January 2014

VOLUME XXXVI, No. 1

AAII Journal

American Association of Individual Investors

2013 AAII STOCK SCREENS REVIEW:

The Factors Behind the Big Returns

Also Inside:

The Conditions That Have Led to Small-Cap Outperformance

How Long-Term Care Insurance Can Protect Your Portfolio

Purchase Guidelines for Following the Model Shadow Stock Portfolio

Access All 65 Stock Screens Online

If you haven't visited AAII.com recently, please take some time today to see what the website offers. Plenty of helpful resources are available at your fingertips to aid you in the investment process.

This issue of the *AAII Journal* includes our year-end stock screening review on page 7. The article offers an in-depth look at the best-performing screens we track on AAII.com. In addition, we take a look at certain factors that have been consistent to winning approaches through the years.

AAII offers all 65 screening methodologies online to members. Screening methodologies are available across all different styles and strategies, and there should be at least a few screens that suit your personal investment beliefs and risk profile. Each stock screen is accompanied by an overview explaining the methodology and rationale behind the strategy. In addition, you can also see the screening criteria used and a list of passing companies for each month. Though we originally created these screens as a way to track investment performance for different strategies across various market cycles, it can definitely be used as a "watchlist" of stocks.

Annual performance for each of our screens is reported online in the Performance History tab (Figure 1). In addition, you can download the monthly performance for our screens going back to 1998. We also offer a risk and return spreadsheet with an expanded version that can be downloaded as an Excel spreadsheet (Figure 2). The risk and return spreadsheet is very telling, presenting risk-adjusted returns as well as best- and worst-performing months for each screen. In addition, the page and downloadable spreadsheet show bull- and bear-market returns.

If you are interested in stock screens, we encourage you to read the year-end stock screening review on page 7. Additional resources that can help you get started are available online for all AAII members at www.aaii.com/stock-screens. Finally, for investors who want to create their own screens, perform additional fundamental analysis, and see weekly instead of monthly lists of passing stocks, AAII offers *Stock Investor Pro*, an advanced stock screener and research database (go to www.aaii.com/stock-investor-pro for more information).

To log into AAII.com, simply type in your 10-digit AAII member number (from the mailing label on your AAII Journal*) for both Login Name and Password when prompted.* ▲

Figure 1. Stock Screens Performance History Page

Performance History

Before following any AAII stock screen, we recommend that you look at the long-term returns as well as recent performance. Understand that the screen portfolios that we present are merely computer-generated lists, based on our own interpretation of popular investment approaches.

That being said, our screen tracking results are quite impressive. Complete performance statistics are presented in the table below.

Note: Click on the column headers to sort by specific year. Definitions of Price Change and Monthly Variability are available by clicking on the question mark icons.

Downloadable Excel Files

Monthly Cumulative Performance

Annual Performance

Other links

FAQs | Disclaimer | Performance Charts

Data as of 11/30/2013

Performance of All Stock Screens

Value | What is a Value Screen?

Strategy	Price Gain (%)																
	YTD	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	Annualized Total*
Cash Rich Firms	33.5	10.5	-32.8	14.4	56.9	-38.0	7.7	17.2	-2.5	18.6	64.0	-9.4	20.1	40.5	37.1	-3.8	**11.1**
Dogs of the Dow	25.9	9.6	10.7	19.4	8.1	-45.4	-1.8	26.8	-9.8	-1.3	20.4	-9.8	-1.2	4.1	5.7	9.8	**2.8**
Dogs of the Dow: Low Priced 5	30.9	15.7	13.1	17.3	-7.7	-58.7	-2.7	34.9	-11.8	6.1	17.6	-6.5	7.2	3.2	-2.0	24.6	**2.1**
Fundamental Rule of Thumb	45.6	-6.9	-35.2	17.7	92.1	-41.5	4.1	31.0	5.0	49.6	83.3	4.7	42.3	28.7	11.7	-9.4	**14.7**
Graham--Defensive Investor (Non-Utility)	31.8	18.9	7.0	31.4	57.9	-32.0	20.6	26.6	26.2	11.7	32.7	3.1	61.5	12.0	3.6	9.6	**18.2**
Graham--Defensive Investor (Utility)	10.9	1.2	8.6	4.6	7.9	-18.4	1.8	29.4	18.5	16.2	16.6	-15.9	5.2	51.4	-8.4	14.6	**7.9**
Graham--Enterprising Investor	10.5	1.1	-1.1	43.5	48.5	-40.7	28.1	72.3	21.3	18.9	25.9	43.5	55.3	24.2	-5.0	-7.3	**17.8**
Graham--Enterprising Investor Revised	4.1	-4.9	-4.1	32.9	168.4	-22.6	29.4	34.5	48.2	10.2	50.1	2.2	65.8	-1.4	5.5	10.2	**21.3**
Magic Formula	24.9	7.9	-30.6	26.6	97.0	-36.3	-5.6	27.9	-9.2	6.5	66.6	6.3	76.1	1.0	9.3	-9.9	**11.2**
O'Shaughnessy: Value	26.6	20.3	-11.2	7.4	31.5	-49.1	-4.2	24.4	2.2	20.2	47.2	-12.1	10.6	22.3	-3.9	7.2	**6.1**
Piotroski: High F-Score	142.3	91.7	-36.4	138.8	34.6	-35.3	1.8	8.1	37.8	37.7	131.6	7.6	76.3	-2.8	35.8	7.5	**31.7**
Price-to-Free-Cash-Flow	91.6	1.1	-7.0	39.2	147.2	-41.5	-21.2	26.6	10.6	30.9	61.7	13.6	63.8	17.8	10.0	2.6	**21.1**
Schloss	39.3	13.1	-35.1	12.5	57.5	-23.1	-8.1	30.1	20.0	-26.6	140.7	-0.1	20.5	14.9	18.8	18.8	**12.9**
Weiss Blue Chip Div Yield	17.6	19.2	7.6	26.9	27.9	-26.2	4.5	14.2	6.4	13.6	48.9	-14.1	25.6	18.8	3.9	3.3	**11.1**

Figure 2. Stock Screens Risk & Return Page

Risk & Return

When selecting a stock screening strategy, there are a number of factors to consider, including your time horizon and risk tolerance, as well as how closely you are able to monitor your stock portfolio. While historical performance is an important component of the selection process, the market can go through periods of extreme fluctuation. As a result, it is also useful to see how various strategies perform over different market conditions. One of the values of the AAII stock screens is that you can compare the performance and risk of a variety of strategies against broad market indexes and other strategies.

The risk and return data provided here allows you to evaluate the riskiness of the AAII stock screens relative to the overall market and their price performance, including on a risk-adjusted basis and over the latest bear and bull market periods.

Note: Click on the column headers to sort by specific year.

Risk & Return Spreadsheet

Data as of 11/30/2013

Value | What is a Value Screen?

Strategy	Historical Annual Risk & Return		Avg Ann'l Price Gain (%)					Price Gain (%)									
	Risk Index (X)	Risk Adj Return (%)	Since Inception	1 Yr	3 Yr	5 Yr	10 Yr	Bull Mkt	Bear Mkt	Monthly Variability Best	Monthly Variability Worst	YTD	2012	2011	2010	2009	2008
Cash Rich Firms	1.37	9.2	11.1	38.7	0.4	13.3	5.4	79.0	-45.6	17.6	-20.7	33.5	10.5	-32.8	14.4	56.9	-38.0
Dogs of the Dow	1.22	2.5	2.8	27.3	17.3	14.4	2.8	177.3	-69.0	17.1	-23.4	25.9	9.6	10.7	19.4	8.1	-45.4
Dogs of the Dow: Low Priced 5	1.58	1.0	2.1	34.7	21.9	12.0	0.3	226.2	-82.9	27.6	-34.8	30.9	15.7	13.1	17.3	-7.7	-58.7
Fundamental Rule of Thumb	1.70	10.3	14.7	39.4	-2.0	17.8	9.5	108.2	-57.0	33.8	-19.2	45.6	-6.9	-35.2	17.7	92.1	-41.5
Graham--Defensive Investor (Non-Utility)	1.37	14.4	18.2	35.1	21.2	30.0	18.2	286.7	-52.1	25.8	-17.3	31.8	18.9	7.0	31.4	57.9	-32.0
Graham--Defensive Investor (Utility)	0.90	8.3	7.9	11.0	8.0	6.0	7.7	55.3	-31.4	12.0	-13.4	10.9	1.2	8.6	4.6	7.9	-18.4
Graham--Enterprising Investor	1.75	11.9	17.8	10.5	3.4	21.8	16.5	159.0	-50.3	33.1	-23.4	10.5	1.1	-1.1	43.5	48.5	-40.7
Graham--Enterprising Investor Revised	1.74	14.0	21.3	13.7	-1.7	28.3	22.9	244.8	-49.9	36.4	-22.4	4.1	-4.9	-4.1	32.9	168.4	-22.6

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EDITORIAL POLICY

It is not the policy of the *AAII Journal* to promote any specific investments or techniques of analysis. The opinions of authors are their own and not necessarily those of AAII. It is the editorial opinion of the *Journal* that no one area of investment is suitable for all investors and that no single method of evaluating investment opportunities has proven to be successful all of the time.

AAII is not a registered investment adviser or a broker/dealer. Readers are advised that articles are provided solely for informational purposes and should not be construed as an offer to sell or the solicitation of an offer to buy securities. The opinions and analyses included herein are based on sources believed to be reliable and written in good faith, but no representation or warranty, expressed or implied, is made as to their accuracy, completeness, timeliness, or correctness. Neither we nor our information providers shall be liable for any errors or inaccuracies, regardless of cause, or the lack of timeliness of, or any delay or interruptions in, the transmission thereof to the users. All investment information contained herein should be independently verified.

Past performance is no guarantee of future results. Investment information provided may not be appropriate for all investors. Investment information is provided without consideration of your financial sophistication, financial situation, investing time horizon, or risk tolerance. Readers are urged to consult with their own independent financial advisers with respect to any investment.

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Editor's Note

The first issue of the *AAII Journal* was published 35 years ago. On the inaugural cover were simply the words: "The American Association of Individual Investors is an independent nonprofit corporation formed for the purpose of assisting individuals in becoming more effective managers of their own assets through programs of education, information and research." (The second issue featured a photo of the Chicago Board of Trade. In recognition of the *Journal's* start, a more current photo appears on this month's cover.)

Many magazines have come and gone since the first *AAII Journal* was published. Much of the credit for the continuation of this journal goes to AAII founder James Cloonan, who is the first recipient of the Cloonan Award for Excellence in Investment Education. (More information about the award can be found on page 4.) My predecessor Maria Crawford Scott also deserves much credit for everything she accomplished during her 25-year tenure as editor.

Much has changed since 1979. As Jason Zweig noted in a November 2013 Wall Street Journal article about Jim Cloonan, brokerage commissions have plunged from over $40 to under $10. Most individual investors only have infrequent conversations with a representative of their brokerage firm, and those conversations are typically about something other than placing a trade. Defined-contribution plans (e.g., 401(k) plans) have largely replaced defined-benefit plans (e.g., pensions) as employer-sponsored retirement plans. Exchange-traded funds, which didn't even exist until 1993, now control over $1.6 trillion in assets. Information is distributed faster than ever and investors can access data, and instantly react to it, anywhere that Internet connectivity exists. The Dow Jones industrial average was approximately 820 at the start of 1979; as we went to press in late December 2013, the Dow was trading at approximately 16,150.

Somet things have not changed. The first feature article in the *AAII Journal* discussed how to resolve problems with your brokerage firm. Memories of the last two bear markets were still fresh in 1979, as they are at the start of 2014. Uncertainty about the direction of the economy and frustration with the federal government existed then and unfortunately exists now.

Another thing that has not changed is AAII's mission. The words that appeared on the inaugural issue remain our mission today. Our goal has always been and continues to be to help you become a better and a smarter investor. Whether you have been member for over 30 years or a member for less than a year, we hope you have benefited from all of the resources AAII provides, including the *AAII Journal*. If so, please tell a friend or a family member. As a nonprofit organization, we are reliant on membership dues to fund operations. Spreading the word about AAII is one of the best ways you can help ensure that we will be around for the decades to come.

As an AAII member, you have access to more than 60 stock screens on AAII.com. These screens are based on the methodologies of many famous investors. I'm a big believer in stock screens since they can not only quickly identify stocks with the traits you desire, but often lead you to good stocks you would have otherwise not looked at. On page 7, you can find updated performance numbers for all of the screens we track and Joe Lan's discussion of what common traits the best screens share.

AAII members also have access to the Model Shadow Stock Portfolio, begun by Jim Cloonan. First discussed in a 1992 *AAII Journal* article, this portfolio continues to follow the philosophy of seeking undervalued, small-cap stocks overlooked by most investors and is still managed by Jim. The latest update to the portfolio—which includes two deletions, one addition and one reinvestment—appears on page 32.

In addition, this month's issue features great articles about longevity insurance, how small-cap stocks react to economic cycles, trend following and the cash value of life insurance policies. I hope you find the articles useful and interesting.

Wishing you prosperity,
Charles

Charles Rotblut, CFA
Editor, *AAII Journal*
twitter.com/charlesrotblut

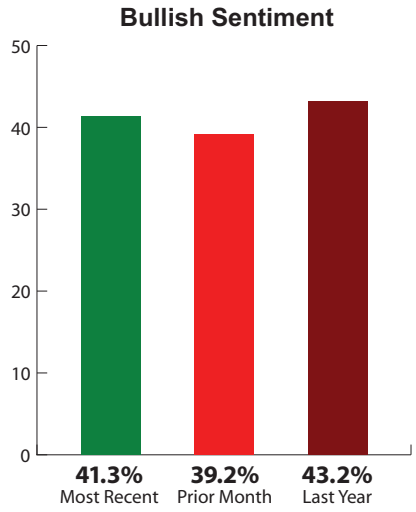
AAII Investor Surveys As of December 11, 2013

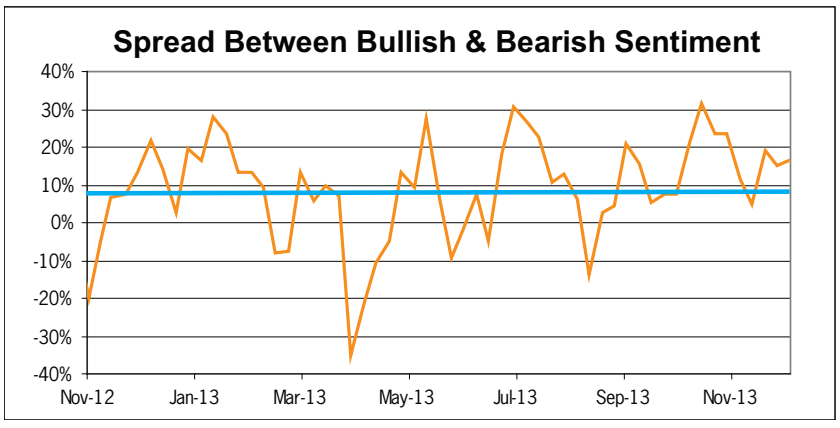
Sentiment Survey

The sentiment survey measures the percentage of individual investors who are bullish, bearish and neutral on the stock market short term; individuals are polled on the AAII website; the percentages and averages are for all members responding.

Historical Averages

Bullish: 39.0%
Neutral: 30.5%
Bearish: 30.5%





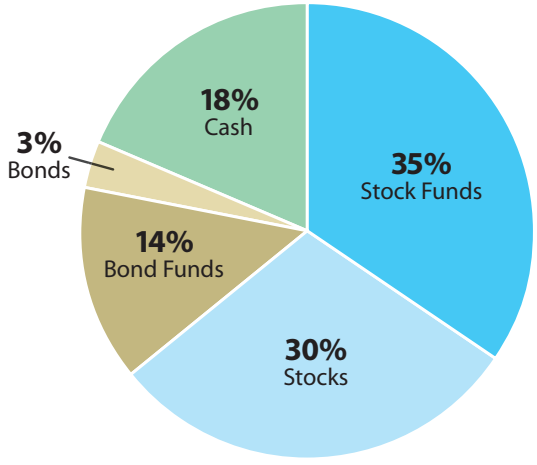
Blue line = historical average

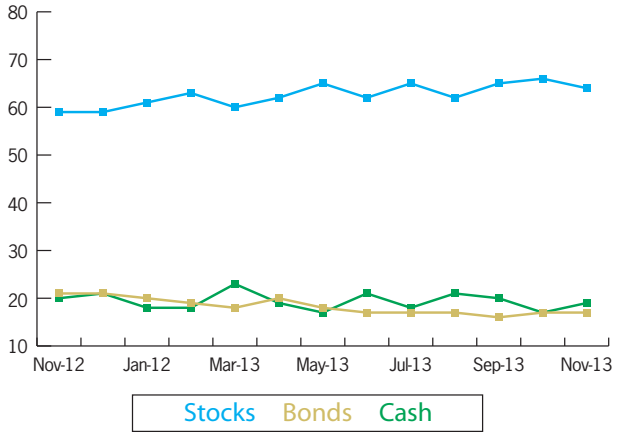
Asset Allocation Survey

The asset allocation survey measures the percentage holdings of members in five asset categories. Members are polled monthly on the AAII website; the percentages and averages are for all members responding.

