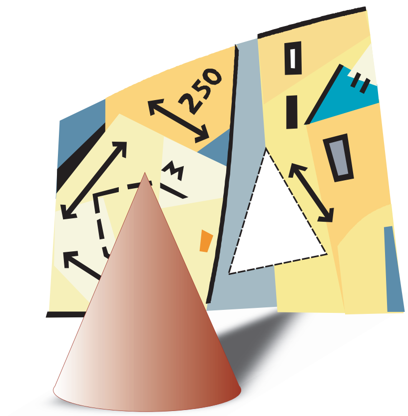
Model Shadow Stock Portfolio: Handling Major Financial Statement Revisions

By James B. Cloonan



The very strong run up at the end of last year for micro-cap stocks reversed in early 2017 and the Model Shadow Stock Portfolio is down 2.2% year to date as of February 28, compared to a positive 5.9% for the S&P 500 index as represented by the Vanguard 500 Index fund (VFINX).

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

No Portfolio Changes

Table 1 shows the current holdings of the Model Shadow Stock Portfolio. There were no indicated sales of holdings at this time, and so no new positions could be taken.

Five stocks passed the purchase criteria, including the liquidity requirement. One of these was Chinese and two were already in the portfolio.

Special Concerns

The promised update of financial reports by Global Power Equipment Group (GLPW) and their request for relisting have still not occurred as of this writing. If current promises are kept, updates for the years up to and through 2015 should be completed before you read this, and a firm date for 2016 results should be given.

Over the past 30 years, the Model

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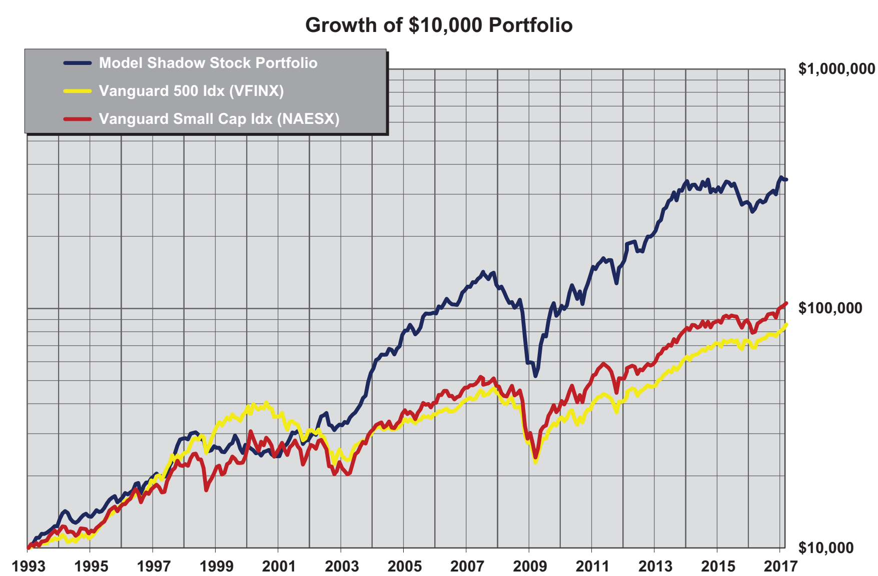
Figure 1. Model Shadow Stock Portfolio vs. Benchmarks (Through 2/28/2017)



Portfolio	Year-to-Date Return (%)	Annual Return (%) 1-Year	3-Year	10-Year	Since Inception	Ann'l Std Dev (%)
Model Shadow Stock Portfolio	(2.2)	32.4	1.7	10.4	15.8	17.0
Vanguard 500 Index (VFINX)	5.9	24.8	10.5	7.5	9.2	10.2
Vanguard Small Cap Index (NAESX)	3.9	31.8	7.2	8.2	10.2	13.4

