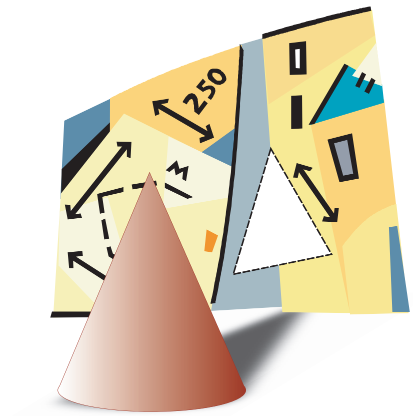
Model Shadow Stock Portfolio: Many Opportunities Among Micro Caps

By James B. Cloonan



While micro-cap stocks have not completely recovered from the unusual January pullback, they have recovered more than the large caps.

Year to date the Model Shadow Stock portfolio is down 4.1% compared to the S&P 500, as represented by the Vanguard 500 index fund (VFINX), which is down 5.1%.

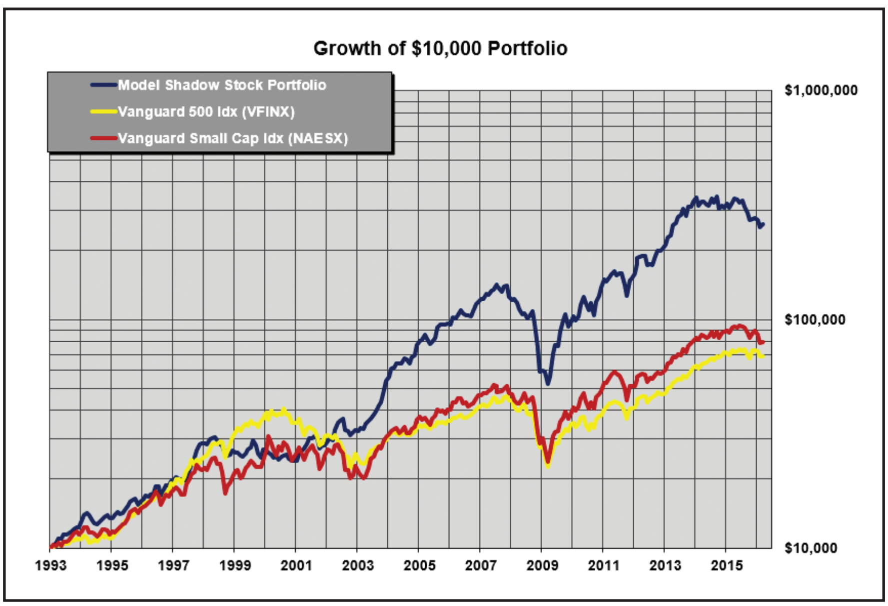
Many analysts believe that a fresh bull move is generally led by smaller stocks. If they are correct, this comeback that is continuing into March, as of this writing, could bode well for the market. However, the Model Shadow Stock Portfolio fell about 20% from its previous high and still has a way to go before we can put the pullback behind us.

Longer-term results can be seen in Figure 1 and Table 3. Since inception, the portfolio is still above an annualized return of 15%, which was our long-term expectation when we began the portfolio in 1993. This expectation was based on the micro-cap research published prior to that time.

Portfolio Changes

Table 1 shows the current holdings in the Model Shadow Stock Portfolio and Table 2 shows the first-quarter changes. Universal Stainless & Alloy Products Inc. (USAP) was sold because it violated earnings probation. However, it had

Figure 1. Model Shadow Stock Portfolio vs. Benchmarks (Through 2/29/2016)



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	(4.1)	(19.5)	3.7	10.0	18.9	3.5
Vanguard 500 Index (VFINX)	(5.1)	(6.3)	10.6	6.3	10.8	10.6
Vanguard Small Cap Index (NAESX)	(6.8)	(13.4)	7.1	6.3	13.0	6.6

*Relative to Vanguard 500 Index fund (VFINX).
Data as of 2/29/2016.