Historical Averages

Stocks: 60%
Bonds: 16%
Cash: 24%





Updated results for both surveys are available by going to www.aaii.com/investorsurveys. The Sentiment Survey is updated every Thursday morning, while the Asset Allocation survey is updated on the first day of every month. Numbers may not add up to 100% because of rounding.

Briefly Noted

The Cloonan Award for Excellence in Investment Education

As stated in the Editor's Note, the very first cover of the *AAII Journal* featured a statement that has defined AAII's mission throughout our history. That statement was: "The American Association of Individual Investors is an independent nonprofit corporation formed for the purpose of assisting individuals in becoming effective managers of their own assets through a program of education, information and research."

James Cloonan founded the American Association of Individual Investors in 1978 with the clear understanding that individual investors have unique investment needs and opportunities. The investment environment was very different when AAII began over 35 years ago. Investment information did not flow easily. Research involved a trip to the library to study a company's "tear sheet" and sending a letter to a company to request an annual report. Investor education for the individual investor was very limited. Fixed-brokerage commissions had just recently been stricken, freeing "mayday" brokers to compete on price and spurring the era of active individual investors.

Jim earned an MBA from the University of Chicago and a Ph.D. from Northwestern University. He was a business professor and was running an options-brokerage firm when he realized the need for an organization that would provide unbiased information, education and research for the individual investor. Jim continues to believe that if you take investing seriously, you can do better than professional money managers. It is important for individual investors to play to their strengths, perform appropriate research, take a long-term perspective and not get caught up in the emotions of the market.

To honor Jim's work in the field of investment education and research for the individual investor, AAII's board of directors has established the Cloonan Award for Excellence in Investment Education. The award will be presented to individuals who have made significant advances and contributions in the area of individual investor education. This past November, the board presented Jim with the inaugural award at AAII's 2013 Investor Conference in Orlando, Florida.

Congratulations, Jim!

Photo by Kathleen Muhle

Companies Play Favorites to Hide Bad News

Corporate executives selectively choose which analysts they interact with during conference calls to avoid unwanted questions. This "casting" of calls happens when there is potentially bad news a company does not want highlighted, according to Harvard researchers.

The researchers reviewed more than 69,000 transcripts for conference calls held between 2003 and 2011. On average, 4.26 analysts were allowed to ask questions during a typical quarterly earnings call out of the 11.45 analysts covering a stock. Though brokerage ratings tend to be overly positive, the analysts who were allowed to speak had more bullish ratings on the stock than those who were not allowed to speak.

Three primary variables played a significant role in determining how casted a conference call was. Companies with unusually high levels of accruals were 25% more likely to call upon only those analysts issuing the most optimistic ratings. Companies that either met earnings expectations or topped earnings estimates by just a penny per share were 23% more likely to cast their calls. Planned insider selling was the third variable. Executives who were intending to sell their shares were 40% more likely to take questions only from analysts issuing favorable recommendations.

Two other characteristics were also identified. Com-

The Top Proxy Issues of 2013, and Likely 2014

IR Magazine, which covers investor relations from a global perspective, compiled a list of the top trends from 2013's proxy season and predicted what shareholders and corporations could see in 2014. First, the top trends for 2013.

Shareholder Engagement: Not only are corporations more willing to engage with shareholders, IR Magazine says institutional investors are becoming overwhelmed with requests for meetings from the companies they invest in. Much of the desired communications surround the topic of executive compensation.

Voting Against Directors: Activist investors became more aggressive last year in forcing changes on corporate boards. A total of 19 proxy contests occurred in 2013, more than double the number in 2010. Accompanying these challenges was an increase in proposals for alternative slates of directors proposed by activist investors.

Executive Pay: The number of executive pay proposals declined to 83 last year from 116 in 2010. The majority of pay proposals made in 2013 focused on seeking to eliminate accelerated vesting of options in change-of-control (e.g., a merger) agreements and equity retention requirements for top executives.

Declassifying Corporate Boards: Ending the practice of staggering board elections was one of most popular demands among shareholder activists. Staggering when the term of each board member expires makes it more difficult for an activist investor or another party to gain control of the board and is viewed as being unfriendly to shareholders.

At the same time, proposals to redeem poison pills and for cumulative voting for directors are down. Poison pill provisions allow companies to alter their capitalization structure, often by allowing shareholders to buy additional shares, and are intended to thwart hostile takeovers. IR Magazine says many companies have either proactively redeemed these plans or chosen not to renew them. Cumulative voting allows shareholders to choose how they distribute their votes for directors.

As far as 2014 is concerned, four key themes could emerge. More attention could be paid to how a CEO's compensation compares to that of his company's average employee. Though companies are not required to disclose this data until 2016, Bloomberg is beginning to publish the ratios. Demands to allow shareholders to propose board candidates, subject to ownership requirements, could intensify. Shareholder activism may increase, with a company's size or stock performance no longer shielding it from scrutiny. Finally, hedge funds may look to proxy fights to push for their interests.

Source: "Proxy Season: What's Hot, What's Not," by Matthew Scott and David Bogoslaw, IR Magazine, December 11, 2013.

panies with more analyst coverage and a higher proportion of institutional ownership tended to cast their conference calls significantly less. Conversely, companies with more volatile stocks were more likely to cast their calls.

Being more selective about which analysts can speak on a conference call gives a company a few advantages. It prevents executives from being faced with tough questions. It reduces the chance of the company's accounting practices or reported numbers from being publicly scrutinized and questioned. It also allows for bad news to be downplayed or to be kept out of the public eye.

The casting of calls is not a continuous event, however. Rather, companies tend to cast conference calls for just one quarter. This suggests, according to the researchers, "that casting is something a wide range of firms engage in selectively at precisely those times they have strong incentives to do so, and is not a behavior concentrated in a few firms that continuously cast their calls." Because the practice is temporary, often the bad news comes out when the next quarter's earnings are released.

Source: "Playing the Favorites: How Firms Prevent the Revelation of Bad News," by Lauren Cohen, Dong Lou and Christopher Malloy, Harvard Business School Working Paper, September 4, 2013.

Letters

The Journal *welcomes letters to the editor. We reserve the right to edit. Letters should be addressed to: Editor,* AAII Journal*, 625 North Michigan Avenue, Chicago, Illinois 60611. Be sure to include your name and address. Alternatively, emails may be sent to: journal@aaii.com and comments can be posted online for all articles. Past* AAII Journal *articles referenced here can be accessed at AAII.com.*

Tax Guide Updates

***Comment posted to "The Individual Investor's Guide to Personal Tax Planning 2013," by AAII staff, in the December 2013* AAII Journal.**

In the Estate Tax section, there is a typo saying for 2014 the total effective exclusion would be $10.68 billion; I believe that should be million.

—Susan Crabtree from Ohio

Charles Rotblut responds:

The estate tax exemption for 2014 is $10.68 million, not $10.68 billion. We've fixed the typo online, and apologize for the error.

On December 6, 2013, the Internal Revenue Service (IRS) published the standard mileage rates for 2014. The deductions are 56 cents per mile for business, 23.5 per mile for medical or moving purposes and 14 cents per mile for charity service. The 2013 Tax Guide has been updated on AAII.com to reflect these new numbers.

—AAII staff

Social Security Spousal Benefits

***Comment posted to "Social Security Strategies for Couples," by William Reichenstein and William Meyer, in the December 2013* AAII Journal.**

My wife and I are pursuing Strategy 2 since I am five years older and have double the primary insurance amount (much like the example). However, I suggest that everyone who hasn't yet committed to a strategy make their own spreadsheet calculator based on the article (good job showing the calculations). You can then set up as many cases as you want. As in all things in life, it all comes down to when each of you perish. So, while my wife and I are pursuing Strategy 2, if we both die at age 85, it would be no different net present value (if I recall correctly when I did this calculation) than if we both took benefits at full retirement age.

In the end, what I made the decision on was that: 1) we don't really need Social Security to live a good life, at least until I am 70, and 2) I wanted to leave my wife a good annuity after I die, assuming average life expectancies (when she is likely to really need it).

—Tim Soles from Texas

I must question the following sentence from the claiming strategy example: "In Strategy 2, Peggy begins benefits in four years, when she turns 62, of $900 a month and Mark begins spousal benefits only at that time of $450 a month, half of her primary insurance amount." I believe Mark's $450 should be $600, half of Peggy's PIA; unreduced because Mark has attained full retirement age. Correct me if I'm wrong!

—Bob G. from Colorado

Bill Reichenstein responds:

You are correct; there is an error in Table 3. Since her PIA is $1,200, he should get spousal benefits of $600 from age 66 through age 69, a total of four years. I incorrectly have Mark getting $450 per month in spousal benefits. Corrections have been made to the online version of the table and the article.

When to Begin Social Security Benefits

***Comment posted to "Social Security Strategies for Singles," by William Reichenstein and William Meyer, in the November 2013* AAII Journal.**

Take the money as early as possible. If not needed for current income, invest the money in an adjustable interest rate mutual fund. At a discount rate of 5%, money today is worth far more than inflows beginning five years or more down the road. Plus, if the retiree needs increased savings for long-term care at age 66 or older, he or she will have ready resources available.

—Edwin Perkins from California

Suppose you have a significant amount of IRA/401(k) money. If you take Social Security at age 62, maybe you should leave the IRA/401(k) to grow tax-deferred until age 70, versus having to draw upon some of those dollars for eight years if you wait until age 70 to take Social Security.

Furthermore, required minimum distributions starting at age 70 will push your taxable income higher. You want to start Social Security at 70, further pushing up taxable income? Anyone else think income tax rates might be higher in eight years?

—Anthony Crocker from California

2013 Stock Screens Review: The Year of the Bulls

By Joe Lan, CFA

Article Highlights

- AAII's Stock Screens realized a median return of 29.4% for the year, with 43 out of 65 screens beating the S&P 500.
- The value-oriented Piotroski High F-Score screen remained the best performer, with a 142.3% gain for 2013.
- Two new risk measures are now tracked: the Ulcer Index and the Martin Ratio.

As we approach another calendar year end, I can't help but reflect on what an incredible year it's been for the stock market.

Coming into this year, analysts were hoping for a positive 2013, but did not really know what to expect. Unemployment was still stubbornly high and, in addition, our economy was facing the possibility of across-the-board tax hikes in conjunction with automatic spending cuts, or sequestration. If you asked me then what the chances of the S&P 500 index gaining more than 25% for the year were, I would have said slim to none, leaning more toward none.

Now, as I am writing this, the major U.S. market indexes have all gained more than 25%, and we are merely a few weeks away from the end of the 2013 calendar year. The market has been in an upward trend for the entire year, with just some minor pullbacks. Market pullbacks during the year were almost always due to two specific reasons: weakness in the global economy, especially from a slowdown in emerging markets; and worries over the potential tapering of U.S. government stimulus measures. These concerns were at the forefront when the market dipped in mid-May. However, after concerns over tapering were alleviated, stocks began rallying again. In October, the market took another breather as the government "shut down" for 17 days due to our politicians' inability to hammer out a nonpartisan budget deal. However, stocks were able to rebound once again shortly after the crisis was resolved.

Looking forward, one cannot help but wonder what is in store. The S&P 500 and Dow Jones industrial average have both rallied to all-time high levels, while the NASDAQ has once again broken 4,000 (the NASDAQ is still significantly lower than it was during the dot-com boom, showing how incredibly rich tech firms were during that time). While I will not make any specific predictions, it is prudent to keep in mind that our economy has been growing with an extended period of unprecedented economic stimulus. It will be telling to see how the economy responds to the tapering of the bond-buying program and, eventually, the raising of interest rates. Federal Reserve Chairman Ben Bernanke has stated that the Fed is not looking to raise interest rates until unemployment drops to 6.5%, but I would be shocked to see the current near-zero interest rate maintained if inflation starts to take off before unemployment hits that level.

In addition, a quick look at some very simple valuation factors provides a small glimpse to the current overall valuation of the market. As of the end of November, the stocks in the S&P 500 were trading with a median price-earnings ratio of 20.7 and a median forward price-earnings ratio of 17.6. Over the past seven years, the average median price-earnings ratio for the large-cap stocks has been 17.0. The S&P MidCap 400 index is trading at a median price-earnings ratio of 21.8, with a forward price-earnings ratio of 19.2 as of November 30, 2013. Over the last seven years, the average median price-earnings ratio of mid-cap companies has been 18.9. Finally, as of November 30, the median price-earnings ratio of the S&P SmallCap 600 index is 23.9, while its median forward price-earnings ratio is 21.3. Over the past seven years, small-cap stocks have traded with an average median price-earnings ratio of 20.7. According to these figures, the current market is trading at a slight premium compared to

