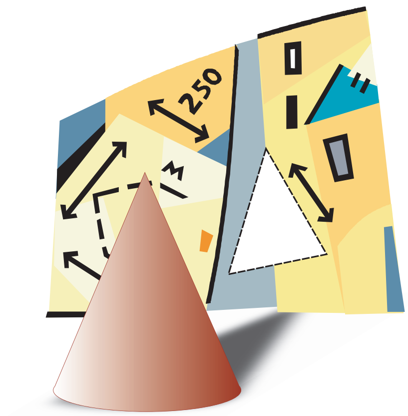
Model Shadow Stock Portfolio: New Additions, Plus Value Leads

By James B. Cloonan



Micro-cap stocks, which had been lagging behind even small-cap stocks, finally began to recover strongly.

The Model Shadow Stock Portfolio is up 23.5% year-to-date, compared to 9.7% for the S&P 500 index as represented by Vanguard 500 Index fund (VFINX). Value so far has led growth this year in all market-cap sizes, and this also has helped the portfolio. The Model Shadow Stock Portfolio is now back to its all-time high.

Results for other periods are shown in Figure 1 and Table 3.

Portfolio Changes

Table 1 shows the current holdings in the Model Shadow Stock Portfolio. Table 2 shows the changes made this quarter.

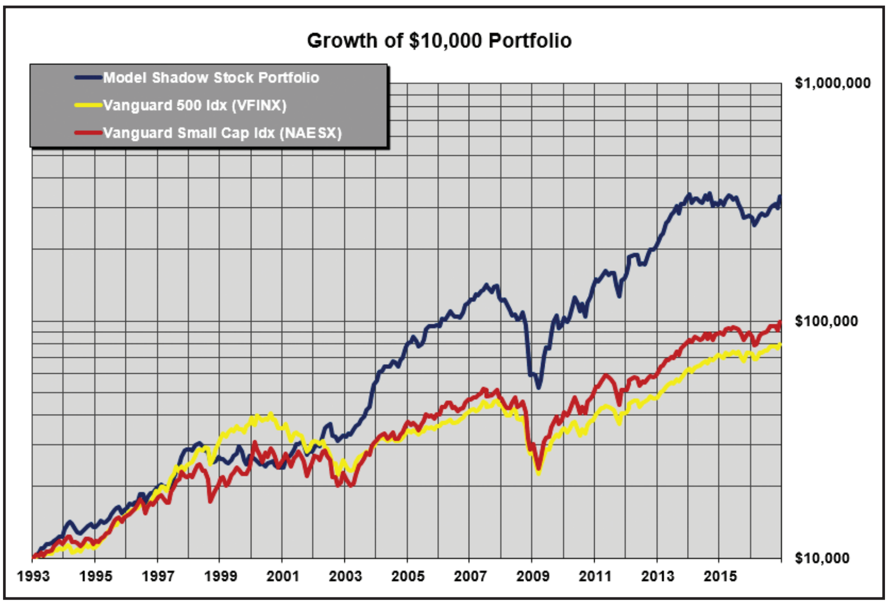
Marlin Business Services (MRLN) was sold because it is really in the finance business and does not qualify under the revised portfolio rules.

With the proceeds from the sale of Marlin Business Services and existing cash holdings, two stocks were purchased: RCI Hospitality Holdings Inc. (RICK) and Roadrunner Transportation Systems (RRTS).

With the liquidity requirement for the average daily dollar volume to be at least 10 times the amount needed, eight stocks passed the screen. (Each investor will see a varying number of qualifying stocks.) One was a Chinese stock and

(continued on page 36)

Figure 1. Model Shadow Stock Portfolio vs. Benchmarks (Through 11/30/2016)



Portfolio	Year-to-Date Return (%)	Annual Return (%) 1-Year	3-Year	10-Year	Since Inception	Ann'l Std Dev (%)
Model Shadow Stock Portfolio	23.5	20.6	0.7	10.9	15.8	17.5
Vanguard 500 Index (VFINX)	9.7	7.9	8.9	6.8	9.0	10.6
Vanguard Small Cap Index (NAESX)	16.0	11.1	7.1	7.9	10.0	13.7

Data as of 11/30/2016.

