A Matter of Opinion

There are many different approaches to managing your own portfolio of stocks, and the Beginner's Portfolio is a good example of one of the simplest methods.

An Individual Investor's Guide to Managing Your Own 'Mutual Fund'

By James B. Cloonan

In the July *AAII Journal*, I expressed the hope that more members would consider managing their own portfolios—at least in U.S. equities—rather than depending on mutual funds. While I admitted that some investors are better off in funds, I think many AAII members can make the switch, save the costs, and (unless they can pick the top-performing mutual funds each year) improve returns. To help those who wish to make the switch, I will use this column over the coming months to discuss different approaches to stock portfolio management.

I am beginning with the simplest of investment approaches—a portfolio based on clear-cut quantitative decision rules, with only occasional adjustment. The Beginner's Portfolio, which we have been running for the past 3½ years, is a perfect example of this type of approach, and I am reviewing it here.

The rules for the Beginner's Portfolio are very specific, and very little is left to judgment. In addition, in order for the time consumed in portfolio management to be minimum, adjustments are made only quarterly.

I should reiterate that the rules have been revised to include consideration of the price-to-sales ratio, as mentioned last month. In keeping track of the Beginner's Portfolio over the coming months, I will note the difference brought about by the new criterion to see its impact.

The Beginner's Portfolio is a real portfolio, and it is up 14.7% through the first half of 1996 (this includes transaction costs), which is better than the S&P 500 over the same time period. The portfolio has also outperformed the S&P 500 over its 3½-year life. While the life of the portfolio is too short to be making wild claims, it does indicate that an investor does not have to be a rocket scientist (as the saying goes) to manage an effective portfolio.

The Beginner's Portfolio is only one example of approaches that follow rather direct quantitative rules. While we set up the portfolio with an eye to the investor who could only spend minimal time—about four to six hours a quarter—this or any other quantitative approach can be managed on a more frequent basis. Since corporate reporting data is only quarterly in most cases, there is little reason to review stocks more frequently. If an individual is able to spend additional time, however, the portfolio could be checked each month for the stocks that had earnings reports the previous month.

To manage this type of portfolio, a computer screening program will be necessary. AAII's *Stock Investor* will do the job, as can most of the other programs available on the market.

In the next issue we will look at the characteristics of this kind of portfolio and develop a categorization of investment styles.

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Beginner's Portfolio Rules

Stock purchases must meet these criteria:

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

Stocks are sold if any of the following occurs:

- Last 12 months' earnings are negative.
- The price-to-book-value ratio goes above two times the buy criteria.
- Market capitalization goes above twice the initial criteria.

Stock Order Rules

- If the quoted bid-asked spread is 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 ask 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 seems better to place day orders. If unfilled, place order again in a few days with a slight adjustment. In NYSE and Amex stocks, use good-til-cancelled (GTC) orders so you keep your place in line. 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. 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 $60 million to $64 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 efficient. You will not need more than 20 stocks until your portfolio exceeds $1 million.