**Relative to Vanguard 500 Index fund (VFINX).*
Data as of 2/28/2017.

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)	75.15	79.59	51.43	882.9	19.8	2.22	0.5	
AV Homes Inc. (AVHI)	16.50	19.13	9.87	372.5	3.0	0.81	0.0	
Beazer Homes USA (BZH)	12.20	15.80	6.81	415.6	146.5	0.60	0.0	
CSS Industries Inc. (CSS)	24.58	29.50	23.84	231.3	6.8	0.74	3.3	
Ducommun Incorporated (DCO)	30.81	31.90	13.52	351.3	nmf*	1.63	0.0	
Ennis, Inc. (EBF)	16.35	21.55	14.40	434.8	17.5	1.69	4.3	
Flexsteel Industries (FLXS)	50.28	62.99	36.06	407.8	16.9	1.79	1.6	
Global Power Equip** (GLPW)	na	na	na	na	nmf*	nmf	nmf	
Hallador Energy Co. (HNRG)	8.38	10.40	3.95	245.6	14.8	1.10	1.9	
Hardinge Inc. (HDNG)	10.47	13.72	8.24	136.9	112.4	0.86	0.8	
Hooker Furniture Corp. (HOFT)	33.00	39.50	20.29	382.7	20.4	2.03	1.5	
Key Tronic Corp. (KTCC)	7.25	8.97	6.85	78.2	11.1	0.73	0.0	
Kimball Electronics (KE)	16.10	19.00	9.98	450.9	14.6	1.35	0.0	
L S Starrett Co. (SCX)	11.00	12.89	8.77	77.9	na	0.80	3.6	earnings probation (2016q4)
PC Connection (CNXN)	26.76	29.74	21.59	714.2	14.8	1.64	0.0	
PCM Inc (PCMI)	26.90	29.15	7.56	332.1	19.0	2.48	0.0	
R C M Technologies (RCMT)	5.80	7.23	5.03	71.7	14.8	2.11	0.0	
RCI Hospitality Holdings (RICK)	17.03	18.00	8.47	167.4	14.8	1.29	0.7	
Renewable Energy Group (REGI)	8.90	10.60	7.01	335.4	nmf*	0.59	0.0	
REX American Resources (REX)	83.22	102.59	49.67	540.4	23.3	1.67	0.0	
Roadrunner Transportation (RRTS)	7.54	13.67	6.49	289.9	11.5	0.46	0.0	
Rocky Brands Inc (RCKY)	10.80	13.95	9.95	84.2	nmf*	0.59	4.1	
Salem Media Group (SALM)	7.15	8.17	4.56	183.3	16.7	0.87	3.6	qualified as of 2/28/2017
Seneca Foods Corp. (SENEA)	37.55	42.65	27.03	371.3	13.3	0.88	0.0	qualified as of 2/28/2017
Shoe Carnival, Inc. (SCVL)	25.34	31.79	21.16	473.8	16.6	1.36	1.1	
SigmaTron International (SGMA)	4.15	7.80	4.07	18.3	38.4	0.29	0.0	
Townsquare Media Inc. (TSQ)	10.87	11.61	7.30	209.7	13.8	0.52	0.0	qualified as of 2/28/2017
TravelCenters of America LLC (TA)	6.50	9.58	5.65	289.5	88.6	0.44	0.0	
Ultra Clean Holdings Inc. (UCTT)	13.85	14.95	4.95	479.7	46.5	2.11	0.0	
Vishay Precision Group Inc. (VPG)	16.10	19.45	11.69	217.7	33.7	1.24	0.0	
VOXX International Corp. (VOXX)	4.95	5.90	2.47	122.0	nmf*	0.31	0.0	

nmf = no meaningful figure
**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 2/28/2017.*

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. First-Quarter 2017 Transactions

Sell

Company (Ticker)	Reason
There are no sells this quarter.	

Buy

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

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Shadow Stock Portfolio has only had a handful of situations with financial statements where major revisions were necessary. Now, with the addition of Roadrunner Transportation Systems (RRTS), there are two at the same time. Roadrunner is revising financials from 2014 onward. There are problems with their expenses and the valuation of goodwill.

In both cases, the revisions will likely lead to reductions in their past earnings. There is no way of knowing whether the initial $5 fall in the price of RRTS stock is appropriate. No action will be taken with these two holdings in the portfolio until the financials are revised, unless the stock violates a sell rule.

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
2016	29.8	11.8	18.2	353,261	80,964	101,248
2017 YTD	(2.2)	5.9	3.9	345,513	85,753	105,244
Since Incep	**15.8**	**9.2**	**10.2**	**345,513**	**85,753**	**105,244**

Data as of 2/28/2017.

Looking Ahead

This has been a very long bull market. Just as it began looking very tired last year, the election results gave it an additional boost. It appears to me that the boost was mainly due to the belief that a Republican Congress and a Republican president would institute changes in the financial environment that would be good for the economy and the corporations that make up the stock market.

To date there has been more talk than action, particularly on the part of Congress. Where are the changes and simplification in the tax laws, particularly the changes in corporate taxes that would make our corporations more competitive and stop them from moving overseas? Where are the actual reductions in unnecessary regulation that stifle small businesses? Where is the modernization of the Dodd-Frank law on financial reform?

So far we have lots of promises and plenty of good intentions. We all know where good intentions lead. If investors begin to believe that nothing of significance is going to actually happen, our bull market could come to a screeching halt as both institutional and individual investors withdraw.

I keep hoping. Maybe we will have some actual change in important areas by the time of the next article on the Model Shadow Stock Portfolio in three months. In the meantime, you can keep up with 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).