Table 1. Performance of Stock Screens on AAII.com

Value Screens	Price Gain (%) YTD	2012	2011	Average Annual Price Gain (%) Since Incep	3 Yr	5 Yr	10 Yr	Price Gain (%) Bull Mkt*	Bear Mkt*	Monthly Variability Largest Gain	Loss	Risk Measures Risk Index (X)	Risk-Adj Return (%)	Ulcer Index (%)	Martin Ratio (X)	Holdings Avg #	Turnover (%)
Piotroski: High F-Score	142.3	91.7	(36.4)	31.7	47.9	61.9	30.4	984.8	(53.6)	43.1	(42.0)	2.06	18.7	14.9	1.97	22	24
Price-to-Free-Cash-Flow	91.6	1.1	(7.0)	21.1	26.8	48.3	19.2	662.8	(62.8)	51.2	(31.7)	1.78	14.7	16.2	1.15	30	22
Fundamental Rule of Thumb	45.6	(6.9)	(35.2)	14.7	(2.0)	17.8	9.5	108.2	(57.0)	33.8	(19.2)	1.70	11.3	19.1	0.64	50	21
Schloss	39.3	13.1	(35.1)	12.9	7.8	13.0	6.1	70.4	(37.6)	27.1	(40.4)	1.86	9.9	21.4	0.49	13	55
Cash Rich Firms	33.5	10.5	(32.8)	11.1	0.4	13.3	5.4	79.0	(45.6)	17.6	(20.7)	1.37	9.8	15.8	0.55	30	25
Graham—Defensive Investor (Non-Utility)	31.8	18.9	7.0	18.2	21.2	30.0	18.2	286.7	(52.1)	25.8	(17.3)	1.37	15.0	12.4	1.27	21	20
Dogs of the Dow: Low Priced 5	30.9	15.7	13.1	2.1	21.9	12.0	0.3	226.2	(82.9)	27.6	(34.8)	1.58	(0.4)	36.7	(0.01)	5	16
O'Shaughnessy: Value	26.6	20.3	(11.2)	6.1	13.2	15.2	4.5	148.4	(69.1)	22.0	(23.8)	1.34	6.0	16.6	0.53	50	21
Dogs of the Dow	25.9	9.6	10.7	2.8	17.3	14.4	2.8	177.3	(69.0)	17.1	(23.4)	1.22	1.9	23.8	0.01	10	7
Magic Formula	24.9	7.9	(30.6)	11.2	2.3	21.8	6.0	156.6	(51.6)	30.7	(22.4)	1.65	9.3	16.6	0.53	30	24
Weiss Blue Chip Div Yield	17.6	19.2	7.6	11.1	17.7	20.3	10.2	174.2	(43.1)	16.0	(16.8)	1.22	10.3	11.9	0.73	12	25
Graham—Defensive Investor (Utility)	10.9	1.2	8.6	7.9	8.0	6.0	7.7	55.3	(31.4)	12.0	(13.4)	0.90	8.0	10.0	0.54	19	13
Graham—Enterprising Investor	10.5	1.1	(1.1)	17.8	3.4	21.8	16.5	159.0	(50.3)	33.1	(23.4)	1.75	13.0	15.8	0.98	4	44
Graham—Enterprising Investor Revised	4.1	(4.9)	(4.1)	21.3	(1.7)	28.3	22.9	244.8	(49.9)	36.4	(22.4)	1.74	15.0	14.6	1.29	9	25
Value With Price Momentum Screens																	
O'Shaughnessy: Tiny Titans	47.9	20.0	(22.9)	25.7	13.9	24.6	11.6	193.5	(67.3)	37.4	(21.0)	1.93	16.4	21.9	1.06	25	42
O'Shaughnessy: Small Cap Growth & Value	44.7	30.3	(0.3)	19.9	27.0	18.6	15.7	175.8	(50.6)	18.5	(18.2)	1.51	15.4	18.0	0.97	25	50
O'Shaughnessy: Growth Market Leaders	41.7	15.8	(1.2)	7.8	19.6	16.0	6.4	124.4	(50.5)	13.6	(18.6)	1.22	7.5	19.9	0.27	10	43
O'Shaughnessy: Growth	40.6	28.8	(7.5)	17.7	21.3	20.8	13.5	197.0	(57.2)	18.6	(17.9)	1.51	13.9	18.5	0.83	50	38
Lakonishok	23.3	7.5	(0.6)	14.6	13.6	23.6	15.7	184.9	(32.5)	16.6	(17.9)	1.20	13.2	10.0	1.21	31	90
O'Shaughnessy: All Cap	14.3	12.4	(5.0)	11.6	11.1	15.3	11.8	114.6	(52.1)	18.4	(21.5)	1.37	10.2	17.7	0.52	22	34
Growth Screens																	
Dual Cash Flow	43.0	5.1	(21.6)	14.9	7.5	23.1	8.8	178.7	(61.0)	34.7	(23.6)	1.53	12.0	17.2	0.73	68	31
Return on Equity	33.8	10.1	(5.7)	13.6	13.0	22.4	11.4	191.1	(47.2)	14.6	(22.2)	1.28	12.0	11.8	0.95	33	21
IBD Stable 70	33.5	24.6	3.7	11.7	22.3	27.2	9.9	224.9	(50.6)	18.4	(21.9)	1.18	10.9	12.6	0.73	40	12
Inve$tWare Quality Growth	30.4	19.7	(9.4)	7.3	14.8	19.3	7.8	151.4	(44.7)	18.2	(22.0)	1.25	7.1	13.4	0.36	21	11
Growth With Price Momentum Screens																	
O'Neil's CAN SLIM Revised 3rd Edition	50.1	7.3	(30.1)	16.7	4.9	13.0	5.3	87.5	(27.8)	52.7	(26.7)	1.86	12.0	15.5	0.92	8	65
Driehaus	38.5	16.7	(14.1)	13.8	13.9	37.4	16.8	386.3	(53.4)	51.3	(25.7)	2.24	9.7	39.7	0.29	15	64
O'Neil's CAN SLIM No Float	27.7	8.9	(3.9)	16.8	12.5	18.4	7.3	181.9	(61.6)	23.5	(35.5)	1.39	13.9	18.8	0.76	16	50
Foolish Small Cap 8	23.7	16.9	(14.9)	12.1	8.6	18.5	4.2	180.5	(67.7)	38.8	(22.5)	2.23	9.0	25.2	0.38	17	40
Kirkpatrick Growth	19.3	(9.8)	(11.6)	16.7	(0.0)	15.6	13.5	103.3	(38.7)	64.1	(23.1)	2.15	11.3	27.7	0.52	12	62
O'Neil's CAN SLIM	15.3	18.0	(10.2)	24.2	6.9	16.9	15.0	118.0	(10.1)	69.6	(23.1)	1.90	15.8	12.2	1.78	6	57
Growth & Value Screens																	
Rule #1 Investing	48.6	11.3	(1.0)	12.3	19.2	37.0	10.3	353.5	(54.0)	27.0	(26.8)	1.77	9.8	19.0	0.52	14	25
Wanger (Revised)	46.9	23.5	(5.2)	10.1	22.0	19.8	11.6	168.0	(51.3)	22.8	(19.8)	1.43	9.0	16.4	0.46	31	27
Neff	42.8	15.0	(4.2)	20.0	18.7	31.7	12.7	303.3	(52.8)	32.6	(21.7)	1.63	14.8	15.0	1.17	22	33
Buffettology: EPS Growth	36.7	17.4	3.8	11.5	19.9	26.2	11.4	240.4	(48.4)	15.1	(20.8)	1.22	10.6	11.4	0.79	47	12
Dividend (High Relative Yield)	36.6	9.8	3.0	9.5	18.0	17.1	7.9	145.4	(40.4)	12.5	(14.2)	0.96	9.6	12.3	0.57	40	20
Murphy Technology	36.2	42.3	(29.8)	(2.0)	13.1	23.6	11.7	168.8	(58.3)	58.5	(44.9)	2.77	(17.1)	73.8	(0.06)	11	21
Fisher (Philip)	34.3	(0.6)	(50.9)	4.0	(12.0)	10.0	(2.6)	49.7	(58.2)	32.8	(27.9)	2.18	1.1	28.5	0.06	20	33
Buffettology: Sustainable Growth	32.7	8.8	0.7	11.9	14.9	24.3	11.6	206.9	(41.9)	16.5	(20.4)	1.28	10.7	10.2	0.92	33	13
Buffett: Hagstrom	32.4	13.0	8.2	15.2	18.9	22.5	13.8	194.9	(39.8)	13.2	(19.0)	1.11	14.3	9.6	1.33	30	20
Price-to-Sales	32.3	11.3	(2.6)	16.2	15.6	23.9	10.7	211.7	(55.1)	18.3	(20.6)	1.32	13.8	13.4	1.03	56	39
Lynch	29.4	0.7	(27.9)	13.0	(0.5)	17.6	12.2	128.1	(47.5)	18.9	(21.3)	1.22	11.8	14.7	0.72	26	21
T. Rowe Price	28.5	(15.0)	117.4	10.4	35.2	32.3	11.5	330.5	(62.5)	33.5	(20.0)	1.68	8.8	23.4	0.34	8	42
Kirkpatrick Value	27.2	19.4	(15.1)	12.3	8.8	(2.4)	15.7	1.1	(23.3)	49.0	(25.3)	2.21	9.1	26.9	0.36	2	74
Dreman	26.2	20.6	(11.7)	11.1	13.2	19.7	8.4	123.2	(55.0)	23.9	(22.2)	1.25	10.2	17.8	0.49	21	32
Templeton	25.9	31.0	3.2	11.0	20.6	27.2	11.3	185.6	(40.0)	14.5	(23.1)	1.23	10.1	13.6	0.63	22	28
Zweig	24.1	6.4	(18.3)	19.7	2.8	4.2	6.6	52.0	(54.4)	32.7	(24.2)	1.79	13.9	25.5	0.68	11	42
Dividend Screen: DRPs	22.9	10.9	1.9	8.8	13.7	18.2	6.4	157.2	(50.4)	20.5	(18.2)	1.10	8.6	15.4	0.41	30	26
Dividend Screen: Non-DRPs	20.4	18.1	4.3	13.2	15.7	18.9	8.9	175.0	(48.1)	17.6	(15.3)	0.91	13.8	12.8	0.84	30	28
Kirkpatrick Bargain	4.8	14.9	3.6	8.3	9.1	10.8	14.9	102.6	(43.2)	21.1	(21.7)	1.37	7.8	16.2	0.36	15	65
Foolish Small Cap 8 Revised	0.4	41.8	(49.2)	15.3	(10.2)	15.5	4.3	105.1	(64.0)	28.1	(31.1)	2.15	10.6	22.7	0.57	6	36

(Continued on next page)

Table 1. Performance of Stock Screens on AAII.com (Cont.)

Growth & Value With Price Momentum Screens	Price Gain (%) YTD	2012	2011	Average Annual Price Gain (%) Since Incep	3 Yr	5 Yr	10 Yr	Price Gain (%) Bull Mkt*	Bear Mkt*	Monthly Variability Largest Gain	Loss	Risk Measures Risk Index (X)	Risk-Adj Return (%)	Ulcer Index (%)	Martin Ratio (X)	Holdings Avg #	Turnover (%)
Value on the Move—PEG With Est Growth	52.9	9.0	(0.3)	20.1	20.7	23.2	17.2	210.6	(50.2)	15.7	(23.1)	1.32	16.8	13.7	1.29	41	44
Value on the Move—PEG With Hist Growth	45.8	4.3	1.0	15.0	16.7	21.3	12.3	183.2	(50.1)	12.7	(19.1)	1.04	14.7	13.5	0.93	81	36
Oberweis Octagon	40.6	32.6	(14.7)	14.8	20.4	23.1	12.3	244.0	(70.6)	24.6	(23.2)	1.92	10.8	26.9	0.46	16	42
ADR Screen	32.2	1.4	(25.9)	8.0	2.3	14.3	6.4	105.1	(68.7)	31.1	(29.7)	1.47	7.5	27.4	0.20	25	44
Stock Market Winners	29.4	13.6	21.2	21.0	22.0	29.5	13.1	354.6	(51.3)	22.0	(23.4)	1.47	16.4	17.0	1.09	12	59
MAGNET Complex	20.3	(19.6)	6.9	12.5	4.1	(10.7)	(4.7)	(30.4)	(55.9)	63.0	(28.2)	2.72	8.7	42.1	0.24	2	74
Muhlenkamp	(11.6)	(3.0)	(45.9)	4.1	(21.1)	(5.7)	(3.4)	(20.7)	(49.0)	21.0	(17.6)	1.40	3.1	26.1	0.06	18	24
MAGNET Simple	(31.1)	(12.4)	19.5	17.7	(7.5)	37.2	15.7	339.7	(75.9)	52.1	(34.0)	2.99	10.2	27.2	0.56	3	68
Earnings Estimates Screens																	
Est Rev: Top 30 Up	35.3	21.9	(2.3)	26.4	20.7	40.9	25.2	366.7	(37.8)	36.4	(26.7)	1.83	17.4	20.3	1.18	30	93
P/E Relative	28.2	14.3	(1.9)	17.0	15.2	26.1	16.5	177.7	(27.6)	18.4	(18.3)	1.13	15.8	8.0	1.82	32	77
Dreman With Est Revisions	27.2	13.0	21.6	16.3	22.7	29.2	17.6	231.7	(39.9)	21.4	(26.2)	1.36	13.7	15.0	0.92	13	83
Est Rev: Up 5%	25.3	28.8	6.1	28.6	22.6	36.7	25.9	299.1	(23.4)	30.8	(21.7)	1.75	19.1	15.7	1.66	42	92
Est Rev: Down 5%	25.0	9.2	(31.1)	1.0	2.4	18.4	2.3	145.2	(63.8)	33.5	(30.5)	1.95	(4.2)	32.9	(0.04)	76	89
Est Rev: Lowest 30 Down	24.8	9.3	(34.1)	0.9	2.4	22.3	1.6	182.5	(71.0)	43.0	(29.9)	2.33	(6.4)	34.3	(0.04)	30	91
Specialty Screens																	
Insider Net Purchases	8.8	11.5	(31.4)	(0.9)	(3.1)	7.7	(2.7)	75.5	(65.5)	27.8	(27.2)	1.81	(7.0)	36.0	(0.09)	28	30

Indexes	Price Gain (%) YTD	2012	2011	Average Annual Price Gain (%) Since Incep	3 Yr	5 Yr	10 Yr	Price Gain (%) Bull Mkt*	Bear Mkt*	Monthly Variability Largest Gain	Loss	Risk Measures Risk Index (X)	Risk-Adj Return (%)	Ulcer Index (%)	Martin Ratio (X)
S&P 500	25.5	13.4	(0.0)	3.9	14.9	14.8	5.4	124.3	(52.6)	10.8	(16.8)	1.00	3.9	22.1	0.07
S&P 500 Growth (w/divs)	32.0	14.6	4.7	5.8	17.7	18.9	7.8	150.1	(44.4)	10.8	(16.5)	1.10	5.6	31.7	0.11
S&P 500 Value (w/divs)	30.6	17.7	(0.5)	5.6	17.8	16.3	7.8	151.1	(56.0)	11.3	(17.1)	1.00	5.6	17.5	0.18
S&P MidCap 400	29.1	16.1	(3.1)	9.0	15.6	20.7	8.8	169.3	(50.5)	14.8	(21.8)	1.20	8.2	13.6	0.48
S&P MidCap 400 Growth (w/divs)	28.5	15.8	(0.9)	12.2	20.8	25.0	11.3	206.2	(47.7)	19.0	(22.2)	1.31	10.3	13.9	0.70
S&P MidCap 400 Value (w/divs)	30.5	20.1	(2.4)	8.7	18.0	21.4	10.2	185.7	(49.4)	15.7	(21.8)	1.11	8.2	13.2	0.47
S&P SmallCap 600	39.1	14.8	(0.2)	8.5	19.7	21.2	9.6	198.0	(52.2)	17.3	(20.2)	1.27	7.5	15.0	0.40
S&P SmallCap 600 Growth (w/divs)	40.7	14.9	4.1	10.0	21.4	24.3	11.6	231.0	(51.1)	17.0	(21.7)	1.31	8.6	13.9	0.54
S&P SmallCap 600 Value (w/divs)	33.5	17.8	(1.2)	8.9	19.1	20.1	9.8	187.8	(51.0)	18.4	(19.6)	1.22	8.0	15.2	0.42
Dow Jones 30	23.0	7.3	5.5	4.6	13.6	12.8	5.1	111.9	(49.3)	11.8	(15.1)	0.97	4.6	16.0	0.13
NASDAQ 100	32.7	16.8	2.7	8.3	18.6	24.4	9.5	152.3	(50.1)	25.0	(27.5)	1.81	6.4	54.0	0.11
All Exchange-Listed Stocks	34.3	14.8	(12.3)	10.8	13.3	24.0	8.5	196.9	(58.6)	23.9	(22.1)	1.38	8.9	16.8	0.50

Bull market period is March 1, 2009, through November 30, 2013. Bear market period is November 1, 2007, through February 28, 2009.
Unless otherwise stated, figures do not include dividends or transaction costs.
Source: AAII's Stock Investor Pro*/Thomson Reuters. Data as of November 30, 2013.*

See the AAII Stock Screens area on AAII.com for details on each approach.

its seven-year historical averages.

The Rankings

With the market so strong, it is no surprise that AAII's stock screens have also fared extremely well. In fact, out of the 65 stock screens that AAII tracks, only two screens had a losing year—the MAGNET Simple and Muhlenkamp screens. Conversely, 43 out of the 65 stock screens outperformed the 25.5% return that the S&P 500 index was able to achieve for the year as of the end of November. The stock screens also returned a median of 29.4% year-to-date. In addition, three of our stock screens managed to have their best years ever—Piotroski: High F-Score, O'Shaughnessy: Growth Market Leaders and Dividend—High Relative Yield.

Table 1 provides summary performance and volatility statistics for the stock screens we track on AAII.com. All of these screens have been created using AAII's fundamental stock screening and research database program, *Stock Investor Pro*, and most of them are pre-built into the software (the exceptions are the Dogs of the Dow and Dogs of the Dow—Low-Priced 5 screens).

Table 1 also presents the price change performance (excluding dividends and transactions costs, time and price slippage, etc.) over various time periods for each stock selection strategy. The screens are grouped by style to identify their underlying premise. These style groups are: value, value with price momentum, growth, growth with price momentum, growth and value, growth and value with price momentum, earn-

What It Takes: The Investment Characteristics of the 2013 Winners

Table 2 presents the characteristics of the top- and bottom-performing screening strategies for 2013, as well as the top and bottom performers based on risk-adjusted return.

This year was an even better year than the last, with all but two of AAII's screens in positive territory as of the end of November, with a median gain of 29.4%. By comparison, the S&P 500 large-cap index is up 25.5%.

Market Capitalization

The median market capitalization (share price times number of shares outstanding) of the stocks that make up the major S&P indexes are:

- S&P 500 index, $16.2 billion;
- S&P MidCap 400 index, $3.6 billion; and
- S&P SmallCap 600 index: $1.1 billion.

In a year when smaller caps fared much better than larger-cap stocks, all five of the top-performing screens fall into the small- and mid-cap category, with the Piotroski screen having the smallest median market capitalization of $865.7 million. However, smaller-cap stocks were not completely immune and tend to have higher volatility as evidenced by smaller-cap screens dominating the bottom-performing screens for 2013 as well.

