A Matter of Opinion

The new rules are designed to go beyond the Beginner's Portfolio, adding some growth criteria and firms with somewhat larger market capitalizations.

Suggested Rules for Stock Investors at the Intermediate Level

By James B. Cloonan

The Beginner's Portfolio returned 44% for 1997, beating the S&P 500 by about 11% and doing so with less risk (I'll get into more details on this in a future column).

It would be tough for any approach at any level to beat those results, be it a portfolio for intermediate-level investors or a more complex advanced-level portfolio with room for personal judgments.

Nonetheless, I think it is well worth the effort for the following reasons:

- Some of the other proven criteria for selecting stocks that will outperform the market are valid, and they may screen out some of the many Beginner's Portfolio stocks that never move.
- The severe market capitalization and value criteria of the Beginner's Portfolio limits the size of the portfolio that can be managed without impacting prices. While it is likely that a portfolio of up to $10 million might be viable for a single investor, there could be problems if a number of individuals used the same criteria.
- Testing growth-oriented criteria will be useful in helping our members. Obviously it will take some time to draw conclusions, but years seem to go by quickly.

The intermediat- level portfolio outlined in this column draws on past research. It is value-oriented but not as much so as the Beginner's Portfolio, and it adds some growth criteria. The criteria are set so that about 100 stocks would be isolated at a given time. If market conditions change, the criteria may have to be adjusted. The individual is left to make the final decisions either by emphasizing some of the criteria used or by adding other criteria of choice. I believe a portfolio of 25 stocks (or fewer) should be sufficient for a portfolio value in the range $5 million to $10 million.

The rules are divided into several segments. The primary criteria are those that isolate the universe of stocks from which the final portfolio will be selected based on criteria determined by each investor.

The secondary criteria can be quantitative, based on data available from AAII's *Stock Investor* program or other available databases; they can be a further refinement of some of the primary criteria; or they can be qualitative, based on the individual's ability to do qualitative research. (I discussed qualitative criteria in my column "A Review of the Qualitative Approaches to Stock Management," which appeared in the February 1997 AAII *Journal.)* Qualitative criteria could include such variables as product recognition and life cycle, the strength of competition, management capability, research and development expenditures, expansion speed and potential, takeover likelihood, market penetration, misevaluation of assets, etc.

The "final cut" rule is simply my suggestion as to how to make the final selections once all the primary criteria, secondary criteria, and trading rules have all been met.

For the intermediate portfolio that we will actually maintain as a test, the secondary criteria will be those I have selected here. I chose quantitative criteria because they can be evaluated and made very specific. I believe in the value of qualitative criteria, but they require time, data access, and expertise that would be more appropriate to an advanced level of portfolio management.

Rules for the Intermediate-Level Portfolio

Primary Criteria

- Market capitalization between $25 million and $500 million. (Designed to capture the "small firm effect," in which research indicates that the stocks of smaller companies provide returns above those that would be expected based on their level of risk.)
- Earnings per share from continuing operations that are positive for the last quarter and the last 12 months. (To screen out firms that are having short-term difficulties.)
- Earnings per share for the last 12 months greater than or equal to earnings per share for the last fiscal year. (A growth screen.)

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- Earnings per share from continuing operations up 10% or more over last 12 months. (A growth screen.)
- Price-to-sales ratio less than or equal to 2.5. (A value screen.)
- Price-to-book value ratio less than or equal to 2.0. (A value screen.)
- Price has appreciated 10% or more in the last six months. (A growth screen.)
- Price greater than $6. (To keep the rules practical.)

Secondary Criteria

- Sales growth averaging 15% or more for the last three years. (Earnings and price appreciation generally cannot be sustained without sales growth.)
- Less than 20% of holdings in any sector, as indicated by the firm's two-digit industry code; financial companies are not eliminated. (With growth screens, financial companies can be included, but note that diversification within this sector is needed.)

Buying and Selling Stock

- Eliminate from consideration any stock if the bid-ask spread is 8% or more.
- Don't use market orders. If the spread is narrow, put in your buy/sell order at the offer/bid. Otherwise put in an order between the bid and the ask and try to get a fill—be patient, these are not hot stocks. For Nasdaq stocks use day orders. For Amex and NYSE stocks, using "good-till-canceled" orders will maintain your position in line. In either case adjust orders to get fills.
- If the price changes, making a stock ineligible after a partial purchase, keep what has been bought but don't buy more unless it passes the screens again.

The Final Cut

- After application of all above criteria and elimination of stocks based on bid/ask spread, selection is in order of lowest price-to-book-value ratios. (This, in my opinion, is the single strongest criteria.)

Criteria for Selling

- Price-to-book-value ratio gets above 5.0. (At this level, it is no longer a value stock.)
- Market capitalization goes above 2.5 times the size selection criteria, which currently means the stock's market capitalization is above $2.5 billion. (At this size, it is no longer a small-capitalization stock.)
- Last 12-month earnings are negative *and* a subsequent quarter's earnings are negative before 12-month earnings go positive. (No longer a value stock, but moving too fast increases turnover rate.)
- Stock price does not go up as much as market in 18 months following purchase. (It no longer has desired growth elements.)

Portfolio Management

- Decisions can be made once a quarter, since company reports are quarterly. However decisions could be made monthly, concentrating on companies with reports made the previous month. For our test portfolio, we will adjust quarterly.
- Use best judgment for tenders or mergers but follow criteria.
- Try to stay as fully invested as possible, adding to existing positions that still qualify if there is not enough for a full new position.

As we gain more experience with this portfolio, which we began in January, I will share any insights with you.