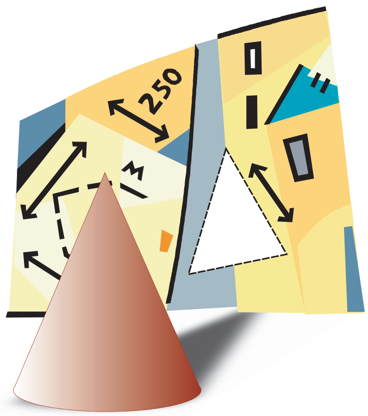
Two New Stocks Added to Model Shadow Stock Portfolio

By James B. Cloonan



Small-cap stocks have lagged the market, and the smaller the capitalization the more they have lagged.

The Model Shadow Stock Portfolio has a negative return of 9.6% year-to-date compared to a gain of 13.8% for the S&P 500 index as measured by the Vanguard Index 500 fund (VFINX).

The results for longer periods can be seen in Figure 1 and Table 3. With 30 days to go in 2014 as of this writing, this appears to be an above-average year for the overall market. But barring a wild December, it will be a rare down year for the Model Shadow Stock Portfolio.

The expected correction has still not arrived. It seems that every strong down day for the market is followed by up days and new market highs. The long-anticipated rise in interest rates has also been delayed and may be delayed further if lower oil prices contain inflation.

Portfolio Changes

Table 1 lists the current holdings in the Model Shadow Stock Portfolio, and Table 2 shows the fourth-quarter transactions. Medical Business Services Corp. (MDCI) was purchased by Owens & Minor and sold from the portfolio on October 1.

Also, after the close of the market on October 31, Kimball International

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Figure 1. Model Shadow Stock Portfolio vs. Benchmarks (Through 11/30/2014)

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	(9.6)	(6.5)	26.7	14.8	18.8	14.8
Vanguard 500 Index (VFINX)	13.8	16.7	20.7	7.9	9.0	20.7
Vanguard Small Cap Index (NAESX)	6.0	8.8	20.0	9.3	11.9	16.0

**Relative to Vanguard Total Stock Market Index fund (VTSMX).*
Data as of 11/30/2014.

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)	47.63	61.27	37.93	551.0	16.3	1.70	0.6	
CSS Industries Inc. (CSS)	29.01	31.94	22.75	270.5	15.2	1.03	2.1	
Ducommun Incorporated (DCO)	24.90	32.00	22.45	272.6	30.4	1.06	0.0	
Ennis, Inc. (EBF)	13.31	18.77	12.53	346.9	26.6	0.93	5.3	
Five Star Quality Care (FVE)	4.40	6.09	3.23	213.9	62.9	0.69	0.0	
Flexsteel Industries (FLXS)	31.72	40.44	25.77	234.8	14.9	1.37	2.3	
Global Power Equip (GLPW)*	12.97	20.04	10.96	222.1	13.8	0.79	2.8	qualified as of 11/30/14
Hardinge Inc. (HDNG)	12.25	15.57	9.70	157.1	nmf	0.79	0.7	
Hooker Furniture Corp. (HOFT)	15.39	17.81	13.60	165.6	18.1	1.20	2.6	
International Shipholding (ISH)	16.47	32.91	16.10	120.3	24.6	0.37	6.1	
Key Tronic Corp. (KTCC)	8.19	11.50	7.50	86.4	21.6	0.86	0.0	
Kimball Electronics (KE)**	na	na	na	na	na	na	na	
Kimball International (KBAL)	9.39	15.68	9.34	364.9	11.3	0.82	2.1	
LMI Aerospace, Inc. (LMIA)	14.04	15.75	11.70	178.3	nmf	1.28	0.0	
L.S. Starrett Co. (SCX)*	14.48	19.32	12.21	101.8	13.7	0.78	2.8	qualified as of 11/30/14
Marlin Business Services (MRLN)	18.64	29.58	17.10	239.0	13.5	1.37	2.7	
Mitcham Industries (MIND)	7.62	17.82	7.60	97.3	na	0.56	0.0	
Olympic Steel, Inc. (ZEUS)	16.26	30.95	16.21	178.6	28.0	0.59	0.5	qualified as of 11/30/14
PC Connection, Inc. (PCCC)	22.37	25.49	17.80	588.4	14.6	1.67	0.0	
PCM Inc. (PCMI)	9.64	11.82	7.43	119.3	17.8	0.90	0.0	
RCM Technologies, Inc. (RCMT)	8.07	8.42	6.02	101.3	29.9	1.51	0.0	
Renewable Energy Group (REGI)	9.52	12.89	8.51	402.8	8.1	0.59	0.0	
REX American Resources (REX)	63.27	110.65	30.46	517.7	7.5	1.60	0.0	
Rocky Brands Inc. (RCKY)	15.04	16.10	12.61	113.6	15.8	0.84	2.7	
SigmaTron International (SGMA)	8.09	12.92	5.80	32.7	16.9	0.59	0.0	
Salem Communications (SALM)	7.86	11.00	5.04	198.6	18.7	0.98	3.2	
Shoe Carnival, Inc. (SCVL)	20.26	29.75	16.68	415.9	17.6	1.24	1.2	
Standard Motor Products (SMP)	38.15	45.80	30.28	873.4	17.4	2.38	1.4	approaching value & size limits
TravelCenters of America (TA)	9.35	11.85	7.18	352.2	8.3	0.69	0.0	
VOXX International (VOXX)	8.41	18.00	6.56	205.5	nmf	0.49	0.0	
Willis Lease Finance (WLFC)	21.79	26.19	15.66	183.4	12.5	0.80	0.0	