Table 2. Characteristics of Winning and Losing Stock Screens

	Price Change (%)		P/E Ratio (X)	Price-to-Book-Value Ratio (X)	Div Yield (%)	P/E to EPS Grth (PEG) (%)	5-Yr Hist EPS Grth (%)	Market Cap ($ Mil)	52-Wk Rel Str (%)
	YTD	Ann'l Risk-Adj							
Top Performers: 2013									
Piotroski: High F-Score (Value)	142.3	18.7	14.3	0.84	0.9	0.6	12.4	865.7	(10)
Price-to-Free-Cash-Flow (Value)	91.6	14.7	19.8	2.27	0.0	1.6	7.3	1,880.3	0
Value on Move--PEG W/Est Gr (Gr & Val w/ Price Mom)	52.9	16.8	16.4	7.30	1.5	0.7	24.5	3,702.5	38
O'Neil's CAN SLIM Revised 3rd Ed (Gr w/Price Mom)	50.1	12.0	21.0	5.30	0.0	1.3	19.4	4,831.1	55
Rule #1 Investing (Growth & Value)	48.6	9.8	13.5	8.90	2.1	0.3	44.0	3,525.2	22
Bottom Performers: 2013									
MAGNET Simple (Gr & Val w/Price Mom)	(31.1)	10.2	*No companies are currently passing the screen*						
Muhlenkamp (Gr & Val w/Price Mom)	(11.6)	3.1	9.7	2.60	0.0	0.4	31.1	888.4	(3)
Foolish Small Cap 8 Revised	0.4	10.6	*No companies are currently passing the screen*						
Graham--Enterprising Investor Revised (Value)	4.1	15.0	9.4	1.00	1.8	0.9	8.2	585.8	(15)
Kirkpatrick Bargin (Growth & Value)	4.8	7.8	21.4	2.40	0.5	1.5	(13.2)	1,978.9	59
Top Performers: Total History, Risk-Adjusted									
Est Rev: Up 5% (Earnings Estimates)	25.3	19.1	31.6	3.16	0.0	1.2	13.2	1,395.5	32
Piotroski: High F-Score (Value)	142.3	18.7	14.3	0.84	0.9	0.6	12.4	865.7	(10)
Est Rev: Top 30 Up (Earnings Estimates)	35.3	17.4	32.0	3.10	0.0	1.6	13.2	1,318.2	26
Value on Move—PEG W/Est Gr (Gr & Val w/ Price Mom)	52.9	16.8	16.4	7.30	1.5	0.7	24.5	3,702.5	38
Stock Market Winners (Gr & Val w/ Price Mom)	29.4	16.4	11.4	1.30	0.0	0.5	22.5	84.0	33
Bottom Perfomers: Total History, Risk-Adjusted									
Murphy Technology (Growth & Value)	36.2	(17.1)	5.0	1.30	1.9	0.2	43.0	1,281.4	(24)
Insider Net Purchases (Specialty)	8.8	(7.0)	18.6	2.40	0.0	1.6	5.3	244.4	(22)
Est Rev: Lowest 30 Down (Earnings Estimates)	24.8	(6.4)	41.7	2.38	0.0	1.5	(3.4)	775.6	(19)
Est Rev: Down 5% (Earnings Estimates)	25.0	(4.2)	20.4	1.90	0.0	1.2	6.8	901.3	(12)
Dogs of the Dow: Low Priced 5 (Value)	30.9	(0.4)	25.0	2.18	3.8	1.1	6.1	142,000.1	12
All Exchange-Listed Stocks	34.3	8.9	20.6	2.00	0.0	1.5	3.9	807.7	26

Performance figures do not include dividends or transaction costs.
Source: AAII's Stock Investor Pro*/Thomson Reuters. Data as of November 30, 2013.*

Multiples

Looking at the price-earnings ratios (price divided by trailing 12-month earnings per share) for the stocks currently passing the top-performing screens for 2013, the Piotroski: High F-Score stocks have a median price-earnings ratio of 14.3, significantly lower than the 20.6 median value for all exchange-listed stocks currently in the *Stock Investor Pro* database. In fact, four of the five top-performing screens have median price-earnings ratios lower than the median for all exchange-traded stocks. O'Neil's CANSLIM approach, a growth methodology, is the only top-performing screen with a median price-earnings ratio slightly above that of the exchange-traded stocks in the database.

Looking at the valuations of 2013's worst-performing strategies, we find a lot of mixed results. In fact, two of the worse-performing screens—Muhlenkamp and Graham Enterprising Investor Revised—have very low median price-earnings ratios. This highlights the fact that low valuation stocks do not necessarily warrant buys. Often, stocks are trading at extremely low valuations because there is little to no growth potential whatsoever for the company.

Relative Strength

The relative strength figure (last column) in Table 2 is calculated against the performance of the iShares Core S&P 500 ETF (IVV), which is used as a proxy for the S&P 500 index. Stocks with performance equal to that of the S&P 500 over the last 52 weeks have a relative strength of 0%. A relative strength value of 13% indicates that the stock outperformed the S&P 500 by 13%. Negative numbers indicate underperformance relative to the index.

The Piotroski screen's negative 52-week relative strength may seem anomalous at first, but it makes perfect sense. Piotroski's methodology seeks out undervalued companies that have strong financial strength. For stocks to be undervalued, they generally fare worse than the overall market, leading to their valuation. The Piotroski screen seeks to find these companies that are trading near their bottom. Alternatively, O'Neil's CAN SLIM approach relies on growth and price momentum. Hence, it has one of the highest 52-week relative strength figures of the screens listed in this table.

Winning Characteristics

When looking at those strategies that have achieved long-term success, several common factors are apparent:

- Low multiples (price-earnings, price-to-book-value, etc.), on a relative rather than an absolute basis;
- An emphasis on consistency of growth in earnings, sales, or dividends;
- Strong financials;
- Price momentum; and
- Upward earnings revisions.

For a more in-depth discussion of the characteristics of successful investment strategies, see the article "Constructing Winning Stock Screens," found on AAII.com on the right side of the Stocks Screens page in the Site Highlights box (www.aaii.com/stock-screens/constructingwinningstockscreen).

—Joe Lan, CFA

ings estimates and specialty.

The AAII stock screens are ranked in Table 1 in descending order by their year-to-date price performance through November 30, 2013, within each of their style groups. At the bottom of the table, you will also find performance data for several market indexes and averages.

Impact of Dividends

The Price Gain and Average Annual Price Gain columns in Table 1 represents the annualized percentage gain or loss realized by a hypothetical portfolio invested in the stocks passing a given screen over varying time periods from January 1, 1998, through November 30, 2013.

However, these performance numbers do not include dividend payments or dividend reinvestment. Therefore, the results for large-cap strategies, such as the Dogs of the Dow (in the value category), do not benefit from dividend payments or reinvestment.

Currently, the 10 stocks that make up the Dogs of the Dow have a dividend yield of 3.5%; investors holding shares in these stocks would, therefore, have a higher annual return by approximately this amount.

The Top Performer for 2013

Following a strong 2012, the Piotroski: High F-Score screen managed to gain an incredible 142.3% in 2013, as of the end of November. The gain, if maintained in December, would be the highest for any one year since we started tracking the screen, which is really exceptional as it historically has been one of AAII's best-performing screens. In fact, barring some catastrophic meltdown by the Piotroski screen during December, this year will mark the fifth year since 1998 that the screen has managed to gain over 75%.

The Piotroski screen is based on research by Joseph Piotroski, an accounting professor at Stanford University Graduate School of Business. During his time as a professor of the University of Chicago Booth School of Business, he undertook a study of low price-to-book-value stocks to see if

Behind the Scenes of the Top 2013 Strategy

The Piotroski: High F-Score screen once again turned in a dominating performance in 2013 with a 142.3% price gain year-to-date through the end of November, its best year yet. In a year where the vast majority of AAII stock screens generated positive gains, no other approach came close. However, when evaluating the performance of a given approach, it is useful to look beyond the simple gain/loss data and examine the individual stocks that contributed to the overall return.

During the economic downtown, many of the top-performing screens did not show any stocks passing their criteria during several months, leading to a 0% return for the month, which was better than most screens were doing. This year, with the bull market in full swing, the

Table 3. Stocks Passing the Piotroski High F-Score Screen During 2013

Company (Ticker)	Price Gain While in Port (%)	Mos in Port During 2013	P/E Ratio (X)	Price-to-Book Ratio (X)	Div Yield (%)	P/E to EPS Est Grth (%)	5-Yr Hist EPS Grth (%)	Market Cap ($ Mil)	52-Wk Rel Strgth (%)
Point.360 (PTSX)	133.8	2	na	0.88	0.0	na	(5.9)	8.1	(26)
Cache, Inc. (CACH)	76.2	1	na	3.82	0.0	na	(33.1)	130.6	116
Renewable Energy Group (REGI)	67.8	4	6.8	0.81	0.0	na	16.6	365.5	77
Global-Tech Advanced Innov. (GAI)	63.1	7	na	0.27	0.0	na	16.0	21.7	(2)
P & F Industries, Inc. (PFIN)	43.5	3	5.4	0.76	0.0	0.3	18.3	28.1	0
Covenant Transportation Gp (CVTI)	31.1	2	29.7	1.04	0.0	1.6	18.6	97.1	13
Revett Minerals, Inc. (RVM)	30.3	1	na	0.27	0.0	na	14.9	22.4	(86)
SkyWest, Inc. (SKYW)	20.7	9	13.4	0.55	1.1	na	(17.0)	782.5	10
Leading Brands, Inc. (LBIX)	17.2	1	20.9	0.97	0.0	1.3	16.3	12.3	(21)
Delta Apparel, Inc. (DLA)	14.1	1	17.3	1.08	0.0	0.2	83.3	147.6	(0)
Fortune Brands Home & Sec (FBHS)	13.0	1	39.9	2.90	0.9	na	na	7,151.6	21
Griffon Corporation (GFF)	12.0	1	104.4	1.08	0.8	na	(19.2)	747.4	(1)
NASDAQ OMX Group (NDAQ)	9.4	3	18.5	0.98	1.5	na	(14.1)	5,928.6	19
Natural Grocers by Vit Ctg (NGVC)	8.4	2	20.8	10.96	0.0	na	na	895.1	58
Benchmark Electronics (BHE)	8.2	2	20.3	1.05	0.0	na	(4.6)	1,235.0	23
Seacor Holdings, Inc. (CKH)	4.2	2	80.2	1.43	0.0	na	(30.0)	1,988.5	15
Fresh Del Monte Produce (FDP)	3.8	8	13.9	0.80	1.9	na	(4.3)	1,492.1	(15)
CRA International, Inc. (CRAI)	(2.0)	2	na	0.89	0.0	na	(61.5)	193.6	(9)
Golden Star Resources (GSS)	(18.2)	3	na	0.58	0.0	na	16.7	128.6	(81)

Source: AAII's Stock Investor Pro*/Thomson Reuters. Data as of November 30, 2013.*

it was possible to establish some basic financial criteria to help separate the winners from the losers.

The AAII Piotroski screen starts with stocks that have price-to-book-value ratios ranking in the lowest 20% of the entire *Stock Investor Pro* database. There are many studies indicating that a portfolio of low price-to-book-value stocks generally outperforms portfolios of stocks trading with high price-to-book-value ratios. Piotroski found that most of the low price-to-book stocks were neglected firms or financially troubled firms. He found that either situation can create buying opportunities—after checking on financial strength—especially when studying smaller-cap stocks.

Piotroski developed a nine-point scale to identify stocks with solid and improving financials. Profitability, financial leverage, liquidity and operating efficiency are examined using popular ratios and basic financial elements that are easy to use and interpret. In order to pass the Piotroski: High F-Score screen, a stock must pass eight of the nine financial tests.

Performance Over Time

AAII's stock screens have a history going back almost 15 years now, and the amount of performance data that we have collected over these years offers some compelling insights. While the

Piotroski: High F-Score screen was fully invested throughout 2013, meaning that at least one stock passed the screen each month. However, Piotroski has been a very strict screen in recent years, so that each individual passing stock has had a large weight in the overall performance of the screen. In a year where smaller-cap stocks dominated, the Piotroski: High F-Score screen benefited from its tilt toward small stocks.

The Piotroski: High F-Score screen starts by isolating stocks with price-to-book-value ratios that rank in the lowest 20% of the entire stock universe. Then, using a nine-point scale to identify stocks with solid and improving financials, passing companies must satisfy at least eight of the nine tests. Prior to 2011, we had required passing companies to satisfy all nine financial strength tests, but we found that this severely limited the number of passing companies. Relaxing the screening requirements led to more passing companies without hurting performance too severely.

As a result of the relaxed standards, the Piotroski: High F-Score screen held a total of 19 stocks throughout 2013, averaging nearly five holdings per month. Historically, the strategy has averaged 22 stocks per month, which is right at the median for all stock screens. When following a given strategy, spreading your investment to more stocks will lower your volatility, while investing in a small number of companies makes a portfolio more susceptible to individual stock price movements. The 10 AAII stocks screens that average the lowest number of passing companies each month are at least 50% more volatile than the S&P 500 index. That is not to say that the Piotroski: High F-Score screen isn't volatile. With a risk index of 2.06, the screen is 106% more volatile than the S&P 500, making it the 11th most volatile screen. But looking at its historical performance, much of that volatility has been to the upside.

Table 3 presents the 19 stocks that passed the Piotroski: High F-Score screen in 2013, as well as their performance while they were held in the hypothetical portfolio, the number of months the stock was held this year, and select current financial data.

Point.360 (PTSX) was the best-performing stock that passed the Piotroski screen in 2013, though it only passed the screen in two months—April and September. The stock gained 42.5% during the month of April and 64.1% during the month of September for a total price-change performance of 133.8%. Point.360 is an integrated media management services company providing film, video and audio post-production, archival, duplication, computer graphics and data distribution services to motion picture studios, television networks, independent production companies and multinational companies. The company provides the services necessary to edit, master, reformat and archive its clients' audio, video, and film content, which includes television programming, feature films, and movie trailers. It derives revenues primarily from the entertainment industry, consisting of major and independent motion picture and television studios, cable television program suppliers, television program syndicators, and advertising agencies. Point.360 also maintains video and audio post-production and editing facilities.

Two of the stocks held in the Piotroski: High F-Score portfolio during 2013 suffered losses, with CRA International Inc. (CRAI) losing 2.0% and Golden Star Resources Ltd. (GSS) down 18.2%. CRA passed the screen for two months while GSS passed the screen for a three-month period.

The 2013 results for the Piotroski: High F-Score screen build on its historical record of strong performance. Its annual average price gain of 31.7% since the beginning of 1998 allowed the screen to overtake Estimate Revisions Up 5% this year as the strongest stock screen that AAII tracks. No matter which risk-adjusted return measure you look at, the Piotroski High F-Score and Estimate Revisions Up 5% are generally always the top two screens.

best-performing screens since inception remain the Piotroski and the Estimate Revisions Up (Est Rev Up) screens, each screen takes its place at the top through very distinct methodologies and with very different returns through various time periods.

The Piotroski: High F-Score screen is a pure value screen and does incredibly well through bull markets. In fact, prior to 2011, the Piotroski Screen's performance trailed that of the Estimate Revisions Up screens. As the market continued rallying in 2012 and 2013, the Piotroski Screen gained 91.7% and 142.3% (so far), respectively, and is now, convincingly, AAII's top-performing screen since inception. However, the screen has a bear market return of –53.6%, with –42.0% as its worse monthly return and a maximum drawdown of 59.0%.

Alternatively, the Estimate Revisions Up 5% screen has managed to achieve its long-term returns through much better protection on the downside. The screen looks for upward revisions in annual earnings estimates; specifically, it identifies companies that have had at least a 5% increase in annual earnings estimates over the last month. The Estimate Revisions Up 5% screen, with an annualized return since inception of 28.6%, has a bull-market return of "only" 299.1%, which is actually lower than that of the Estimate Revisions Top

30 Up screen. However, the screen has a bear-market return of –23.4%, with a largest monthly loss of 21.7% and a maximum drawdown of 46.9%.

Interestingly, two of AAII's worst-performing screens are Estimate Revisions Lowest 30 Down and Estimate Revisions Down 5%, giving credence to the belief that earnings estimates play a huge factor in the short-term performance of stocks. As of the end of November, these two screens have basically been flat since 1998.

Average Holdings and Turnover

Stock screens are often used by investors as a method to winnow down a universe of stocks into a more manageable number. For stock screens to be useful, there should ideally be enough stocks passing to provide various alternatives, but not too many that investors are bogged down with options.

The right-most columns of Table 1 present the average number of passing stocks and the turnover percentage for each of our stock screens. For many of the screens, you will notice patterns depending on the market cycle. For example, the Price-to-Sales screen (in the growth & value category), which looks for undervalued companies on a price-to-sales basis showing strong growth and price strength, passes 56 stocks per month on average. However, at the beginning of 2006 through October of 2007, during the peak of the market before the great recession, the screen only passed more than 50 stocks in one single month and often only passed around 30 stocks. Using this screen as a gauge pointed to the possibility that the market was overvalued during that period compared to historical averages. Moving forward, an increasing number of companies passed the price-to-sales screen until the number peaked from April of 2009 through March of 2010 with 11 straight months where more than 90 companies passed the screen per month. As the market continued to recover, the number of passing companies for the price-to-sales screen once again fell back to normal ranges. Currently, the number of stocks passing the screen is below-average once again, but only slightly, showing that the market is slightly rich compared to historical averages based on this valuation factor.

The rightmost column in Table 1 shows the average monthly turnover percentage for each of the screens. The Estimate Revisions screens have some of the highest monthly turnovers of any of the screens that AAII tracks. From a conceptual standpoint, this characteristic for these screens makes perfect sense. As I stated, the Estimate Revisions screens looks for companies that have had upward or downward earnings revisions over the past month. Not many companies will continuously pass this screen since that would suggest that analysts are continuously revising the estimates of a specific company upward or downward month after month. Also, keep in mind that as a general rule, value screens tend to have lower turnover and growth screens tend to have higher turnover.

AAII's Piotroski screen has an average monthly turnover of 24% since the beginning of 1998, meaning that a little under a quarter of any month's passing stocks should be expected to be new (around three quarters of the stocks will remain the same). The screen with the lowest turnover is the Dogs of the Dow screen, with an average monthly turnover of 7%, while the Estimate Revisions Top 30 Up screen has the highest average monthly turnover of 93%. The median average monthly turnover for AAII's screens is 34%.

Volatility

Most investors look closely at the performance of a screen when choosing an investment methodology. Perhaps just as important, however, is a comparison of the overall risk, or volatility, of the screens. In Table 1, the risk index is presented for each of our screens (this figure is also available on AAII.com and updated on a monthly basis).

The risk index is calculated by dividing a screen's monthly standard deviation since inception by the monthly standard deviation of an index—in this case, the S&P 500. In essence, the risk index quantifies how volatile on a price return basis a screen is compared to the S&P 500: A risk index of 2.00 means that the screen is twice as volatile as the S&P 500.

