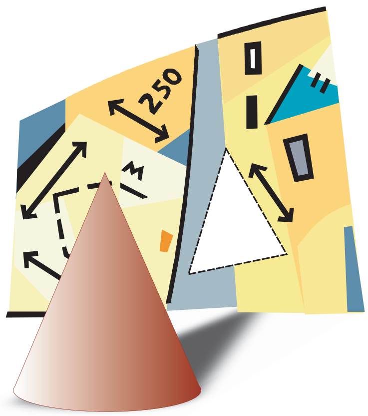
Maintaining Model Shadow Stock Portfolio Purchase Rules

By James B. Cloonan



After lagging small stocks for so long, the larger stocks are trying to catch up.

The year-to-date return through August for the Model Shadow Stock Portfolio is 1.4%, compared to the S&P 500 index's 9.8% return, as measured by Vanguard 500 Index fund (VFINX).

The results for longer periods can be seen in Figure 1 and Table 3. In Table 3, you can also see that larger-cap stocks have outperformed in six of the last 21 years.

Lack of Candidates

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

We continue to experience a shortage of qualifying stocks. This month the only qualifiers were stocks we already owned and Chinese stocks, which we eliminate because of data uncertainty.

Due to the lack of candidates, we did not sell REX American Resources (REX), even though its price-to-book-value ratio is over the 2.4 maximum. (As shown in the Model Portfolio Rules, a stock is sold if there is a replacement for it when its price-to-book-value ratio goes above three times the initial criterion, which is currently 0.80.) Therefore, there are no buy or sell transactions to the portfolio for this period, as shown in Table 2.

It can be frustrating to have no qualifying stocks when following a process.

(continued on page 36)

Figure 1. Model Shadow Stock Portfolio vs. Benchmarks (Through 8/31/2014)

Portfolio	Year-to-Date Return (%)	Annual Return (%) 1-Year	3-Year	5-Year	10-Year	Ann'l Std Dev (%)*	Risk-Adjusted Return (%)
Model Shadow Stock Portfolio	**1.4**	**22.2**	**34.6**	**28.3**	**18.3**	**20.1**	**22.3**
Vanguard 500 Index (VFINX)	9.8	25.0	20.4	16.7	8.3	11.4	21.2
Vanguard Small Cap Index (NAESX)	6.1	22.0	20.9	18.8	10.8	15.4	17.1

**Relative to Vanguard Total Stock Market Index fund (VTSMX).*
Data as of 8/31/2014.

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)	49.34	61.27	44.26	599.4	17.9	1.61	0.6	
CSS Industries Inc (CSS)	25.31	31.94	21.57	236.0	12.7	0.92	2.4	
Ducommun Incorporated (DCO)	30.06	32.00	22.45	327.6	29.8	1.29	0.0	
Ennis, Inc. (EBF)	14.56	19.59	13.54	380.6	29.7	1.03	4.8	
Five Star Quality Care (FVE)	4.68	6.09	4.41	227.5	27.5	0.71	0.0	
Flexsteel Industries (FLXS)	34.47	40.44	22.40	252.0	17.5	1.52	1.7	
Hardinge Inc. (HDNG)	11.32	16.03	11.11	145.2	47.2	0.68	0.7	
Hooker Furniture Corp. (HOFT)	15.56	17.81	13.35	167.3	19.5	1.22	2.6	
International Shipholding (ISH)	22.29	32.91	20.75	162.8	29.7	0.50	4.5	
Key Tronic Corp. (KTCC)	11.11	11.50	9.60	117.2	16.1	1.13	0.0	
Kimball International (KBALB)	15.93	20.10	9.61	612.3	18.5	1.39	1.3	
LMI Aerospace, Inc. (LMIA)	14.93	16.40	10.81	194.8	nmf	1.37	0.0	
Marlin Business Services (MRLN)	19.83	29.58	17.10	256.1	14.6	1.48	2.5	
Medical Action Indus (MDCI)	13.76	13.85	5.04	227.3	229.3	2.01	0.0	approaching value limit
Mitcham Industries (MIND)	13.34	17.87	12.65	169.1	83.4	0.98	0.0	
Olympic Steel, Inc. (ZEUS)	23.43	31.68	20.88	257.3	41.8	0.85	0.3	
PC Connection, Inc. (PCCC)	22.80	25.94	14.47	597.9	15.5	1.76	0.0	
PCM Inc. (PCMI)	10.17	11.82	8.95	125.9	15.0	0.94	0.0	
RCM Technologies, Inc. (RCMT)	7.30	7.36	5.47	91.6	33.2	1.40	0.0	
Renewable Energy Group (REGI)	11.88	16.09	8.51	502.6	3.2	0.73	0.0	
REX American Resources (REX)	95.33	102.92	26.70	780.0	14.8	2.56	0.0	approaching value & size limit
Rocky Brands Inc (RCKY)	14.66	19.97	13.32	110.6	15.9	0.84	2.7	
SigmaTron International (SGMA)	11.28	12.92	4.26	45.5	15.7	0.81	0.0	
Salem Communications (SALM)	8.23	10.34	5.04	207.8	12.9	1.02	2.9	
Shoe Carnival, Inc. (SCVL)	21.42	29.75	17.30	439.5	16.5	1.31	1.1	
Standard Motor Products (SMP)	37.97	45.80	29.72	869.0	17.4	2.39	1.4	approaching value & size limit
TravelCenters of America (TA)	10.52	11.17	7.01	396.3	10.0	0.68	0.0	
VOXX International (VOXX)*	9.59	18.00	6.84	234.3	nmf	0.55	0.0	
Willis Lease Finance (WLFC)	23.07	26.19	13.80	193.4	10.3	0.84	0.0	