Medical Business Services Corp. (MDCI) was purchased by Owens & Minor and sold from the portfolio on 10/01/2014.
**Added to portfolio 12/01/2014.*
***Shares received on 10/31/2014 from spin off from Kimball International (KBAL).*
nmf = no meaningful figure.
na=data not available.
Source: AAII's Stock Investor Pro*/Thomson Reuters. Data as of 11/30/2014.*

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. Fourth-Quarter 2014 Transactions

Company (Ticker)	Reason
Buy	
Global Power Equipment Group (GLPW)	
L.S. Starrett Co. (SCX)	
Sell	
Medical Action Industries (MDCI)	acquired by Owens & Minor
Spin-Off Shares Received	
Kimball Electric (KE)	spin-off from Kimball Int'l (KBAL)

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(formerly KBALB, now KBAL) spun off its electronics division, resulting in the portfolio holding shares of Kimball Electronics that trade under the symbol KE. If you own this stock, you should have received 0.8 shares of Kimball Electronics for each share of Kimball International. Since the combination violates no portfolio rules, we continue to hold both stocks for the time being. Going forward, there should be separate financial results for each company, and we will evaluate them separately.

We finally had some new stock candidates to consider during our fourth-quarter review. After eliminating the Chinese stocks, the stocks we already owned and those with not enough liquidity, there were four candidates left. We have added two of these to the portfolio: Global Power Equipment Group (GLPW) and L.S. Starrett Co. (SCX). Final selection was based on liquidity and bid-ask spread. As a reminder to those following the portfolio without excess cash to buy the two new stocks, more than 20 stocks is not needed until your portfolio exceeds $20 million.

There are no deletions for the fourth quarter based on the portfolio sell rules. The stocks approaching value or size limits fell victim to the quarter's stock price pullback, and no stocks were on earnings probation.

Looking Ahead

The mid-term elections are over, but there will probably be little impact from actual legislative change until after the January swearing-ins, which will be around the time you are reading this.

The timing of any Federal Reserve action to let interest rates rise remains a mystery. Action in the second or third quarter seems most likely. While higher interest rates make bonds more interesting in comparison with stocks, I don't see that hurting stocks because it would only occur with a growing economy, which should increase earnings.

I do think that small-cap stocks will start to outperform large caps again. My hope, of course, is that any outperformance comes from small caps going up more than large caps, rather than from small caps declining less than large caps. As a long-term investor, I should be happy with the recent volatility and price weakness of small-cap stocks because that portends higher returns in the future. However, I am like everyone else and have a hard time with weak markets. Besides, I am looking for that Mystery Cycle +42.4% return in 2015 (see my columns in the October or November *AAII Journal* for an explanation).

I wish everyone a Happy New Year! The next Model Shadow Stock column will be in April 2015, but you can follow any updates at AAII.com in the meantime. ➤

James B. Cloonan is founder and chairman of AAII.

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	(9.6)	13.8	6.0	$307,805	$71,705	$87,972
Since Incep	**16.8**	**9.4**	**10.2**	**$307,805**	**$71,705**	**$87,972**

Data as of 11/30/2014.