Almost all of AAII's screens have risk indexes above 1.00, which is to be expected. Stock screens, after all, typically pass anywhere from a handful of stocks to around 50, while the S&P 500 is made up of 500 very heavily traded companies. In fact, as of the end of November, only three screens have a risk index lower than 1.00: Graham Defensive Investor—Utility, Dividend—High Relative Yield and Dividend Screen: Non-DRPs. These three screens are all made up of "safer" stocks, with two dividend screens and a screen that focuses on utility stocks. On the opposite end of the spectrum, we have several screens with risk indexes above 2.00. Our top performer for 2013, the Piotroski screen, has a risk index of 2.06, meaning that it is 2.06 times as price-volatile as the S&P 500.

Risk-Adjusted Return

Table 1 also presents the risk-adjusted return for each of the screens. This calculation is a bit more convoluted, but essentially it adjusts the performance of each screen using their standard deviations of returns, penalizing screens with higher standard deviations. Using risk-adjusted returns, we still find the usual suspects at the top. However, the Estimate Revisions Up 5% screen is now at the top, with a risk-adjusted return of 19.1% since inception, and the Piotroski High F-Score screen is second with a risk-adjusted return of 18.7%.

Ranking the 65 stock screens according to risk index, we see that the Graham Defensive Investor—Utility screen has the lowest risk index, 0.90. Since its risk index is lower than 1.00, it is less price-volatile than the S&P 500. This means that the screen's risk-adjusted return was actually adjusted upward, going from a return of 7.9% since 1998 to a risk-adjusted return of 8.0%.

Graham's philosophy divides investors into two groups by the amount of time they are able to devote to researching and managing a stock portfolio as well as by their level of market experience. For the defensive or passive investor, his analysis is geared toward avoiding serious mistakes or losses. Graham tries to establish a procedure that provides freedom from great effort and frequent decision-making. Graham feels that the defensive investor should confine his or her holdings to the shares of important companies with a long record of profitable operations and strong financial condition. By "important," he means a company of substantial size with a leading position in the industry, ranking among the first quarter or first third in size within its industry group.

AAII's Graham Defensive Investor—Utility Screen first seeks companies with total assets greater than or equal to $200 million. The screen then identifies companies with strong financial condition and earnings stability, and those that pay a dividend, exhibit earnings growth and have moderate price-earnings and price-to-assets ratios.

In contrast, AAII's MAGNET Simple screen has had the highest risk index and standard deviation of returns since 1998. Accordingly, its annualized return of 17.7% since 1998, which is on the high end of all screens, becomes a much more pedestrian risk-adjusted return of 10.2% since 1998.

A MAGNET stock, according to Jordan Kimmel, offers a blend of technical and fundamental characteristics. Kimmel believes the MAGNET process "encompasses the best of the momentum aspects of the market, while demanding the downside protection of a value approach and insisting on top-line revenue growth." The MAGNET acronym stands for the following:

M—Management must be outstanding; momentum must be improving;
A—Acceleration of earnings, revenues and margins;
G—Growth rate must exceed valuation;
N—New product or management may be the driver;
E—Emerging industry or product creates opportunity; and
T—Timing needs to be right (technically poised for large price increase).

Ulcer Index

Two other measures of risk and risk-adjusted return are also presented in Table 1. The Ulcer Index is a measure of downside volatility; it was named as such because downside volatility causes stress and stomach ulcers. Needless to say, a lower number is better, meaning that there is less volatility on the downside.

Stock screens with high overall volatility, as measured by standard deviation, but relatively low downside volatility, as measured by the Ulcer Index, are especially attractive. These stocks' price movements tend to be to the upside instead of to the downside. The Piotroski Screen is a great example, with a risk index over 2.00 and an Ulcer Index of 14.9%, below the median Ulcer Index of all the screens (16.6%).

For a more in-depth description of the Ulcer Index, see the Technically Speaking column in the Third Quarter 2013 issue of AAII's *Computerized Investing*.

Martin Ratio

The Martin ratio takes the Ulcer Index one step further. The ratio is calculated by subtracting the risk-free rate from the return and dividing this total by the Ulcer Index. The ratio, much like the Sharpe ratio, measures returns above the risk-free rate per unit of risk, with the unit of risk being the Ulcer Index. The main difference from the Ulcer Index is that the Martin ratio does not penalize investment methodologies for their upside volatility, only adjusting returns for downside risk. Using this metric, the Piotroski Screen still has the best overall performance, with the P/E Relative screen second. While the P/E Relative screen returned "only" 17.0% on an annualized basis since 1998, its Ulcer Index is a mere 8.0, allowing it to jump various other methodologies in terms of risk-adjusted performance using the Martin ratio.

Conclusion

AAII's stock screens have performed very well over the years, and 2013 was no exception. When choosing a stock screen, it is important to understand your personal investment profile before deciding on a screening methodology. It is easier to stay the course if you are investing with a methodology that you believe in. Also, be sure to keep in mind that growth portfolios tend to take a larger time commitment to successfully administer. If you do not have the time and energy to closely monitor an investment portfolio, a value strategy may suit you better.

Furthermore, a stock screen should only be the first step in the investment research process. While it is easy to get enamored with the performance of various screening methodologies, it is prudent to perform additional analysis on each company that passes a screen before buying shares. Try to resist the urge to use screens as simply a buy and sell list.

Finally, the nature of how screens are created leads to certain types of stocks passing certain screens. As you can see from Table 1, there are numerous categories of screening methodologies. From a diversification standpoint, it is beneficial to follow several screens with differing methodologies. This will enable you to diversify your investment portfolio across different sectors, styles and market capitalizations. ▲

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Beginning Investor

A series providing guidance for new investors on how to become successful investors. See AAII.com for the other articles in this series.

Determining How Much to Allocate to Each Investment

The influence any single investment has on your overall portfolio's performance depends significantly on its position size. Position size is the percentage of portfolio dollars allocated to a specific investment, such as a stock. To use a simple example, say an investor has a $100,000 portfolio invested in 20 stocks. Under an equal-weight scenario, each stock would have a position size of 5% of the overall portfolio's value. In other words, $5,000 would be invested in each of the 20 stocks.

Focus on Dollars, Not Shares

Notice how the number of shares is not discussed. When allocating, focus solely on the amount of dollars and not the number of shares. If you focus on shares, you could end up buying 100 shares of a stock trading at $20 and 100 shares of a stock trading at $50. The dollars at risk are $2,000 and $5,000, respectively—a big difference. If you allocate $5,000 to each stock rather than being concerned with how many shares you are buying, the amount of money at risk is the same for the two stocks.

Going back to the original example of a 20-stock portfolio, if the price of any one of the stocks were to drop to $0, the maximum downside risk posed to the portfolio by that particular stock would be 5%. Since your dollars are distributed evenly, each stock's downside risk is also evenly distributed.

What if you held a smaller number of investments? The percentages would change accordingly. In a portfolio equally distributed between five stocks and five funds, each investment would pose a maximum downside risk of 10%. The lower the number of investments you hold, the larger the risk each investment poses to your portfolio. Conversely, holding more securities (stocks, bonds, etc.) and funds decreases the risk each investment poses. This is why diversification depends in part on holding an adequate number of securities.

Periodically Take Action to Maintain Balance

Equal weighting only lasts temporarily since stocks and bonds, and funds that hold them, do not move in lockstep. Within asset classes, some securities rise, some stay flat and some fall. Even if all of the individual investments in your portfolio do move in the same direction, the magnitude of the price changes will differ. This causes the position sizes to be ever-shifting.

Small divergences are not significant. If one investment accounts for 6% of the portfolio's overall value instead of 5%, the proportionately higher risk posed by that one investment is not significant. The transaction costs of constantly bringing the portfolio back to an equal weighting can negate the benefit of making small changes. This is why even equal-weighted funds tend to limit how often they adjust the position sizes of each investment.

Bigger divergences, however, deserve attention. If one asset class (e.g., stocks) realizes higher returns than another asset class (e.g., bonds), the risk profile of the portfolio is altered. During a bull market for stocks, the portfolio could become too tilted toward stocks and incur more price volatility than you are comfortable with. In such situations, it makes sense to rebalance across asset classes, which, in this example, entails shifting dollars out of your stocks and your stock funds and buying bonds and bond funds.

Within an asset class, if one or two investments perform exceptionally well, their position size could become exceptionally large. This could not only lead to greater investment-specific risk (the potential damage to your portfolio caused by a significant drop in one security or fund), but also alter your portfolio's overall allocation. In such scenarios, first check to see if the investment's valuation is too high. If so, consider selling it outright. If not, consider reducing the position size down closer to the average dollar amount of your other holdings to reduce the investment-specific risk.

Establish Reasonable Bands of Divergence

The key is to establish bands of divergence wide enough to let your winning investments run, but not so wide that position sizes become too large. A useful rule of thumb is to adjust your asset class allocations when they move five or 10 percentage points off target. For individual investments, consider paring or selling them when their position size grows beyond 2.5 times the average size of your other investments.

—*Charles Rotblut, CFA, Editor,* AAII Journal

Exploiting the Relative Outperformance of Small-Cap Stocks

By John B. Davenport, Ph.D., and M. Fred Meissner

Article Highlights

- Small caps outperformed large caps 51% of the time between 1926 and 2012, but realized a cumulative excess return of 253%.
- There are certain economic conditions that are more favorable for small-cap stocks relative to large-cap stocks.
- Small-cap sectors realize higher returns than large-cap stocks when the large-cap sectors are in favor.

Since Rolf W. Banz first posited the size effect of equity returns in a 1981 study published in the Journal of Financial Economics, the relative outperformance of small-capitalization (small-cap) stocks compared to large-capitalization (large-cap) stocks has remained a steady point of debate within the investment management literature.

Even a cursory review of the annualized returns since the inception of the S&P SmallCap 600 index shows that the small-cap index has produced a higher cumulative return than the large-cap S&P 500 index (209.02% versus 188.13%).

The nature of this outperformance has been one of the central points of discussion within the literature. Of primary concern is the variability over time of this outperformance, as discussed in a 1983 Journal of Financial Economics study by Philip Brown, Allan W. Kleidon, and Terry A. Marsh. Sherman Hanna and Peng Chen found that small-cap equities were riskier equity investments relative to large-cap equities for holding periods of less than 15 years, while they were less risky for holding periods of longer than 15 years in their July 1999 *AAII Journal* article, "Small Stocks vs. Large: It's How Long You Hold That Counts."

A review of Eugene Fama's and Kenneth French's small-versus-big index series shows that in monthly returns between July 1926 and February 2012, small-cap stocks outperformed roughly 51% of the time. During that time, small-cap stocks also delivered a cumulative excess return of 253% relative to large-company stocks.

Given the variability of relative returns of small-cap equities versus large-cap equities, the question for investors is which environments or economic conditions are most conducive to small-cap stocks outperforming large-cap stocks. This article explores this very question. We explore several hypothesized scenarios that conceptually make sense as to producing favorable environments for small-cap stocks.

Theoretical Foundations

Modern portfolio theory as espoused by Harry Markowitz suggests that assets that demonstrate higher levels of risk, as defined by standard deviation ("volatility"), would require higher levels of returns to investors for assuming the additional relative risks versus other assets. Therefore, for investors who have higher tolerances for risk, higher standard deviation assets, over time, should produce higher returns. Investors often assess the value of underlying organizations via some form of discounted cash flow. Equity prices then reflect the perceived value of these discounted cash flows, as suggested by Jonathan Berk in a 1997 Financial Analysts Journal study.

More precisely, equity prices, more often than not, attempt to reflect the visibility of these discounted cash flows. Small-cap stocks tend to have three primary characteristics that diminish the visibility of future cash flows. First, small-cap stocks will often have shorter track records upon which to build cash flow assumptions. Second, small-capitalization

Table 1. Small-Cap Excess Returns Following U.S. Recessions

Recession (Ending Year)	Post 12 Mo. Excess Return (%)
1948	2.18
1953	(1.32)
1957	10.48
1960	1.60
1970	7.25
1973	9.79
1980	17.45
1990	8.73
2000	24.84
2008	8.50

companies may be less widely followed by Wall Street analysts. Lastly, investors may perceive small-capitalization stocks as more economically sensitive assets. All of the above factors may have implications as to when small-cap stocks should theoretically outperform less risky equity assets.

As Zaugang Liu and Jia Wang surmised in a 2010 Financial Services Review article, large-cap growth stocks appear to be the safest equity investment for investors with short time horizons, while small-cap equities are the most profitable for long-term investment horizons. However, these findings consider only time horizon and do not sufficiently explore the variability of returns across changing macroeconomic conditions. With respect to the economic sensitivity and visibility of future cash flows, it would intuitively follow that higher risk assets that are more economically sensitive may outperform in time of improving macroeconomic conditions and conversely underperform in times of deteriorating economic conditions. This leads us to hypothesis #1 and hypothesis #2:

- H1: Small-capitalization stocks will outperform when macroeconomic conditions as measured by gross domestic product (GDP) are improving.
- H2: Small-capitalization stocks will outperform when improving macroeconomic conditions are measured by falling unemployment.

Our third hypothesis is born out of observations by LeRoy Brooks and Gary Porter, in their 2012 Financial Services Review study. They found that there is a growing body of literature that suggests investors can extract portions of stock market returns by exploiting various information signals related to size, style and other subsets of the broad market. Sector rotation strategies have long been a method for investors to attempt to extract such portions of equity returns. However, the literature has not given ample attention to examining the size effect of sector rotation. Within sector rotation strategies, investors posit that by making the appropriate sector allocation at the various points in the economic cycle, they can add excess returns to the broad market. If we extend this argument beyond just the sector allocation to include a size allocation as well, the question arises as to whether the presumably higher-risk and thus higher-reward small-cap equities within those specific sectors will perform better. Therefore, our third hypothesis is presented:

- H3: When specific equity sectors of the broad market are in favor, small-cap constituents of the respective sector should perform better than their large-cap counterparts.

Methodology

Our two hypotheses attempt to address small-cap equity performance relative to that of their large-cap counterparts. In this study, we are attempting to address how small-cap equities perform under various conditions:

- Are there economic conditions that are more conducive to small-cap equities performing better than large-cap equities?
- In a sector rotation strategy, can small-cap equities deliver excess returns?

Small Cap Versus Large Cap and Economic Indicators

To explore our first premise, we have gathered quarterly U.S. economic data via GDP and U.S. unemployment rates as provided by the U.S. Bureau of Labor Statistics. We have also gathered small-cap equity returns relative to large-cap equity returns. For this, we have used the Fama and French small-versus-big index returns. This data series extracts the excess returns of small U.S. equities versus large U.S. equities as defined by market capitalization. The intent is to determine whether these points of economic data can be used as predictive measures of when to favor large-cap equities versus small-cap equities in investment portfolios.

With these data sets we then cross-referenced the excess returns of small-cap equities against various time periods within the GDP and unemployment series.

Small-Cap Sector Rotation

To examine the concept of a size effect on equity sector rotation strategies, we gathered monthly investment index returns of the large-cap S&P 500 index, the S&P SmallCap 600 index and each of their respective sector indexes. We then calculated periods of positive equity returns as found within the broad market index (S&P 500). We then calculated excess returns of each sector of the S&P 500 relative to the S&P 500 itself, which would then indicate favorable conditions to allocate additional assets to that sector. Lastly, we calculated the excess returns of the small-cap sector to the broad market.

Findings

Hypothesis 1: Small-Cap Excess Returns Relative to GDP

The findings suggest that there are certain economic conditions that are more favorable for small-cap excess returns relative to large-cap equities.

An examination of the GDP data series suggests that in a period of expanding economic activity—i.e., when GDP is increasing—small-cap stocks tend to outperform large-cap equities. Further, the data suggests that for the four quarters following the official end of a period of contracting economic activity, small-cap equities outperform

large-cap equities. In our data series going back to 1948, we identified 10 periods of prolonged contracting economic activity sufficient enough to be labeled a recession. Following the end of those recessionary periods, small-cap equities outperformed in nine of the 10 recessions in the ensuing four quarters. These recessions are listed in Table 1 along with the cumulative excess return of small caps in the following four quarters.

These periods of excess returns were analyzed and found to be statistically significant. Further, small-cap equities produced cumulative excess returns of 89.5% for all these periods, inclusive of the 1953 recession when small-cap stocks delivered negative excess returns.

We also ran correlations of the small-cap excess returns to periods of rising and falling GDP and found that small-cap excess returns were negatively correlated to falling GDP and the results were statistically significant. Small-cap excess returns were only slightly positively correlated to the entire data series. Therefore, Hypothesis 1 is accepted.

Hypothesis 2: Small-Cap Excess Returns Relative to Unemployment

We conducted a similar analysis of small-cap excess returns against U.S. unemployment rates, again using quarterly data going back to the first quarter of 1948 through the fourth quarter of 2012. Small-cap excess returns were found to be only slightly negatively correlated (–0.14) to unemployment rates and the results were not statistically significant. Therefore hypothesis #2 is not accepted.

However, we did cross-reference periods of expanding GDP following a recession, which also corresponded to a cumulative drop in unemployment rates during the same four-quarter period. Examining the four quarters following a recession where unemployment rates were also falling, we identified seven time periods. As shown in Table 2, small-cap equities delivered excess returns in six of those seven periods, a success ratio of 86%. During these seven periods, small caps delivered excess returns of 38.48% relative to large caps.

