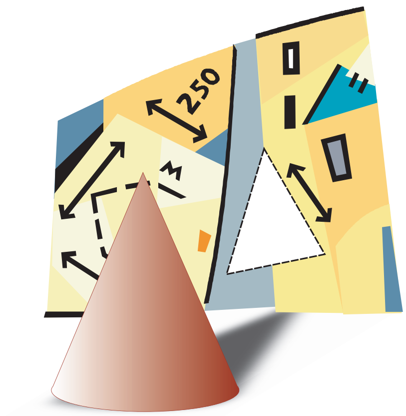
Model Shadow Stock Portfolio Rules Amended and Clarified

By James B. Cloonan



The strong five-year bull market continued in December, slowed in January for some profit realization, and tried to continue in February.

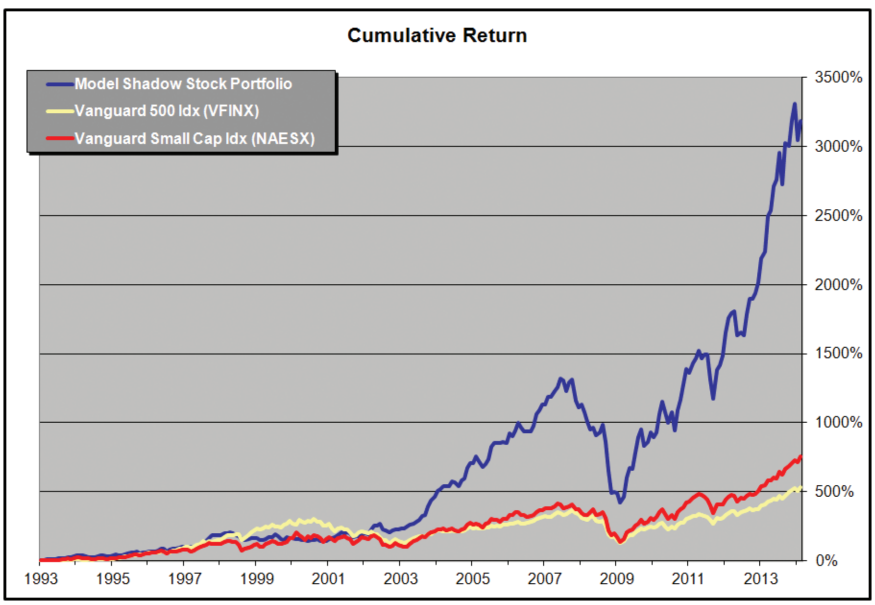
January represented quite a pullback for the Model Shadow Stock Portfolio. The year-to-date return through February is –3.6% as opposed to +0.9% for the S&P 500 index, as measured by the Vanguard 500 Index fund (VFINX). As I write this in early March, small stocks have strengthened again. Returns for longer periods can be seen in Figure 1 and Table 3.

This has been a very long bull market without any significant correction, although most pundits have been predicting one for over a year. The market is still behind where it would have been if it had risen by its average of 12% a year from 2006 and avoided the great recession. Undoubtedly there will be a correction sometime, but it could be in two weeks or two years.

Rules Clarification

Our general rules for the Model Shadow Stock Portfolio permit foreign stocks if they are listed on a U.S. exchange. Our (possibly) temporary rule against companies located in China or doing most of their business in China is not included in the general screening criteria, nor is our elimination of stocks not trading an average of $150,000 in

Figure 1. Model Shadow Stock Portfolio vs. Benchmark (Through 2/28/2014)



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	(3.6)	40.2	28.9	18.2	20.8	18.7
Vanguard 500 Index (VFINX)	0.9	25.2	14.2	7.0	12.2	14.3
Vanguard Small Cap Index (NAESX)	2.9	31.4	15.2	10.0	16.2	12.5