Table 1. 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)	73.07	75.67	48.26	852.5	19.2	2.16	0.5	
AV Homes Inc. (AVHI)	15.85	17.45	8.50	366.8	2.8	0.82	0.0	qualified as of 11/30/2016
Beazer Homes USA (BZH)	13.48	14.65	6.07	459.0	82.4	0.67	0.0	
CSS Industries Inc. (CSS)	27.19	29.90	23.84	246.6	19.4	0.91	2.9	
Ducommun Inc. (DCO)	28.60	29.66	12.28	324.5	nmf**	1.51	0.0	
Ennis, Inc. (EBF)	16.15	21.55	14.40	425.7	14.4	1.66	4.3	
Flexsteel Industries (FLXS)	54.88	55.98	36.06	426.7	18.5	1.98	1.5	
Global Power Equip (GLPW)†	na	na	na	na	nmf	nmf	nmf	
Hallador Energy Co. (HNRG)	9.19	10.40	3.95	273.4	16.2	1.21	1.7	
Hardinge Inc. (HDNG)	11.03	13.72	7.85	135.9	708.9	0.87	0.7	
Hooker Furniture Corp. (HOFT)	27.30	35.95	20.29	318.6	18.4	1.73	1.5	
Key Tronic Corp. (KTCC)	7.73	8.97	6.09	82.5	11.5	0.78	0.0	
Kimball Electronics Inc. (KE)	17.45	18.33	9.15	486.5	18.0	1.49	0.0	
L S Starrett Co. (SCX)	9.90	12.89	8.40	66.6	na	0.77	4.0	earnings probation (2016q4)
PC Connection (CNXN)	26.84	27.87	19.19	732.2	14.7	1.66	0.0	
PCM Inc. (PCMI)	20.15	24.53	7.48	240.6	nmf**	1.93	0.0	
R C M Technologies (RCMT)	6.46	7.23	4.24	78.1	16.5	2.35	0.0	
RCI Hospitality Holdings (RICK)*	12.18	12.30	7.50	120.7	11.1	0.94	1.0	qualified as of 11/30/2016
Renewable Energy Group (REGI)	9.75	10.43	6.02	370.1	nmf**	0.64	0.0	
REX American Resources (REX)	97.68	98.32	44.48	610.5	27.4	1.96	0.0	
Roadrunner Transportation (RRTS)*	10.03	13.67	6.39	381.5	15.3	0.61	0.0	qualified as of 11/30/2016
Rocky Brands Inc. (RCKY)	10.65	13.95	9.67	79.8	nmf**	0.58	4.1	
Salem Media Group (SALM)	5.70	8.17	3.60	154.9	13.3	0.69	4.6	
Seneca Foods Corp. (SENEA)	37.60	40.88	26.90	371.8	7.4	0.90	0.0	qualified as of 11/30/2016
Shoe Carnival, Inc. (SCVL)	26.11	31.79	19.60	492.2	nmf**	1.40	1.1	
SigmaTron International (SGMA)	5.20	7.91	4.66	21.6	14.0	0.36	0.0	
Townsquare Media Inc. (TSQ)	8.73	12.05	7.30	161.9	11.1	0.42	0.0	
TravelCenters of America LLC (TA)	6.60	10.48	5.65	262.3	89.9	0.44	0.0	
Ultra Clean Holdings Inc. (UCTT)	10.04	10.56	4.50	328.9	nmf**	1.61	0.0	
Vishay Precision Group (VPG)	18.25	19.45	10.27	242.7	nmf**	1.36	0.0	
VOXX International (VOXX)	4.85	6.25	2.47	123.2	105.7	0.30	0.0	qualified as of 11/30/2016

nmf = no meaningful figure
**Added to the portfolio 12/1/2016.*
***Trailing four-quarter GAAP earnings negative, but adjusted earnings positive.*
†Global Power was delisted on 3/31/2016 after failing to meet the NYSE deadline for restating its 2013 and 2014 financial statements.
Source: AAII's Stock Investor Pro/Thomson Reuters. Data as of 11/30/2016.

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 $400 million. Stocks are marked "approaching size limit" if their current market cap exceeds 2½ times the initial criterion, or $1 billion.

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.

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 $400 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.
- Relative price strength over the last 26 weeks must rank in the top 50% of the stock universe.
- No financial stocks, including those in the rental & leasing industry, or limited partnerships will be purchased.
- No utility stocks will be purchased.
- No stocks on foreign exchanges or ADRs will be purchased due to 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, shares 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 available new purchases, the excess receipts are kept in cash until the next quarter. If too much cash is accumulated, the rules will be adjusted.
- 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.

Table 2. Fourth-Quarter 2016 Transactions

Sell	
Company (Ticker)	Reason
Marlin Business Services (MRLN)	avoid stocks primarily involved in rental & leasing operations
Buy	
Company (Ticker)	Maximum Price to Pay
RCI Hospitality Holdings (RICK)	$13.35
Roadrunner Transportation Sys (RRTS)	$16.57

(continued from page 33)
three were already owned. Two home construction stocks were eliminated to avoid concentration in the portfolio, since two stocks in that industry were added to the portfolio last quarter. The remaining two stocks were bought.

Special Note on GLPW

A number of members have asked why Global Power Equipment (GLPW) continues to be held in the Model Shadow Stock Portfolio since it has been delisted. The company missed the deadline for providing revised financial reports, prompting its delisting. Revised filings have been promised by year-end 2016. Since the company has not violated any of the formal Model Shadow Stock Portfolio rules and already has taken a reduction in price, it seems reasonable to hold on until the new figures are released.

While a delisted stock would never be bought or recommended for the Model Shadow Stock Portfolio, it often makes sense to continue to hold if new information is anticipated. Often, it is clear that the delisting is the beginning of the end for a company, in which case selling would be indicated.

This situation, like a buyout offer, is an area where some judgement is required.

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	23.5	9.7	16.0	336,091	79,408	$99,399
Since Incep	**15.8**	**9.0**	**10.0**	**336,091**	**79,408**	**$99,399**

Data as of 11/30/2016.

Looking Ahead

The presidential uncertainty, or at least a part of it, is settled. The removal of that uncertainty has helped the market.

In the long term, less restrictions on business, particularly small business, should be a positive. Other impacts will play out over the next year.

In general, the first year of a new president is a weak year in the market: only 8.0% versus 12.5% for the overall average since 1935. So many things are different this time, however, that I hesitate to even guess. But since the Model Shadow Stock Portfolio is a long-term fully invested approach, estimates of what will happen don't influence decisions. It should be an interesting year.

More to come on the Model Shadow Stock Portfolio in the April *AAII Journal*. In the meantime, follow the portfolio at AAII.com. ▲

James B. Cloonan is founder and chairman of AAII. He is author of the new book "Investing at Level3: Higher Returns With Minimal Risk for the Long-Term Individual Investor" (www.level3investing.com).