Hypothesis 3: Small-Cap Sector Excess Returns

This analysis was performed under specific assumptions. First, we determined periods of favorable equity returns as measured by positive monthly returns of the S&P 500 index, also referred to as the broad market. We also then identified periods in which each of the 10 respective S&P 500 sectors outperformed the broad market. Operating from the premise that higher-risk assets in times of favorable equity environments should produce higher returns, we then calculated whether the small-cap sector counterpart (S&P SmallCap 600) outperformed their large-cap counterpart.

The results demonstrated high percentages of outperformance for each of the respective small-cap sector indexes. There were 220 monthly periods observed in our data set. Table 3 demonstrates how often each of the respective large-cap sectors outperformed within the 220 monthly periods. Further, the table demonstrates how often the small-cap sectors outperformed when the large-cap sector was in favor. Additionally, the table illustrates the cumulative excess returns of the small-cap sectors versus the S&P 500 during the periods of outperformance of the large-cap sectors relative to the broad market.

The results show that all small-cap sectors added excess return when the large-cap sectors were in favor. Additionally, all of the small-cap sectors added excess returns more than 50% of the time. Utilities, materials, information technology, healthcare, energy and consumer staples all outperformed 70% or more of the time. The excess returns of each small-cap sector, with the exception of the utilities sector, were statistically significant, providing a relatively high level of confidence in providing excess returns via a small-cap sector usage in a sector rotation strategy. The least-consistent small-cap sectors were consumer discretionary and financials, only outperforming 57% and 61% of the time, respectively. However, the excess returns of the consumer discretionary sector were statistically significant.

Table 2. Small-Cap Excess Returns Following Recessions With Falling Unemployment

Recession/Falling Unemployment (Ending Year)	Post 12 Mos. Excess Return (%)
1948	2.18
1952	(1.32)
1957	10.48
1960	1.60
1970	7.25
1974	9.79
2008	8.50

Limitations of the Study and Future Research

Index Construction

Excess returns of small-cap equities

Table 3. Small-Cap Sector Excess Returns

Sector	# Times Large-Cap Sector Outperformed	# Times Small-Cap Sector Outperformed	Outperformance (%)	Small-Cap Sector Excess Returns (%)
Utilities	104	78	75.00	1.69
Telecommunications	107	73	68.22	5.16
Materials	103	80	77.67	2.62
Infomation Technology	110	77	70.00	2.21
Industrials	112	77	68.75	2.11
Healthcare	111	85	76.58	3.39
Financials	110	67	60.91	1.66
Energy	112	82	73.21	4.27
Consumer Staples	109	82	75.23	2.83
Consumer Discretionary	123	70	56.91	2.68

versus large-cap equities within the examination of post-recessionary periods and periods of falling unemployment were conducted relying on underlying index methodology as presented by Fama and French's definitions of small stocks versus large stocks.

Excess returns at the sector level were conducted with the index construction methodology of Standard & Poor's, using the S&P SmallCap 600 as the definition of small-cap equities and the S&P 500 as the definition of large-cap equities. This was done given the prevailing popular acceptance of the S&P sector definitions within the practicing investment profession.

Results of this study may be influenced by the reliance on these distinct methods of index construction. There are numerous readily accepted means of index construction (index providers, market-cap weighted, fundamentally weighted, etc.) that may vary the meaningful contribution of excess returns of small caps versus large caps as defined by those varying methodologies. Future research may look to aggregate excess returns from various index methodologies.

Timing of Sector Rotation Implementation

Our analysis of excess sector returns assumes that an investor demonstrates a high level of proficiency at making the appropriate sector 'bet' at the appropriate time. The value of these findings may be limited by investor proficiency. The discussion as to whether investors can, with any proficiency, correctly identify and allocate assets to the appropriate sectors relative to the broad market is a separate discussion for another research effort.

Conclusion

This study attempted to examine the nature of the variability of excess returns of small-cap equities relative to large-cap equities. Given Markowitz's assertion that higher-risk stocks should deliver higher returns to investors, it is presumed that small-cap stocks with their higher standard deviation would need to deliver excess returns to investors for that additional risk. The variability of these excess small-cap returns is a problem that has been noted throughout the investment management literature.

This study sought to examine specific assumptions as to whether there are identifiable economic periods where these excess returns are more likely to occur. Our findings suggest that investors have higher probabilities of capturing small-cap excess returns in times of economic expansion immediately following recessionary periods. Further, we found that investors can also capture relative excess returns at the sector level by investing in the small-cap sector when the accompanying large-cap sector is outperforming the broad market. While the findings are not meant to be a definitive approach to any specific investment process, it does help provide some direction in the further exploration of the variability of small-cap excess returns over time. ▲

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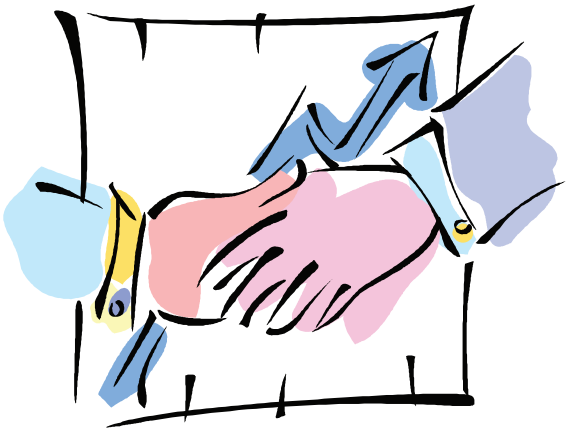
To Trend or Not to Trend

By Ray Rondeau

Article Highlights

- Combining technical, fundamental and implied volatility indicators can give valuable insight into trend analysis.
- Price action is related to and influenced by the technical landscape of the charts.
- Technical analysis does not necessarily predict price action, but indicates where and when a trend is likely to resume its path.



It is obvious that markets change and markets evolve. Investors who accept this as reality and adjust their approaches accordingly put themselves in a better position to succeed.

Like seemingly everything today, markets and their characteristics are changing at an ever-increasing pace. One of the more apparent changes is that we seem to be in an endless series of boom/bust cycles. These "bubbles" are being formed by a continuous revolving series of overextended price trends.

An investor may attribute these changes to multiple factors, including globalization, technological advances, the Internet, constant media coverage, increases in automated high frequency trading or the growing amount of hedge fund assets. New investment vehicles designed to allow individual investors to short and/or leverage (while staying long) is also a likely contributor. Add in ultra-low commissions and the fact that an investor can change his entire portfolio with a few clicks of a button, and it is easy to see why markets seem to be trending longer and wider than at any point in history.

Regardless of the reasons why, the fact is that our markets are trending. Popular or not, an elementary understanding of trend analysis theory in today's market environment is no longer a complementary addition, but rather a necessity to maximize the chances of success.

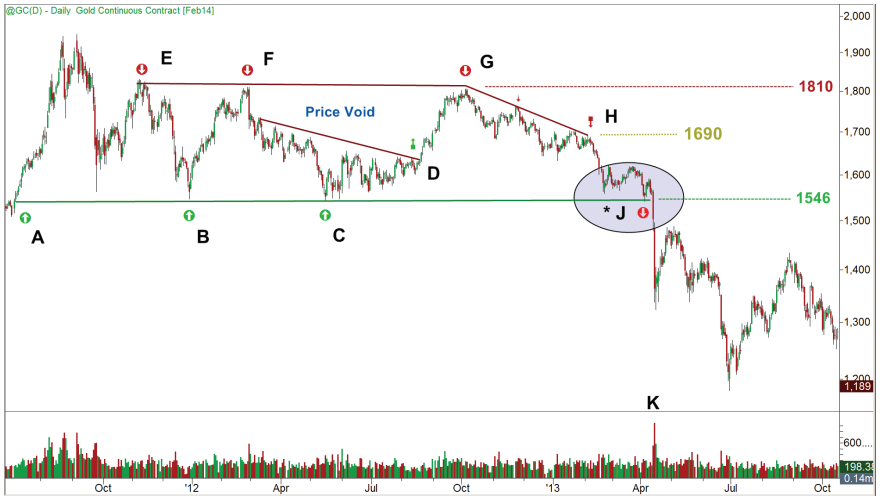
This is the focus of this article as I explore where an investor should turn to in evaluating trends and probable future price action. Specifically, I discuss three primary areas to help you differentiate between a normal retracement of a strong continuing trend and the early warning signs of a major trend reversal. In other words, the primary question is "to trend (continue) or not to trend (reverse)"?

Price Action and Trend Changes

For the purposes of this article, I define a trend simply as the general direction of a market or the price of an asset. With today's extensive financial news coverage, investors are often well aware of the overall direction and trends of the major indexes and their respective components. Unfortunately, simply knowing the direction of the trend isn't enough for evaluating potential directional changes. For this, an investor needs to get some deeper insight into the characteristics of the established trend, such as the longevity, intensity and developing changes in momentum. This leads us to an obvious starting point, charting and technical analysis, where a picture is truly worth a thousand words.

To illustrate, I have chosen the popular investment/trading vehicle gold. From the beginning of 2000, gold had been on a decade-plus upward climb from a price of $280 per ounce in January 2000 to over $1,950 per ounce in September 2011. This rise of nearly 600% certainly qualifies as an established long-term uptrend. Figure 1 shows that, using only basic support and resistance levels, the charts did an excellent job

Figure 1. Technical Analysis of Gold



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of not only forecasting future price movements for shorter trading profits, but also identifying the overall end to the primary upward trend, which is our primary goal.

If an investor was bullish on gold and looking to establish a long position, point C on Figure 1 would have been a fairly obvious first choice. Here, there is a level of support, extended from points A and B, where buyers showed a previous interest in accumulating shares around the price of $1,546. At point D, there was more evidence supporting the bullish position, with the breach of the intermediate downward sloping trendline (green block arrow). With gold having moved into a huge "price void," the next logical stop would have been at the next area of resistance around the $1,810 level. This was an area of clear resistance, where sellers had shown a previous desire to distribute shares. (Points E and F on Figure 1 established this resistance.) At point G, bullish investors would have looked to take profits, while bearish investors might have looked to establish new short positions. Both of these actions created downward pricing pressure, simply because of the technical landscape of the charts, essentially causing a self-fulfilling prophecy of price movement.

At point H on Figure 1, there was the third touch of the now-confirmed short-term downward sloping trend line, extending from point G. This was an excellent short opportunity, forcing the price into another price void, and it would not have taken much technical expertise to deduce that the next logical battle area would have been back at the $1,546 price level. This, of course, was not only self-fulfilling, but also logical and where active traders make their money. At this point, future bullish investors would have been hesitant to purchase shares at higher price levels when they felt that they may have been able to get a better price at $1,546, so they waited. Bearish investors were not going to close their short positions at a higher price, and hence they were prone to also wait for prices to fall back to the $1,546 level. Both parties were reluctant to transact, in hopes that they could get better prices. The hesitation by the bulls and the bears completed the technical formation and led to the major key price area on Figure 1: point J.

Point J was an obvious and key inflection point for the long-term trend and the world was watching. What happened there likely determined the intermediate-term price direction for gold going forward from that point. After a two-month battle, the bulls abandoned the $1,546 level and prices collapsed $200 (12.7%) in two days. Here, both experienced bullish and bearish technical traders would have transacted correctly once the market had finally showed its hand. The bulls would have been stopped out below the $1,546 level and retreated to fight another day, and the bears would have profited by establishing or adding to their short positions. The huge volume spike at point K is noteworthy and was further evidence of the importance associated with this technical event.

This example highlights three key points. First, popular or not, price action is related to and influenced by the technical landscape of the charts, and technicals can be used to assist one in the timing of executions. Second, the failure of the price to hold support at point J reaffirms that technical analysis doesn't tell us necessarily if a price trend is going to continue, but only indicates where and when the trend is likely to resume its path. Third, price action at these key inflection points has significant value in determining the probable continuation or change in an established trend—our main goal. In this example, once the price of gold breached the $1,546 level at point J, the charts signaled that the intermediate and possibly the long-term uptrend was over.

Combing Technical and Fundamental Indicators

Rightfully so, longer-term-oriented investors love to look at fundamentals for making their investment selections. Thus, incorporating these valuations into analysis for probable continuation or reversal for long-term trends is not only reasonable, but also effective.

One measure of fundamental valuation that can be useful to consider is the relative price-earnings (P/E) ratio. The relative price-earnings ratio is a comparison of stock's current price-earnings ratio to that of its history. For the purposes of this article, I include

a graphed example of relative price-earnings ratios in conjunction with support and resistance.

Figure 2 shows the price action of Lockheed Martin Corp. (LMT) coupled with its price-earnings ratio (lower pane). The interpretation here is that a low numerical reading would be viewed as a potentially bullish reading, indicating a "relative" historical-based low and perceived attractive valuation. In Figure 2, we can see that whenever the price-earnings ratio approached a level of 9.0—the lower band of fundamental support—buyers stepped in. At the opposite side, when Lockheed's price-earnings ratio approached 11.0—the upper band of fundamental resistance—the price seemed to roll over as the sellers seemed to take control.

Coupling these fundamental support and resistance areas with the price action (points A, B and C on Figure 2) is where we get our insight into the likelihood of the technical trend continuing or breaking, again our primary purpose. If the price has been ranging and is currently at the lower edge of price support, we would want to see a fundamental indication that the stock is undervalued. A low relative price-earnings ratio would be bullish and would confirm the likelihood of the trend continuing.

Conversely, if the stock approached support (lower prices) and was still trading with a high relative price-earnings ratio, then this could be a interpreted bearishly with an increase in the probability of a breach of the existing trend. Often this can lead to a scenario where fundamental-oriented investors begin to liquidate their positions. This liquidation then causes a drop in price that prints a bearish technical pattern on the charts (a breach of major support), which further exacerbates the selling, now by the technical traders. The additional pricing pressure begins to trigger protective stops on established long positions. Automated trading programs designed to recognize such activity then jump in, adding to the building of momentum and the subsequent forming of a new trend in the opposite direction.

The use of technicals and fundamental studies for trend analysis are obviously and widely used, but for additional insights we will now look at one example in our third area of study—derivatives.

Figure 2. Technical and Fundamental Analysis of Lockheed Martin

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What Investors Might Be Thinking

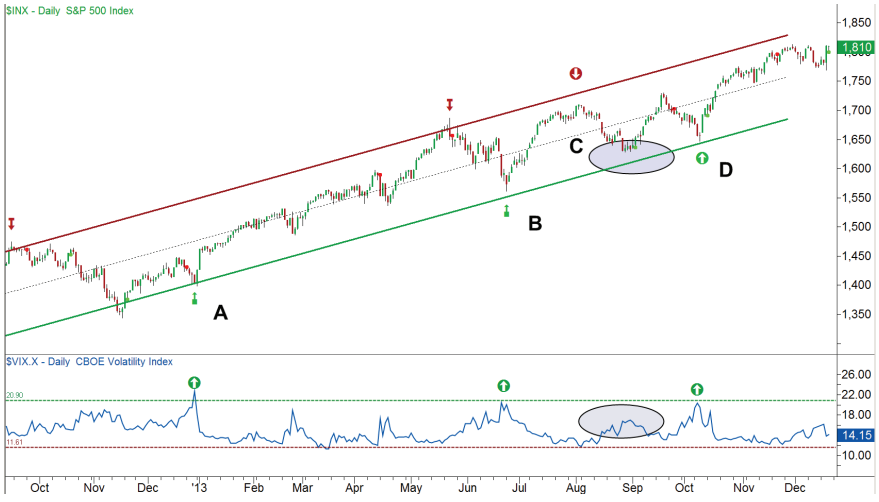
By looking at the implied volatility (IV) of optionable issues, the investor has the ability to gain some additional insights (that are not only shown in price) into what market participants might be thinking. This measurement has potential forecasting value when issues approach extreme relative historical implied volatility levels or when it creates divergences with price that cannot be directly associated with other known factors.

To illustrate, Figure 3 shows the S&P 500 index and the widely used "fear index," the Chicago Board Options Exchange (CBOE) Volatility Index (VIX). The classic interpretation in action at points A, B and C of "when high, it's time to buy, and when it's low, look out below" appear on this chart. How high is high and how low is low? For this example, I will use the VIX levels as the reference and the bottom of a linear regression price channel (lower green line) as support for the established trend.

To get a benchmark, I first do some quick calculations starting at point A. Point A marks a 4.9% price pullback within the channel and a VIX peak of 23.23. Point B marks a 5.3% price pullback within the channel and a corresponding VIX peak of 21.3. Using these as the reference levels, look at point C to observe a similar size pullback of 4.7% to support, but with a subsequent rise in the VIX to *only* 17.8. An interpretation here could be that there was less demand for protection in relation to other recent pullbacks and that the overall market had less concern with this retracement and a major trend change. In hindsight, we can see that this is what happened, as support did hold and the price continued to reach a higher high.

