A Matter of Opinion

A strategy based on criteria that have been successful over the long term and that is followed religiously should lead to above-average results.

A Performance Review and Rules Recap for the Beginner's Portfolio

By James B. Cloonan

I haven't discussed the Beginner's Portfolio for some time now, except to use it as an example in our recent coverage of stock market approaches.

We began the Beginner's Portfolio over four years ago, not to prove any one theory of investing, but to show that a consistent approach could be followed without great time requirements. We also wanted to examine and share the problems and procedures of managing a portfolio of small stocks.

Our approach was based on historical evidence that small-capitalization stocks (these are now more commonly called micro-cap stocks) and stocks with low price-to-book-value ratios outperformed the market over the long run. It was also based on the belief that a portfolio could be managed by making adjustments only once each quarter.

Based on our practical experience in handling the portfolio (it is a real portfolio), we have adjusted the guidelines; the rules provided below represent our latest ideas for managing such a portfolio.

The purpose of the portfolio is to study processes; it is not meant to be an advisory regarding stock picks. Because of this, we have not listed the stocks as we purchased them, although anyone with a stock database can screen it using our rules and come up with approximately the same selections.

The performance results for the first four years are presented in Table 1; passively managed portfolios of several indexes are also presented for comparison. For the first four months of 1997, the Beginner's Portfolio is running even. Its return lags a passively managed portfolio of the S&P 500, but it is ahead of passively managed portfolios of the Russell 2000 and the micro-cap index. Note that on a risk-adjusted basis, the performance is better.

The Beginner's Portfolio may do better or worse in the future, but I believe that a strategy based on criteria that have been successful over the long term and followed religiously will lead to above-average results.

From a practical point of view, we have found the necessary information easy to find, and the time requirements to be less than eight hours a quarter. Commissions have been minimal—about 0.25% a year—and by following the guidelines below, we have been able to avoid high bid-asked spreads.

While the Beginner's Portfolio is performing well to date, there are ways that individual investors can tailor the current rules, and add new rules, if they want a more sophisticated approach. In the future, I'll take a look at the possible ways to accomplish this.

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Beginner's Portfolio Rules

Stock purchases must meet these criteria:

- The stock's price-to-book-value ratio is less than 0.70. (This figure will change gradually as the overall market value changes.)
- The firm's market capitalization is between $13 million and $100 million (this will also change over time).
- The firm's last quarter earnings and last 12 months' earnings from continuing operations were positive.
- No financial stocks or limited partnerships are purchased.
- The share price is greater than $4.
- In order to reduce turnover in stocks that are forever marginal, do not rebuy a stock you have sold within two years.
- Note first item under stock order rules concerning spreads when buying shares.
- From the list of stocks remaining after the above screens have been applied, choose those with the lowest price-to-sales ratios in order until you have used up available funds. However, do not go above a price-to-sales ratio of 0.54.

Stocks are sold if any of the following occurs:

- The firm's earnings for the last 12 months are negative.
- The stock's price-to-book-value ratio goes above two times the buy criteria.
- The firm's market capitalization goes above twice the initial criteria.

Stock Order Rules

- If the quoted bid-asked spread is

Table 1.
Beginner's Portfolio vs. Passive Portfolios:
Four-Year Performance and Risk

	Beginner's Portfolio	S&P 500*	Russell 2000*	Micro Caps*
1993 Return (%)	32.3	9.8	18.7	21.0
1994 Return (%)	2.0	1.1	-0.6	3.1
1995 Return (%)	20.7	37.4	28.7	34.5
1996 Return (%)	22.3	22.9	18.1	17.6
4-Year Arithmetic Mean (%)	19.3	17.8	16.2	19.1
4-Year Risk** (%)	11.0	13.7	10.6	11.2
4-Year Return per Unit of Risk***	1.75	1.30	1.53	1.70

* *Based on passively managed portfolios. The S&P 500 is represented by the Vanguard Index 500 fund; the Russell 2000 is based on the Vanguard Index Trust Small Cap fund, and micro-caps are represented by the Ibbotson small cap index.*
** *Standard deviation: The amount by which most returns varied around the average.*
*** *Sharpe ratio: 4-year return divided by 4-year standard deviation.*

more than 8% (asked price minus bid price, divided by asked price), eliminate the stock from consideration. Better to stretch other criteria, if necessary, than pay high spreads.

- Market orders are not used. Instead, orders are placed between the bid and asked prices unless the difference between the two is 4% or less, in which case purchases are placed at the offer price and sales are placed at the bid price.
- Unfilled orders on exchange-listed stocks should be adjusted after a few days. In the over-the-counter market, it appears to be better to place day orders. If the order goes unfilled, place it again in a few days with a slight adjustment. In NYSE and Amex stocks, use good-til-canceled (GTC) orders so you keep your place in line in the specialists' books. If the market isn't close to your price, adjust in a few days with a new GTC order.
- 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, keep what is already purchased and cancel balance of order.

Portfolio Management Rules

- Decisions are made only at the end of each quarter. In order to react to the majority of earnings reports as early as possible, consider doing the quarterly reviews early in February, May, August, and November—but be consistent.
- Best judgment is used for tenders or mergers, but all criteria must be obeyed.
- At end of quarter, if receipts from stocks sold exceed requirements for new purchases, keep the excess receipts—up to 5% of portfolio value—in cash until next quarter. If the excess receipts are greater than 5% of the total portfolio value, distribute the amount above 5% to smaller holdings that still qualify as buys. Buy in efficient quantities. If over 10% of portfolio is in cash, move the market-cap screen up a bit (for instance, from $100 million to $110 million) to find new qualifying stocks.
- Divide your portfolio so that you have at least 10 stocks. For portfolios over $100,000, investing in 15 to 20 stocks is sufficient. You will not need more than 20 stocks until your portfolio exceeds $1 million.