American Association of Individual Investors

Guide to AAII's

MODEL SHADOW STOCK PORTFOLIO

AAII’s purpose is to provide investment education and information. Our ongoing goal is to prepare individual investors to effectively manage their investments and to provide the necessary education, data and support to help them in that effort.

Over the years, however, we became increasingly aware that many of our members wanted more specific help. In talks with members, we found that there is a need for an intermediate level of support—not a complete advisory letter, but some specific guidance for individuals in developing an effective investment program—a real-world example of how to use an investment approach to construct and monitor an actual portfolio. AAII addresses this need by currently offering our members access to its Model Shadow Stock Portfolio.

This brief guide is offered as a starting point for those members interested in following the investment direction and education we offer through this model stock portfolio. Along with specific additions and deletions, we also outline our rationale behind each investment holding. The performance of this portfolio has been impressive, but please be advised that a bit of study and commitment is required of members seeking to follow it.

Beyond this guide, AAII offers a webpage at www.aaii.com/model-portfolios for more timely information and additional guidance.

Year-to-Year Performance

		Annual Rate of Return (%)										
	25-Year	**YTD**	**2023**	**2022**	**2021**	**2020**	**2019**	**2018**	**2017**	**2016**	**2015**	**2014**
Model Shadow Stock Portfolio	**12.8**	-0.3	20.8	–19.7	35.3	13.8	19.6	–24.4	14.0	29.8	–15.2	–5.8
Comparison: **Vanguard S&P 500 Index (VFINX)**	7.9	27.9	26.1	–18.2	28.6	18.3	31.3	–4.5	21.7	11.8	1.3	13.5

Data as of 11/30/2024.

AAII Model Shadow Stock Portfolio

The Model Shadow Stock Portfolio provides guidance for investing in the promising micro-cap value sector of the market. The portfolio was initially conceived to show the membership of AAII how to capitalize on the most promising academic research to manage a stock portfolio without having to commit a great deal of time and effort to day-to-day monitoring. *In fact, AAII manages this stock portfolio by simply reviewing holdings on a quarterly basis.*

The Model Shadow Stock Portfolio reflects the following beliefs:

- The best stocks for individual investors are not the same stocks that are best for institutions.
- Over the long run, research indicates that value stocks outpace the market, as do small- and micro-cap stocks.
- Excessive trading of small-cap stocks hurts your bottom line; you can achieve solid returns by simply adjusting your portfolio quarterly.
- Ultimately, the best returns come from giving major consideration to risk. Success comes more from concern for the overall portfolio than for individual stocks.

AAII Model Shadow Stock Portfolio

Company (Ticker)	Ticker	Current Price ($)	52-Week High ($)	52-Week Low ($)	Market-Cap Size ($ Mil)	Price-Earnings Ratio (X)	Price-to-Book Ratio (X)	Dividend Yield (%)	Industry
Alpha Pro Tech, Ltd.	APT	5.25	6.92	4.64	57.7	14.2	0.94	0.0	Building Products
American Vanguard Corp.	AVD	5.26	14.28	4.95	151.4	nmf	0.40	2.3	Chemicals
Amplify Energy Corp.	AMPY	6.27	8.15	3.56	249.4	4.1	0.64	0.0	Oil, Gas & Consumable Fuels
Castor Maritime Inc.	CTRM	3.05	6.50	2.83	29.5	1.3	0.06	0.0	Marine Transportation
Clarus Corporation	CLAR	5.03	7.55	3.89	193.0	nmf	0.66	2.0	Recreational Products
Core Molding Technologies	CMT	16.31	21.00	14.64	141.1	9.3	1.02	0.0	Non-Paper Containers & Pkg
Covenant Logistics Group	CVLG	57.90	61.54	43.00	763.1	19.5	1.89	0.8	Freight & Logistics - Ground
DMC Global Inc.	BOOM	7.40	19.73	7.16	148.2	nmf	0.24	0.0	Energy Equipment & Services
Ennis, Inc.	EBF	21.39	25.75	18.88	556.2	13.6	1.59	4.7	Commercial Printing Services
Escalade, Incorporated	ESCA	15.29	22.01	12.34	212.2	16.3	1.29	3.9	Recreational Products
FONAR Corporation	FONR	15.53	24.05	14.05	99.4	10.9	0.64	0.0	Advanced Medical Equip & Tech
Friedman Industries	FRD	15.77	19.52	13.01	109.9	13.9	0.86	1.0	Metals & Mining - Iron & Steel
Gilat Satellite Networks Ltd.	GILT	5.95	6.66	4.04	339.3	20.5	1.23	0.0	Communications Equipment
Hooker Furnishings Corp.	HOFT	16.93	27.15	13.09	178.5	nmf	0.79	5.4	Home Furnishings
Kimball Electronics, Inc.	KE	18.93	27.73	16.64	467.2	37.9	0.88	0.0	Semiconductors

Go online for the most current list of companies, or see the January, April, July or October issues of the AAII Journal.