Moving forward at point D, a similar "high" VIX reading of 20.34 can be seen. This new "high" reading, though, occurred in the toxic environment of a partial government shutdown, with the threat of a possible U.S. government debt default. Considering the amount of uncertainty, when an investor compared this reading to the average VIX reading of 20.32 (from January 2004), he could theorize that the big money and those

Figure 3. Analyzing Implied Volatility (VIX)



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who were "in the know" did not seem overly concerned. In other words, based on this one indicator, an investor could have surmised that the market had a relatively bullish stance and that there would be a satisfactory resolution and future upward price activity. Again in hindsight, we now know that this was indeed the case, even though only a short-term solution to the concerns was reached.

Conversely, let's say the VIX instead jumped to a hypothetical level of 45 at point C. In this scenario, one interpretation might have been that there was a high degree of fear with this similar measured price pullback and that the current trend and support was less likely to hold. Here, an investor could have theorized that the market's larger players were more pessimistic or concerned about the eventual outcome.

A Synergistic Viewpoint

After decades of working with individual and groups of traders and investors, I have often noticed that novice or unsuccessful investors are the ones who seem to question little and seem sure of a lot, while the proficient and successful investors are the ones who question a lot and seem sure of little. As Oscar Wilde once stated, "the pure and simple truth is rarely pure and never simple." In the investment world, the truth is, despite what someone may try to "tell you or sell you," the markets are not stupid. Attaining a true edge on longer-term-oriented positions takes good resources, hard work and research. Our markets are more sophisticated than ever. Simple get-quick-rich schemes don't work here. All of this leads us to a few final thoughts in regard to trend analysis and price forecasting.

First, the good news. After researching, when these observations are combined they can give an investor valuable insights into the health of a current trend. In addition, it is important to note that these measurements are more effective when used together, as they work synergistically. Single observations or the use of a single indicator is generally less effective. A professional investor will consider researching many factors, and not just those that are quantitative, before making an informed "decision."

George Bernard Shaw once stated that "the [only] golden rule is that there are no golden rules" and this the bad news investors must face. You can have a stock that technically has been in a sustainable uptrend that has just broken out of a major continuation pattern, off of multiple key converging moving averages on high volume with a gap into a huge price void. The stock could also be showing continued but sustainable relative strength and leadership to the market and its industry. It could have true insider (non-stock option related) buying, positive price movements to seemingly negative news and be entering a favorable seasonable cycle for its industry, all while being at the very top of your favorite stock adviser's lists and newsletters. Yet, we still would not know what the stock price is going to do.

In this one-sided scenario, it would be natural for one to assume that with all the overlapping and reinforcing positive signs that we would know what the stock price is going to do, right? No, no one really knows (barring inside information or manipulation). Even if everything that you know is complete (impossible) and totally true (unlikely), it is important to remind ourselves of the famous quote attributed to John Maynard Keynes, "The market can stay irrational longer than you can stay solvent." Unfortunately, price and trend analysis is about probabilities and never guarantees. This is the reason that experienced investors look to protect assets with diversification and hedging strategies.

Now the unpopular truth: If something on initial analysis looks too good to be true, it probably is. So look further and then, if necessary, even further. There are no free rides on Wall Street. Yes, an argument can be made for the "analysis paralysis" side of the debate. But scanning the entire field for hidden sinkholes before sprinting to pick up your pot of gold at the end of that rainbow (that you assume no one else sees) just makes more sense.

One could argue that the markets may not be totally efficient, but market participants are not totally incompetent either. As anything changes—either real or perceived—the markets and prices adjust immediately to reflect that new information. Put another way, everything that has happened, is expected to hap-

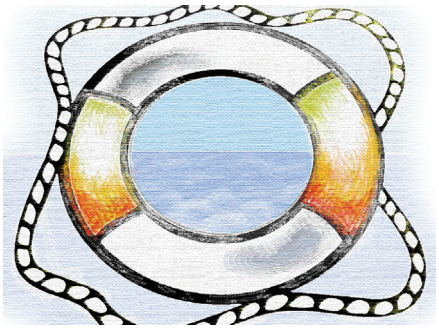
(continued on page 36)

Long-Term Care of Your Personal Finances

By Christine Fahlund, Ph.D., CFP

Article Highlights

- Covering the costs of long-term care should be part of your financial planning. Insurance is one way to provide for those expenses.
- Long-term care insurance can help you maintain a larger allocation to stocks, which provide better longevity and inflation protection.
- Triggering conditions and their elimination (waiting) period determine when benefits will be paid.



Your odds of needing long-term care—care to help you with the activities of daily living—are seven out of 10.

According to the 2011 handbook of the American Association for Long-Term Care Insurance, 70% people over the age of 65 will require long-term care, either at home or in a facility. And with medical advances keeping people alive but not necessarily healthier longer, the odds may change—and not in your favor.

Don't be lulled into a false sense of security because you have good health insurance or by thinking you can rely on Medicare. Long-term care isn't the same as care during an illness or for an emergency medical condition, so it isn't covered by health insurance or Medicare. Long-term care is defined as assistance with the activities of "daily living": bathing, continence, dressing, eating, toileting and transferring. Most policies today also cover cognitive impairment (such as Alzheimer's disease).

Long-term care can occur either in your own home or in a facility, such as a nursing home or an assisted-living situation. Be sure to read the fine print with respect to care in your own home, as policy coverages may differ. (See the sidebar titled "Read the Fine Print.")

There are three ways to pay for long-term care: By self-insuring (i.e., having no insurance, and paying all of your costs out of pocket); by having some sort of long-term care insurance coverage; and by relying on Medicaid, which requires that you exhaust almost all of your financial resources in order for the government to pay for your care. If your goal is to stay in your own home as long as possible and to maintain control over your care for as long as possible, consider purchasing some form of long-term care insurance. The more coverage you pay for, the more choices you will have.

The costs of providing long-term care are significant. According to the government-run website LongTermCare.gov, average costs for long-term care in the United States (in 2010) were:

- $205 per day, or $6,235 per month, for a semi-private room in a nursing home;
- $229 per day, or $6,965 per month, for a private room in a nursing home;
- $3,293 per month for care in an assisted-living facility (for a one-bedroom unit);
- $21 per hour for a home-health aide;
- $19 per hour for homemaker services; and
- $67 per day for services in an adult day health care center.

The older you are when you purchase coverage, the higher the annual premiums. On the other hand, the younger you are, the more years you will be paying premiums. (For information about long-term-insurance care costs, visit the American Association for Long Term Care Insurance's website at www.aaltci.org.)

If you don't factor the possible need to pay for long-term care, either through insurance or out of pocket, into your financial plans, it could play havoc with your financial stability down the road, and your ability to leave anything behind for your heirs. And how you choose to cover those expenses could have an impact on how you invest your money in retirement.

Read the Fine Print

There are almost limitless numbers of variations with regard to long-term care coverage. Two policies of the same type from different companies could have different levels of coverage, and prices vary as well.

While it's important to understand any kind of insurance policy—or any document you sign, for that matter—it's especially important with long-term-care insurance because it is very difficult, not to mention expensive, to change your coverage once you start receiving benefits. You may want to consider consulting with a lawyer who specializes in elder care when evaluating policies.

Below is a list of some of the areas and issues you may want to go over in greater detail. It is by no means exhaustive, but is meant to serve as a starting point:

Levels of Care

- Will you be covered for skilled nursing care? For personal/custodial care?

Where You Can Receive Care

- Will your care be covered in any licensed facility—nursing home, assisted living, adult day care, other facilities? If there are exclusions, what are they?
- If you are receiving care at home, will you be covered for benefits provided by skilled nurses, home health aides, homemaker services, family members, or other providers?

Benefit Duration and Amounts

- How much will the policy pay per day for care in a nursing home, assisted living facility, or at home?
- Do the benefits increase with inflation?
- What are the limits, if any, for the number of days or visits per year for which benefits will be given?
- What are the dollar limits on the amount the policy will pay during your lifetime? Are there limits for each different kind of care or facility?

Eligibility and Triggers

- What is the waiting period (aka elimination period) for when benefits begin? Does the waiting period differ depending on what kind of care you are getting or where it is administered? Are waiting periods cumulative or consecutive?
- Which trigger(s) will start your benefits? How many activities of daily living do you need help with for benefits to trigger?

Miscellaneous

- Are your premiums deductible as a medical expense? Will your benefits be taxable or income tax-free?
- What happens to your policy if you can no longer afford the premiums?
- If your policy is later acquired by another insurance company, can the terms of the policy be changed?

Should You Buy?

Long-term care insurance is designed to allow you to have more control over your destiny if your health deteriorates. (One way of thinking about it is as "stay in your own home" insurance). It can also be just as important for couples as it is for single people or those without children or family nearby, since it can free up loved ones—a spouse, children, grandchildren, siblings—from having to provide care for you. Relatives may not be up to the challenge of providing long-term care because of their own career and family obligations or geographic location, and there is no guarantee that your spouse will be physically up to the job.

If you're by nature a more cautious person, you will likely want to be insured for catastrophic expenses. And the costs of long-term care can certainly fall into that category.

Investment Alternatives

How you choose to provide for the possibility of long-term care will likely affect how you invest, not only for your retirement but also during your retirement. If you're self-insured, you need to have ready access to some of your assets, which you set aside in cash and short-term investments to cover long-term care needs, without having to worry about liquidating assets during unfavorable market conditions. On the other hand, this allocation to short-term investments will limit your flexibility to invest a significant portion of your portfolio in equities.

An advantage of having these potential long-term care costs largely covered via insurance is that you will have the freedom to keep a larger percentage in stocks in your portfolio, which will provide needed growth potential (i.e., longevity and inflation protection) over the long term.

The time to buy long-term care insurance is well before you need it. Generally, the younger and healthier you are, the less expensive the premiums will be. Also, you are more likely to be insurable. The emergence of a condition such as diabetes or high cholesterol could be seen as a red flag that you are at a higher chance of needing long-term care down the road. Your insurability could be affected, or your coverage could exclude pre-existing conditions. And unlike other forms of insurance, such as fire or theft, which you can buy after an incident (albeit with higher premiums), this would not be the case

How & Where to Buy Long-Term Care Insurance

So let's say you decided you want to buy some form of long-term care insurance. How do you do it?

You may wish to purchase your own insurance policy, or you may prefer to purchase coverage offered through your employer.

On Your Own

Begin by contacting your state insurance department to find out if they have any informational materials for residents wishing to purchase long-term care insurance. Also ask about whether they provide an insurance counseling program and how you can benefit from its services before making your purchase.

Then check with several companies and agents and compare the features and benefits (and costs) of their products. Also compare the financial stability of each company you are considering. A variety of rating agencies have websites where you can learn about the financial strength of each company (e.g., www.ambest.com, www.moodys.com and www.WeissRatings.com).

Once you have made your purchase, be sure you look at your policy during the free-look period. In most states, if you change your mind, you have 30 days to cancel and get your money back.

Through Your Employer

With the escalating costs of long-term care insurance, fewer employers provide it as part of their benefit package. However, some offer it as an add-on that you pay for. The advantage to buying it through your employer is that it is an easy, available solution. It also will have an open enrollment period at the time you join the company when you will be eligible to purchase coverage without any type of a questionnaire or medical exam.

If you would otherwise be uninsurable, or have a pre-existing condition excluded from coverage, this may be your best option. However, you can't assume that the rates are lower than you could get elsewhere, or that the policy is as comprehensive as what you want/need.

Through Your State

Today, many states offer long-term care partnership programs. By purchasing an insurance policy that qualifies as a "partnership policy" (check with your state insurance department), you will receive insurance benefits until your policy is exhausted, at which time the state will enable you to qualify for Medicaid without having to spend down the amount of money you paid over the years on long-term care insurance premiums.

This is a potential win-win arrangement for you and the state. In other words, the state delays or avoids paying you Medicaid benefits and in exchange you are potentially allowed to retain more assets to leave to your heirs.

with long-term care insurance.

When it comes to choosing a policy, you will have to decide what kind of insurance you want—strictly a long-term care policy (either joint or single), or as a part of a life insurance policy or annuity—as well as the amount of coverage. Regardless of how you choose to be covered, there are myriad variations (see the sidebar titled "Read the Fine Print").

For example, a joint long-term care policy from two different companies could vary in terms of exclusions, triggers and benefit periods, depending on what kind of coverage you choose. This is why it's so critical that you do your homework. And as you would expect, premiums vary widely as well.

Below is a brief summary of the various kinds of policies, and the pros and cons of each.

Single-Life Long-Term Care Insurance

As the name suggests, a single-life long-term policy covers just one person. It's the obvious choice for a single person who wishes to have and can afford coverage, but some couples choose to buy two single policies rather than a joint one to maximize their coverage.

Conversely, some couples only buy insurance for one of them. How do you know which one to buy for, or that you both won't need it? Bet on the wrong person, and you're not only out the cost of the premiums, but the costs of care for the uninsured party who ends up needing it.

Joint-Life Long-Term Care Insurance

A joint policy provides a maximum dollar amount of coverage for both members of a couple. If the policy maximum is $200,000 and your spouse uses up $150,000, you are left with $50,000 of coverage for yourself.

While a joint policy is almost guaranteed to be less expensive than two single policies, you run the risk of one person maxing out the coverage, effectively leaving the other person with nothing.

Fixed Annuity With Long-Term Care Benefits

A fixed annuity with long-term care benefits is usually a single-premium product that will provide money to be used for long-term care if needed. Any money that is dispersed for long-term care will affect the amount of the annuity at maturation.

This type of policy is generally less expensive than a traditional long-term care policy, and if you don't need long-

term care, you will receive the annuity. However, today's low interest-rate environment currently makes fixed annuities less attractive overall.

Life Insurance With Coverage for Long-Term Care Expenses

You can also get long-term care benefits by putting your money in a cash-value insurance vehicle—whole, universal, or variable universal life—and then electing to purchase "an accelerated death benefit" or "life/long-term care" policy. After you've "triggered" the long-term care coverage, any such benefits that are paid out by the company are subtracted from the policy's death benefit. (Usually the insurance company has limits on the daily or monthly benefits paid, depending on the policy's death benefit.) Your beneficiaries will ultimately inherit any benefits remaining.

If you want more long-term care benefits than the life insurance policy will permit, you can also purchase more long-term care coverage in the form of a rider.

Triggers and Elimination Periods

When your long-term care benefits start kicking in will depend on two things: Triggers—the condition(s) that must be present)—and your elimination period.

Whether you will need one trigger or two will depend on your policy. Also, whether care will be administered in a nursing home or other facility as opposed to your own home could make a difference as to what is considered a trigger. And you will need verification from a doctor—which could be your own, or the insurance company's—to qualify. Below is a list of common triggers.

- ***Medical Necessity:*** Sickness or injury requires covered care, which must be consistent with accepted medical standards for treating the sickness or injury. The absence of such care would have a negative impact on your health.
- ***Loss of Functional Capacity:*** You need assistance performing at least two of the six defined activities of daily living. (The number of activities you need help with to trigger benefits could be another variable.)
- ***Cognitive Impairment:*** You require supervision, direction, and assistance with activities of daily living because of cognitive impairment, such as Alzheimer's disease.

You also need to look at the elimination period—the amount of time the triggering conditions must be present—before insurance will start paying for your benefits. You will be paying out of pocket for your care during the elimination period. Think of it as the equivalent of a deductible in other types of insurance policies. A long elimination period will likely mean lower premiums, but it could also mean significant out-of-pocket costs for you.

A final consideration is the soundness and stability of the insurance company you choose. The recent less-than-favorable economics of meeting the demands of policyholders has caused some companies to get out of the business and has discouraged others from entering.

Risks

Even if you do purchase long-term care insurance, there will still be risks. Most obvious is the risk that you will pay premiums for coverage you never need. Or, you may purchase an amount of insurance that does not come close to covering the significant costs of care.

There are other risks as well. The insurance company may experience financial difficulties or, in extreme cases, even go bankrupt before you claim any benefits. Or you may not need benefits beyond your elimination period, because you have a long elimination period or a relatively short-term need for long-term care. Not only will you have paid for premiums without getting benefits, but you will end up paying the out-of-pocket expenses. (Remember, however, that we prefer to pay homeowner's insurance premiums annually and NOT have our house burn down. Consider the situation with long-term care insurance the same way.)

Sometimes premiums can be raised significantly for an entire class of policyholders. This could happen, as it did recently, after bond interest rates fell and remained low for an unexpectedly long time, while the insurance companies were depending on bond interest to pay for current and future claims. It could also happen as the result of revised assumptions and calculations on the part of actuaries employed by the insurance companies.

At some point you may find you cannot afford the premiums anymore. Several options may exist for you, but it is important to consult with the insurance company at the time you initially purchase the long-term care policy to determine which options, if any, will be available. Some companies will negotiate with you, for example, to provide reduced coverage in the future for a lower annual premium.

Others will offer you a non-forfeiture benefit when you first purchase your policy. Although this benefit will raise your premiums, it will also ensure that if you need to stop paying your premiums you will receive a paid-up policy from the insurance company. The revised policy will have a lower daily benefit or a shortened benefit period, or some other adjustment, but you will still have long-term care coverage, depending on how long you have been paying premiums and the cumulative dollar amount you have paid. Some companies have been very slow in paying benefits even after eligibility has been met. That's another reason why it is important that you review the histories of each service provider before making your selection.

