If I'd only known—and, of course, used—these guidelines, I'd have avoided some costly mistakes.

Fortunately for me, my fortunate

education in investing taught me enough great lessons soon enough that I was able to enjoy many years of investing success.

Not everyone will be so lucky, so they will need professional help—not on beating the market, but on defining and sensibly solving their own unique investment problem. ▲

Charles D. Ellis, Ph.D., CFA, founded Greenwich Associates international strategy consulting firm in 1972. He now serves as an investing consultant to large institutional investors, government organizations and wealthy families. His numerous books include "Winning the Loser's Game: Timeless Strategies for Successful Investing" (6th edition, McGraw-Hill, 2013). For more, go to www.aail.com/authors/charles-ellis.