Over the last 25 years, AAII's Model Shadow Stock Portfolio has returned an average of 12.8% each year, versus 7.9% for the S&P 500 index as measured by the Vanguard 500 Index fund (VFINX). A partial list of stocks in the Model Shadow Stock Portfolio as of December 13, 2024, is shown on the bottom of the previous page.

A True Do-It-Yourself Model

To pick the right stocks for AAII's Model Shadow Stock Portfolio, the focus is primarily on portfolio formation and risk reduction. The stocks in the Model Shadow Stock Portfolio are largely risky stocks when evaluated separately. But when taken together as a portfolio, most of that individual stock risk has been diversified away. In fact, the average risk of the individual stocks has been reduced by about 70%. The central point of our Model Shadow Stock Portfolio is that the risk of any individual stock is not important if your portfolio is well diversified. What is important is how the addition of that stock affects the risk of your overall portfolio.

If you are not following the full model portfolio but instead use the list of Shadow Stock Ideas as a tool to generate investment ideas, it is suggested that you adhere to the overall strategy by selecting and monitoring a portfolio that consists of at least 10 stocks. Choosing stocks in different sectors will provide added diversification and protect your portfolio from some sector volatility. Furthermore, be sure to consider fees when making your investments. While there is no recommended minimum, investments should be large enough so that fees are insignificant.

While the Model Shadow Stock Portfolio minimizes risk, it is still prudent to take into account your personal risk tolerance. Investors are rightly worried about the amount they invest in a micro-cap strategy. Even a properly diversified micro-cap portfolio will be more volatile than the total market because these stocks are inherently more risky. The worst time to sell a stock is at the bottom, so be sure not to put so much weight into your micro-cap portfolio that you cannot stomach the losses. Keep in mind that due to the nature of the Model Shadow Stock Portfolio, it will offer very little income in the form of dividends.

Two Ways to Build Your Own Shadow Stock Portfolio

1. Follow the printed guidance provided here and issued in the AAII Model Portfolios columns in the January, April, July and October *AAII Journal*—remember, this portfolio was designed to require only simple modifications on a quarterly basis when company fundamentals change.

   OR:

2. Utilize the online resources at www.aaii.com/model-portfolios/ideas where you can see a list of potential Shadow Stocks that is updated daily. The Shadow Stock Ideas list shows all companies that currently meet the criteria for the

Shadow Stock screen. However, the stocks that appear on the Ideas list may not be added to the model portfolio. Alternatively, you can start with the stocks in the Model Shadow Stock Portfolio that are marked as "currently qualifies" in the Notes column. This shows you which stocks that are held in the model portfolio still meet the purchase rules using current data. (Stocks not marked as "currently qualifies" will continue to be held in the portfolio until they meet one of the portfolio deletion rules. Keep in mind that changes are only made to the model portfolio holdings quarterly.)

Ongoing Management of Your Stock Portfolio

AAII's Model Shadow Stock Portfolio is not intended to be an advisory service in the usual sense of that term—it is not intended to be a list of individual stock recommendations. Instead, the model portfolio serves to show you *how to use a value-oriented approach to select micro-cap stocks in an effort to build your own Shadow Stock Portfolio.* Profitable micro-cap investing requires extra care. The portfolio construction and monitoring rules were developed over the years to minimize real-world costs and maximize profits.

In the pages of the *AAII Journal*, we provide regular commentary on the Model Shadow Stock Portfolio (ours has been running for over 30 years) and provide suggestions on how you can vary the approach to build a portfolio suitable for your own specific needs. At our website (www.aaii.com/model-portfolios), we present the detailed rules for building and managing a Shadow Stock Portfolio as well as a list of stocks that currently meet the criteria for inclusion.

Ongoing performance of the Model Shadow Stock Portfolio is tracked online, but keep in mind that a portfolio can be built by simply following the investment moves outlined in the Model Shadow Stock Portfolio columns found quarterly in the *AAII Journal.*

Stock Portfolio Management Criteria

A quarterly review of the following purchase, sale and management criteria is all that should be needed to build your own Shadow Stock Portfolio. Simply review your holdings on a quarterly basis to see if any fundamental changes make them candidates for sale (see deletion rules below). If you have new investment funds available or cash from sales, you can look at AAII's online list of Shadow Stock Ideas (www.aaii.com/model-portfolios) to see if any companies meet your needs for inclusion in your Shadow Stock Portfolio.