**Removed from earnings probation based on adjusted earnings.*
nmf = no meaningful figure.
Source: AAII's Stock Investor Pro/Thomson Reuters. Data as of 8/31/2014.

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 and, if there are earnings estimates, the estimates must be positive for the current quarter and year.
- 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. Foreign stocks traded primarily on U.S. exchanges are OK with one exception: The stock of any company whose primary business is in China will not be purchased.
- 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.
- 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 based on lowest price-to-book-value ratio. However, if this difference is not greater than 0.10 (i.e., 0.65 vs. 0.50), use lowest bid-ask spread.
- 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. Third-Quarter 2014 Transactions

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

(continued from page 33)
If we had more than 5% in cash, we would have stretched the price-to-book-value ratio criterion to a limit of 0.90 to 0.95, since in an absolute sense anything less than 1.00 is a bargain (on average). Raising the price-to-book limit would have led to additional qualifying stocks.

The Mystery Cycle

The election cycle indicates an above-average return in the year prior to the U.S. national election; this has been widely discussed and will be in the news as we approach 2015. Twenty years ago, I came across another cycle for which I can find no rationale but that has been pervasive for the last 100 years. It is the positive impact on the market of years ending in 5. This cycle is particularly important in years when it coincides with the election cycle. This combination occurs only every 20 years, and the year 2015 is one of those years.

I have always been suspicious of data like this that indicates a possible anomaly when I can't find a rationale for the behavior. In the election cycle we have the rationale that government spending and talk of government spending prior to the election boosts expectations, but I cannot think of any cycle for years ending in 5, or any 10-year cycle, to explain this rather dramatic impact. While it could be coincidence, it is also possible that I simply can't find the explanation. Note that although the data covers a large number of years, the actual sample size is small.

I must admit that in 1995, I was extra bullish and was rewarded. I will be a little extra bullish in 2015, although I hesitate to suggest that anyone else should do the same. But here are the numbers.

Average annual returns since 1935:
11.0% = S&P 500 index
20.7% = year 3 of the election cycle
28.4% = years ending in 5
42.4% = year 3 + years ending in 5

0 = number of times year 3 was negative

Just an observation.

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	1.4	9.8	6.1	$345,501	$69,156	$88,063
Since Incep	**17.8**	**9.3**	**10.6**	**$345,501**	**$69,156**	**$88,063**

Data as of 8/31/2014.

Looking Ahead

Very little has changed from last quarter. The strong stock market continues. Those crying for a correction will eventually get one, but they may have missed most of a very strong upsurge before they get it. Strangely, interest rates are staying low and even going down a bit. This may be due to expectations that a really strong economy is still a year or more away. In my opinion, it's more likely that in a mixed-up world investors are putting their money in U.S. Treasuries whether they get any return at all except for the return of their investment.

Mid-term elections will be over before the next Model Shadow Stock Portfolio column in January 2015. No matter how it turns out, it seems unlikely we will have a cohesive government. But there may be more pressure to work together before 2016. In the meantime, you may follow updates to the portfolio in the Model Portfolios area at AAII.com. ➤

James B. Cloonan is founder and chairman of AAII.