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)	51.89	64.45	43.98	592.8	13.8	1.67	0.7	
CDI Corp. (CDI)	4.88	18.55	4.31	96.1	nmf*	0.40	10.7	
CSS Industries Inc. (CSS)	27.07	31.61	24.11	245.7	15.0	0.89	3.0	qualified as of 2/29/2016
Ducommun Inc. (DCO)	14.38	33.45	12.28	159.4	nmf*	0.64	0.0	earnings probation (2015q3)
Ennis, Inc. (EBF)	19.74	20.94	13.18	509.5	12.8	1.69	3.5	
Flexsteel Industries (FLXS)	40.83	48.67	27.25	310.8	13.3	1.56	1.8	
Global Power Equip (GLPW)**	3.48	14.10	3.20	54.1	nmf	nmf	nmf	
Hardinge Inc. (HDNG)	8.86	11.89	7.85	113.7	26.1	0.67	0.9	
Hooker Furniture Corp. (HOFT)	31.92	32.54	17.57	345.1	21.1	2.26	1.3	
Key Tronic Corp. (KTCC)	7.18	12.49	6.09	76.9	11.8	0.75	0.0	qualified as of 2/29/2016
Kimball Electronics (KE)	11.42	17.01	9.15	330.5	14.1	1.05	0.0	
L S Starrett Co. (SCX)	9.43	21.76	8.40	66.2	30.4	0.64	4.2	qualified as of 2/29/2016
LMI Aerospace, Inc. (LMIA)	9.56	14.48	8.85	126.7	nmf*	1.04	0.0	
Marlin Business Services (MRLN)	13.81	19.29	11.17	171.4	11.0	1.14	4.1	
PC Connection, Inc. (PCCC)	24.77	26.91	18.86	655.0	14.1	1.67	0.0	
PCM Inc. (PCMI)	7.56	10.70	7.48	90.1	nmf*	0.73	0.0	
RCM Technologies, Inc. (RCMT)	5.90	5.95	3.42	72.4	15.9	1.70	0.0	
Renewable Energy Group (REGI)	7.29	12.80	6.02	319.6	20.8	0.45	0.0	
REX American Resources (REX)	50.50	67.99	43.50	346.3	8.1	1.10	0.0	
Rocky Brands Inc. (RCKY)	11.51	23.11	9.67	87.1	13.2	0.61	3.8	qualified as of 2/29/2016
Salem Media Group (SALM)	4.81	7.50	3.60	122.5	20.9	0.59	5.4	qualified as of 2/29/2016
Seneca Foods Corp. (SENEA)	33.26	33.90	25.85	328.9	7.7	0.85	0.0	
Shoe Carnival, Inc. (SCVL)	23.57	30.00	17.36	470.3	17.1	1.33	1.1	
SigmaTron International (SGMA)	6.70	9.12	5.02	27.9	11.0	0.47	0.0	
Townsquare Media Inc. (TSQ)	9.75	14.35	8.60	174.2	27.1	0.47	0.0	qualified as of 2/29/2016
TravelCenters of America LLC (TA)	8.63	18.10	6.41	331.4	5.3	0.57	0.0	
Ultra Clean Holdings (UCTT)	5.23	8.54	4.50	168.7	nmf*	0.84	0.0	
Vishay Precision Group (VPG)	11.72	16.18	10.25	154.3	nmf*	0.90	0.0	
VOXX International (VOXX)	3.99	9.85	3.37	96.4	nmf*	0.25	0.0	
Willis Lease Finance (WLFC)	19.88	21.40	15.11	163.6	39.0	0.71	0.0	qualified as of 1/31/2016

nmf = no meaningful figure

**Trailing four-quarter GAAP earnings negative, but adjusted earnings positive.*

***Global Power is in the process of an ongoing review of its historical financial information and will be restating its 2013 and 2014 financial statements.*

Source: AAII's Stock Investor Pro/Thomson Reuters. Data as of 2/29/2016.

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 1.00. Stocks are marked "approaching value limit" if their current price-to-book-value ratio exceeds 2½ times the initial criterion, or 2.50.

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.

Table 2. First-Quarter 2016 Transactions

Sell

Company (Ticker)	Reason
Universal Stainless & Alloy Products (USAP)	negative earnings

Buy

Company (Ticker)	Maximum Price to Pay
There are no buys this quarter.	

dropped so far in price that the proceeds from the sale did not provide enough revenue to buy a new position. Cash is less than 5% of the actual portfolio, so we did not add any stocks this quarter.

There were 28 qualifying stocks, of which two were Chinese and four were in the portfolio already. My list has a liquidity requirement without which the list of qualifiers would be much longer. The continued price fallback for micro-cap stocks has created many more opportunities.

Global Power Equipment Group (GLPW) has not completed updating its 2013 and 2014 financials and the deadline of March 31, 2016, will have passed by the time you read this. The company will have completed the update or been delisted from the New York Stock Exchange (NYSE), or they could be granted another extension. Google the company or check Yahoo Finance to see the latest news when you read this.

Table 3. Model Shadow Stock Portfolio: Annual Performance

	Average Annual Return (%)			Cumulative Growth 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
2014	(5.8)	13.5	7.4	320,844	71,516	89,105
2015	(15.2)	1.3	(3.8)	272,161	72,410	85,693
YTD	(4.1)	(5.1)	(6.8)	260,961	68,701	79,857
Since Incep	**15.1**	**8.6**	**9.3**	**$260,961**	**$68,701**	**$79,857**

Data as of 2/29/2016.

Looking Ahead

As I indicated in my Model Fund Portfolio column last month, I can't see any strong indication of direction, and the market has been very perverse lately. It seems to go up on bad news and down on good news. As of this writing, the "talking heads" on CNBC are mostly bearish, which is a pretty bullish indicator.

By my next Model Shadow Stock Portfolio column in July it should be clearer as to who the presidential nominees may be, and we should have some market movement. Keep in touch at AAII.com.

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 or equal to 1.00. (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 10 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 1.00.
- At the end of a quarter, if receipts from stock sales are insufficient to buy all newly qualifying stocks, purchases are made based on the width of the bid-ask spread and the number of shares at bid or ask price.
- 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. ➤

James B. Cloonan is founder and chairman of AAII.