Stock additions must meet these criteria:

- Price-to-book-value (P/B) ratio must be less than or equal to 1.00. If the price-to-book ratio moved up a bit since the stock was included in the portfolio, it is still OK to purchase the stock unless the ratio goes above 1.10.*
- Market capitalization must be between $30 million and $400 million.*

- The firm's last quarter and last 12 months' earnings from continuing operations must be positive and, if there are consensus earnings estimates, the estimates must be positive for the current quarter and year.
- The share price must be greater than $4.
- No bulletin board or pink sheet stocks will be purchased.
- No stocks in the utility sector will be purchased.
- No financial stocks, including those in the rental and leasing industry, or limited partnerships will be purchased.
- No stocks on foreign exchanges 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.
- Any stock that was removed within two years will not be added back.
- Note second item under stock order guidance (below) concerning spreads when buying shares.
- Eliminate any company that failed to file a 10-Q (quarterly) report in the last six months.
- The AAII A+ Momentum Score is used as a tie-breaker among qualifying stocks. This score ranks stocks based on their weighted four-quarter relative strength index.

**These figures will change over time as market values change. Any changes will be noted in the* AAII Journal *and online.*

Stocks are deleted if any of the following occur:

- The stock reports a string of negative earnings:
  — If trailing 12-month earnings from continuing operations are negative, the stock is placed on probation; if a subsequent quarter has negative earnings prior to trailing 12-month earnings becoming positive, the stock is removed. When available, adjusted (non-GAAP) earnings are used to put stocks on probation or remove them. These are earnings that have been adjusted to eliminate the impact of nonrecurring events such as markdown of inventory or goodwill. These are earnings reported in the media and firms reporting consensus estimates.
- The stock's price increases so that it is no longer considered a small/micro-cap value stock:
  — The stock's price-to-book ratio goes above three times the initial criterion.
  — Market cap goes above three times the initial maximum criterion.

- Stocks that have been held for four years are deleted unless:
  - — they currently qualify,
  - — they are up more than 10% annually from their purchase, or
  - — there is no qualifying stock to replace them.

In summary, stocks are removed when the market recognizes the value of one of the portfolio holdings, thus driving up the price so that it no longer remains in the "shadows" of Wall Street.

Stock order guidance:

- These rules are for general guidance. Your own experience, market conditions and size of position will impact decisions.
- 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 zero commissions, it is often better to place partial orders than to try to establish a large position all at once. Be patient.
- Be careful if the dollar value of the average daily number of shares traded is not at least 10 times the amount needed for your position. It may be too difficult to get in and out of the position, but you may be able to grow the position gradually and sell gradually.
- If price changes cause a stock to become ineligible (due to changes in the price-to-book ratio or market cap) 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, not equal number of shares.
- Decisions are made quarterly. In order to react to the majority of earnings reports as soon as possible, quarterly reviews are done at the beginning of March, June, September and December.
- Best judgment is used for tenders or mergers, but all criteria should be followed.
- After a quarterly review, if proceeds from stocks removed exceed requirements for available new purchases, the excess proceeds are kept in cash until the next quarter. If too much cash is accumulated, the rules will be adjusted.
- After a quarterly review, if proceeds from stock deletions are insufficient to add all newly qualifying stocks, purchases are based upon the weighted four-quarter relative strength rank.
- 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.

Getting Started: AAII Model Shadow Stock Portfolio

AAII communicates information about the Model Shadow Stock Portfolio to our membership via the *AAII Journal*, online and email. Performance information, news and commentary are always posted and kept up-to-date on the AAII website at www.aaii.com/model-portfolios.

Once a month, a Model Shadow Stock Portfolio Update email is sent to interested members with commentary, updated performance figures and news on the stocks in the portfolio. Addition and deletion alerts, if any, are also reported in the monthly email. You can sign up to receive this free email by logging on to AAII.com and going to www.aaii.com/email.

You are encouraged to study this guide, read the *AAII Journal* articles and, if you have internet access, to visit the AAII Shadow Stocks area of AAII.com prior to investing in any stocks.

Receive Ongoing AAII Model Shadow Stock Portfolio Coverage

Online at:
www.aaii.com/model-portfolios

- Current Model Shadow Stock holdings
- Weekly news on holdings
- Monthly performance results
- Model Shadow Stock Portfolio rules
- Explanation of important concepts
- Shadow Stock Ideas list of stocks meeting the portfolio criteria
- Archive of commentaries and updates

Model Shadow Stock Portfolio Update Email:
www.aaii.com/email

- Monthly performance results
- Alerts announcing portfolio changes

AAII Journal Model Shadow Stock Portfolio Update Columns

- January
- April
- July
- October

Back issues of the *AAII Journal* can be found online at:
www.aaii.com/journal.

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