**Relative to Vanguard Total Stock Market Index fund (VTSMX).*
Data as of 2/28/2014.

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
Alamo Group, Inc. (ALG)	52.58	61.27	35.34	635.2	18.7	1.87	0.5	approaching size limit
Alpha & Omega Semicon (AOSL)	7.29	9.30	6.64	189.5	nmf	0.66	0.0	earnings probation (2013 Q4)
CSS Industries Inc (CSS)	27.00	31.94	21.57	251.0	13.9	0.97	2.2	
Ducommun Incorporated (DCO)	27.80	31.35	14.32	301.3	17.3	1.24	0.0	
Ennis, Inc. (EBF)	15.80	19.59	13.54	414.4	11.9	1.09	4.4	
Five Star Quality Care (FVE)	5.79	6.87	4.41	281.5	25.2	0.90	0.0	
Flexsteel Industries (FLXS)	37.15	37.80	18.56	268.3	22.4	1.72	1.6	
Hardinge Inc. (HDNG)	14.75	16.88	11.91	175.3	41.0	0.88	0.5	
Hooker Furniture Corp. (HOFT)	15.10	18.31	13.35	162.4	17.0	1.21	2.6	
International Shipholding (ISH)	30.46	32.12	16.07	220.8	14.9	0.66	3.3	qualified as of 2/28/2014
Key Tronic Corp. (KTCC)	10.35	12.19	9.60	109.0	11.3	1.09	0.0	
Kimball International (KBALB)	18.77	19.86	8.63	571.4	24.7	1.70	1.1	
LMI Aerospace, Inc. (LMIA)	14.91	22.69	10.81	191.7	19.9	0.89	0.0	
Marlin Business Services (MRLN)	21.50	29.58	17.32	279.4	16.8	1.65	2.0	
Medical Action Industries (MDCI)	7.32	10.07	5.04	120.0	30.5	1.21	0.0	
Mitcham Industries (MIND)	14.39	18.41	13.58	184.2	30.6	1.06	0.0	
Olympic Steel, Inc. (ZEUS)	27.51	31.68	19.54	301.7	nmf	1.01	0.3	
PC Connection, Inc. (PCCC)	20.25	25.94	13.83	530.5	15.0	1.66	0.0	
PCM Inc. (PCMI)	9.71	11.96	6.02	113.7	13.5	0.91	0.0	
RCM Technologies (RCMT)	6.91	7.22	5.29	86.0	18.7	1.36	0.0	
Renewable Energy Group (REGI)	11.67	16.50	5.90	451.4	2.9	0.71	0.0	
REX American Resources (REX)	47.68	49.93	17.12	385.1	28.9	1.47	0.0	
Rocky Brands Inc. (RCKY)	13.76	19.97	13.13	103.4	14.0	0.79	2.9	qualified as of 2/28/2014
SigmaTron International (SGMA)*	10.71	10.80	3.77	42.4	23.3	0.79	0.0	qualified as of 2/28/2014
Salem Communications (SALM)	9.09	10.14	6.17	226.5	nmf	1.15	2.4	earnings probation (2013 Q1)
Shoe Carnival, Inc. (SCVL)	25.84	29.75	19.19	529.5	17.9	1.63	0.9	
Standard Motor Products (SMP)	35.15	39.99	24.52	806.9	15.4	2.32	1.5	approaching size & value limits
TravelCenters of America (TA)	9.06	12.50	6.71	340.9	15.6	0.67	0.0	
VOXX International (VOXX)	13.00	18.00	8.91	316.9	9.6	0.66	0.0	
Willis Lease Finance (WLFC)	17.90	18.24	11.70	150.9	17.9	0.72	0.0	

**Company is new to the portfolio as of 3/3/2014.*
nmf = no meaningful figure.
Source: AAII's Stock Investor Pro*/Thomson Reuters. Data as of 2/28/2014.*

Explanation of Notes

Approaching Size Limit: Stocks are sold if their market capitalization goes above three times the initial maximum criterion and there is a stock to replace it. The current market capitalization maximum for initial screening is $300 million. Stocks are marked "approaching size limit" if their current market cap exceeds 2½ times the initial criterion, or $750 million.

Approaching Value Limit: Stocks are sold once their price-to-book-value ratio goes above three times the initial criterion and there is a stock to replace it. 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 in parentheses is 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 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. If the price-to-book-value ratio moved up a bit since the stock was included in the portfolio, it is still OK to purchase the stock unless this ratio goes above 0.90. (Figure will change gradually with changes in overall market values.)
- Market capitalization must be between $30 million and $300 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 and there is a stock to replace it.
- Market capitalization goes above three times the initial maximum criterion and there is a stock to replace it.

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. Fourth-Quarter 2014 Transactions

Buy	
Company (Ticker)	Maximum Price to Pay
SigmaTron International (SGMA)	$12.20
Sell	
Company (Ticker)	Reason for Selling
Gilat Satellite Networks Ltd. (GILT)	negative earnings

volume per day included. These screens must be performed manually if you choose to use them or a variation of them.

We are also amending the rules for selling stocks based on high price-to-book ratio or market capitalization. We will not sell based on these criteria unless we have a stock to buy. This has never been a problem over the last 20 years, but it has recently become a concern.

New Data on Purchase Price

The world can change between the time we purchase a stock and the time you find out about it. You should check recent news on the company to make sure nothing has happened that would disqualify it.

You should also never pay a price-to-book ratio over 0.90. While 0.80 is our normal criterion, going as high as 0.90 is acceptable. To help with this, we will now indicate in Table 2 the maximum price to be paid for new additions to the portfolio.

Portfolio Changes

Table 1 shows the current holdings in the Model Shadow Stock Portfolio. We sold Gilat Satellite Networks (GILT) because it violated probation.

After eliminating Chinese stocks and those we already owned, there was only one qualifying stock, SigmaTron Int'l (SGMA), and we bought it. As Table 2 indicates, the maximum price to pay for SGMA would be $12.20 per share, based on the company's current book value of $13.56 multiplied by our maximum price-to-book criterion of 0.90.

Looking Ahead

Almost all the economic data indicates a slow and steady recovery. The extreme winter weather had an effect, but everyone seems to be allowing for that. The only negative I see is the fact that things look too good, and as a moderate contrarian this always worries me a bit. Of course, as always, there are international concerns, and we have a mid-term election coming up that will probably stir up real and imagined concerns.

I have always felt that the majority of pundits will be wrong when predicting markets. Last year was a perfect example: There were a significant number of experts predicting a strong down year, a modest down year or a moderate up year. Virtually no one was predicting a strong up year, and that is what we got.

This year, we have many predictions for a significant correction and for a modest up year. That leaves a modest down year or another strong up year as likely outcomes. As always, only time will tell.

We will be covering the Model Shadow Stock Portfolio again in the July *AAII Journal*. In the meantime, you will be able to follow it at AAII.com. ➤

Table 3. Model Shadow Stock Portfolio: Annual Performance

	Average Annual Return (%)			Cumulative Value of $10,000 ($)		
Year	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
2013	61.0	32.2	37.6	340,599	63,009	82,966
YTD	(3.6)	0.9	2.9	328,176	63,596	85,359
Since Incep	**17.9**	**9.1**	**10.7**	**328,176**	**63,596**	**85,359**

Data as of 2/28/2014.

James B. Cloonan is founder and chairman of AAII.