Conclusion

There are no perfect solutions. You need to define your risk and determine how much exposure you can live with. For certain investors, it would be unwise to purchase this insurance. For example, if you have trouble meeting your existing bills for essential day-to-day living

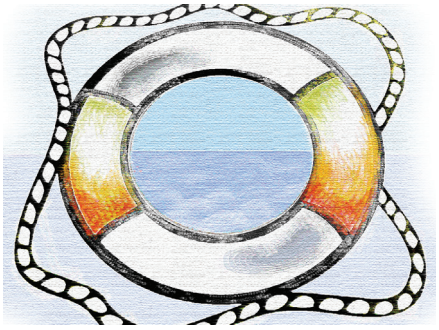
(continued on page 36)

Life Insurance Cash Value: A Practical Discussion

By Peter Katt

Article Highlights

- A life insurance policy's cash value is not the same thing as a bank account.
- Borrowing or withdrawing cash values will reduce the death benefit by the same amount.
- Surrender charges show up as the difference between the account value and the cash value.



As readers of my AAII articles know, I believe the best way to understand the maddeningly complicated life insurance asset is to present various anecdotes on specific issues.

In this spirit, several recent client encounters about aspects of life insurance cash value has prompted me to discuss cash values—not in a historical and comprehensive sense, but with narratives to provide a better practical understanding of cash values for owners of life insurance policies.

It's My Money and I Want It Now

A client I will call Stan came to me furious because he was being charged interest on cash value loans from his participating whole life policies. Recently, his agent told him that without either premium or loan interest payments his policies would terminate. Stan was furious because of his insistence that no loan interest be charged, since it was his money and he viewed the cash balance like a bank account.

This isn't the way life insurance cash value works. Life insurance as an asset is not dissimilar to, say, apartment units. If you want cash from the apartment asset (or your life insurance), you take a mortgage (loan) and pay interest. This reduces the net value of the apartment (the life insurance death benefits) by the amount of the mortgage (loan). Alternatively, you could sell some units (withdraw cash value) to receive cash. You would not create a mortgage (loan), but you would reduce the net of your asset (you would own less). This is why a life insurance policy's cash value is not, nor should it be viewed as, a bank account.

Unattended Cash Value Loans Can Crater a Policy

Stan's loans accumulated due to a combination of factors. His agent left the business. When Stan moved, the insurance company lost track of the correct address to send him premium notices. As a result, Stan didn't receive them. Stan also didn't pay premiums because he thought the premiums were covered within the policy. The premiums were covered by loans. Due to missed premium notices and the loans, the policy eventually reached a tipping point of being in danger of lapsing with phantom income within a year.

Stan, mistakenly believing that the cash values were his to do with as he pleased, then spent hours in discussions and written communications with the insurance company trying to pin blame on them for this situation. He threatened legal action. He churned up a lot of frustration. Even if Stan successfully proved that the company mismanaged this situation, the cost in money and time would have produced a huge net loss to him. The amount at stake was really quite small.

Cash value life insurance with a large loan can cause a policy to lapse without value, but with taxable income. This is because the cash value loan value (known in the tax world as boot) is the gross value of the policy when it lapses. (In this example, the gross value is the loan.) The insurance

company's calculation of the cost basis is subtracted from the gross value and the difference is the reportable taxable income. Note that when a policy lapses with no value but with taxable income, there are no funds from the policy to pay the taxes. This is known as phantom income.

I determined that Stan had three choices to rescue the situation, but only one that was in his best interest. Fortunately, Stan has a relatively high net worth with cash resources. Repaying the loan of approximately $46,000 immediately raises the policy's cash value by about an equal amount. It also raises the death benefits from approximately $28,000 to $81,000. Taking into account the payments and the death benefit payout at Stan's life expectancy, the calculated yield is 3.14% of tax-free income based on the current dividend.

In the current low fixed-income yield environment, this is a decent return. More to the point, it is the only way for him to have a positive outcome with this policy. All the other options produce negative financial outcomes, including repaying the loan and then terminating the policy for its surrender value. (Doing so would produce significant taxes.) Because of his negative feelings generated for this insurance company during his long battle, Stan only reluctantly repaid the loan. Astonishingly, during the long ordeal the insurance company spent most of its time defending its practices. To the extent the company suggested repaying the loan as the only real solution, Stan didn't accept the suggestion because of his total mistrust.

Account Value Is Not the Same as Cash Value

Almost all universal life policies have significant surrender charges that are listed in the contract. They also show up as the difference between the account value and cash value in statements and illustrations. Many clients and advisers don't understand the difference.

Let's say a $1 million universal life (UL) policy has a $100,000 account value and a $50,000 cash value. The surrender charge is $50,000. The client could borrow or withdraw against the $50,000 cash value, but not the account value. If the client were to withdraw most of the cash value, the policy could continue for quite some time because the monthly insurance charges are usually deducted from the account value that would be approximately $50,000.

Let's say that the client wants to reduce the policy from $1 million to $500,000. This would cause half of the $50,000 surrender charge to be incurred, or $25,000. After the reduction to $500,000, the account value would be $75,000 while the cash value would remain at $50,000. (The difference between the account value and the cash value is the surrender charge, the penalty paid for reducing the policy.) Since the surrender charges go down each year, this is a real loss in policy value.

The account value offset by the surrender charge is really a way for the insurance company to hide the sales commissions. If the commissions are lower, the surrender charges are lower and the surrender cash value is higher. This can be done on some universal life policies (not all) by demanding that blending be used to replace base death benefits with term insurance. This blending alters nothing in the policy's pricing, except to reduce the commissions and surrender charges and increase the cash value.

Can I Have My Cake and Eat It Too?

A client reviewing his annual universal life statement showing $2.5 million cash value for his $10 million policy had a question: Does the cash value add to the death benefit? He then had an epiphany that the answer for his policy is no. So why not take out most of the cash value?

There are two reasons why this shouldn't be done. First, borrowing or withdrawing cash values will reduce the death benefit by the same amount, so nothing is gained. Secondly, the cash value is the foundation of a permanent current assumption universal life policy (as opposed to guaranteed universal life). The target premiums are set up to level the annual cost of the policy with the buildup of cash value used to support the increasing cost of insurance charges as insureds get older, with the account value reducing the amount of actual life insurance.

The overall management of a level death benefit universal life policy needs to take into account an insured's potential for a change in health so the target funding age is accurate. For a healthy insured, we need to fund the policy as if he will live to age 100 or beyond—lifetime funding. Depending on the type of policy, this may mean generating a cash value equal to the death benefit at 100. In others, we only need $1 to continue lifetime funding beyond age 100. But if an insured incurs significant health issues, we may decide to fund the policy to an earlier age, if the probability of living to the earlier age is low because of health issues. The goal is to have $1 of cash value when the insured dies.

This, of course, is a theory and not reality, but we can save significant premiums by assessing mortality prospects and minimizing the cash value buildup when mortality probabilities are more in favor of dying around, say, age 85 than age 100. The secret to effective universal life cash value management is not to build it up in the first place, because as I've explained, you can't get it out without reducing the death benefits.

Guaranteed universal life (ULG) has low to zero cash values. Unlike other permanent policies that terminate if there is no cash value, guaranteed universal life depends on a specified premium being paid as contracted for the coverage to remain in force, regardless of zero cash values. ▲

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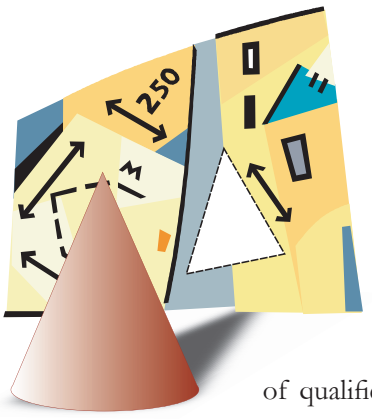
Investment Education Person-to-Person

Model Shadow Stock Portfolio: Purchase Guidelines and Rule Changes

By James B. Cloonan



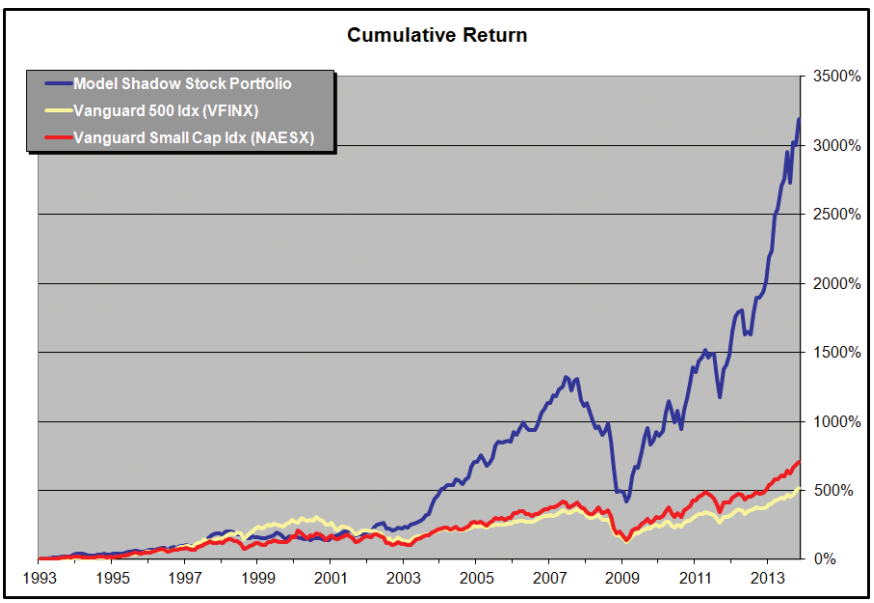
The Model Shadow Stock Portfolio is up 55.6% year-to-date compared to 29.0% for the S&P 500 index, as measured by the Vanguard 500 Index fund (VFINX). Figure 1 shows the year-to-date returns as of November 30, 2013, as well as annual returns for one-, three- and 10-year periods.

This has been an exceptional year, and if the Model Shadow Stock Portfolio stays at this level it will be the third-best year in its 21-year history. As you can see in Table 3, the years 2003 and 2009 were both up over 70%.

Many pundits keep predicting a pullback. It may happen, but the market increase has about doubled since the dire predictions began.

We had been running a chart in this column showing the number of first-pass qualifying stocks at my quarterly review. If the number of stocks passing my initial screen each quarter had any predictive value, the market would have fallen six months ago, since very few stocks have been qualifying. Like most possible predictors of future market direction, it has not shown any meaningful guidance. Therefore, we are no longer showing historical figures here in chart form, although we may mention the number of qualifiers when discussing purchases.

Figure 1. Model Shadow Stock Portfolio vs. Benchmark (Through 11/30/2013)



Portfolio	Year-to-Date Return (%)	Annual Return (%) 1-Year	3-Year	10-Year	Ann'l Std Dev (%)	3-Year Risk-Adjusted Return (%)*
Model Shadow Stock Portfolio	55.6	61.4	33.8	19.9	20.5	21.9
Vanguard 500 Index (VFINX)	29.0	30.1	17.6	7.6	12.3	17.6
Vanguard Small Cap Index (NAESX)	34.2	38.3	18.4	10.2	16.4	14.8

**Relative to Vanguard Total Stock Market Index fund (VTSMX).*
Data as of 11/30/2013.

Table 1. The 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)	58.71	58.95	31.15	709.2	20.9	2.08	0.5	
Alpha and Omega Semicon (AOSL)	7.75	9.30	6.64	199.2	nmf	0.70	0.0	earnings probation (2013 Q4)
CSS Industries Inc. (CSS)	31.14	31.94	20.11	288.9	15.7	1.17	1.9	
Ducommun Incorporated (DCO)	25.34	30.98	14.32	273.2	15.7	1.13	0.0	
Ennis, Inc. (EBF)	18.54	19.59	13.92	486.1	15.3	1.29	3.8	
Five Star Quality Care (FVE)*	4.93	6.87	4.44	238.0	18.3	0.77	0.0	qualifed as of 11/30/2013
Flexsteel Industries (FLXS)	27.66	28.10	18.56	198.6	14.6	1.28	2.2	
Gilat Satellite Networks (GILT)	4.45	6.20	4.37	187.0	nmf	0.79	0.0	earnings probation (2013 Q3)
Hardinge Inc. (HDNG)	15.49	16.88	9.27	184.1	15.6	1.07	0.5	
Hooker Furniture Corp. (HOFT)	17.08	18.31	13.33	183.7	18.6	1.38	2.3	
International Shipholding (ISH)	28.31	32.12	15.95	205.2	12.8	0.71	3.5	qualifed as of 11/30/2013
Key Tronic Corporation (KTCC)	10.52	12.28	8.95	110.8	10.8	1.15	0.0	
Kimball International (KBALB)	14.89	15.02	8.48	449.1	23.6	1.38	1.3	
LMI Aerospace, Inc. (LMIA)	12.69	23.20	10.81	163.1	16.9	0.76	0.0	qualifed as of 11/30/2013
Marlin Business Services (MRLN)	24.85	28.64	15.46	323.2	21.1	1.70	1.8	
Medical Action Industries (MDCI)	8.60	10.07	2.53	141.0	nmf	1.46	0.0	
Mitcham Industries (MIND)	17.50	18.41	11.51	224.7	30.2	1.27	0.0	
Olympic Steel, Inc. (ZEUS)	28.07	31.68	18.10	307.7	nmf	1.04	0.3	
PC Connection, Inc. (PCCC)	21.73	22.34	10.00	568.7	16.6	1.78	0.0	
PCM Inc. (PCMI)	9.50	11.96	5.66	111.2	13.2	0.89	0.0	
RCM Technologies (RCMT)	6.46	6.97	5.00	79.9	17.5	1.27	0.0	
Renewable Energy Group (REGI)	11.37	16.50	5.42	414.5	2.9	0.70	0.0	
REX American Resources (REX)	32.74	41.00	17.12	267.4	57.4	1.05	0.0	
Rocky Brands Inc. (RCKY)	15.24	19.97	12.56	114.6	10.8	0.90	2.6	
Salem Communications (SALM)	8.99	10.14	4.97	224.0	nmf	1.14	2.4	earnings probation (2013 Q1)
Shoe Carnival, Inc. (SCVL)	28.93	29.00	18.80	592.8	19.2	1.88	0.8	
Standard Motor Products (SMP)	34.72	39.99	19.03	802.3	16.1	2.30	1.3	
TravelCenters of America (TA)	10.63	12.50	4.18	314.3	18.3	0.79	0.0	
VOXX International (VOXX)	17.84	18.00	6.21	433.2	14.0	0.96	0.0	
Willis Lease Finance (WLFC)	18.23	18.24	11.70	153.7	18.2	0.74	0.0	

**Company is new to the portfolio as of 12/2/2013.*
Source: AAII's Stock Investor Pro*/Thomson Reuters. Data as of 11/30/2013.*

Explanation of Notes

Approaching Size Limit: Stocks are sold if their market capitalization goes above three times the initial maximum criterion. The current market capitalization maximum for initial screening is $300 million. Stocks are marked "approaching size limit" if their current market cap exceeds 2½ times the initial criterion, or $750 million.

Approaching Value Limit: Stocks are sold once their price-to-book-value ratio goes above three times the initial criterion. The current initial price-to-book ceiling is 0.80. Stocks are marked "approaching value limit" if their current price-to-book-value ratio exceeds 2½ times the initial criterion, or 2.00.

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 within the parentheses lists 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.

Unusual Activity

There have been only a couple of times in 20 years where dramatic news came out right after a stock was purchased for the portfolio and before the purchase was reported to you. This time, it was Fab Universal Corp. (FU). The situation with Fab Universal involved a report of unexpected high earnings for the quarter with very positive predictions for the future. This drove the stock price up dramatically from $4.25 to an intraday high of $11.25. Shortly afterward, short sellers challenged the figures, emphasized the extreme dilution coming, and questioned the validity of the sales. (You can go online to SeekingAlpha.com for the details.) The stock price had dropped to $5.50 by the time we sent out an emergency notice to sell on November 20, and a few days later it stopped trading.

By the time we indicated our purchase, the stock had increased so much that its price-to-book-value ratio was far above 0.80; based on our rules, it should not have been purchased. If you purchased it on the way down when it qualified again (based on questionable data), I hope our emergency sell message got to you. If it did not, I would recommend selling it when you can, as we did in the actual portfolio.

The story of Fab Universal does present an opportunity to review two

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 0.80. If the price-to-book-value ratio moved up a bit since the stock was included in the portfolio, it is still OK to purchase the stock unless this ratio goes above 0.90. (Figure will change gradually with changes in overall market values.)
- Market capitalization must be between $30 million and $300 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.
- No financial stocks or limited partnerships will be purchased.
- No stocks on foreign exchanges or ADRs will be purchased because of different accounting and/or withholding tax on dividends.
- 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.
- Market capitalization goes above three times the initial maximum criterion.

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 four 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.
- For NASDAQ stocks, it appears to be better to use day orders. If the order is not filled, it is placed again with a slight adjustment. For NYSE and Amex stocks, good-till-canceled (GTC) orders are used to keep a place in line in the specialists' books. If the market isn't close to the desired price, the price is adjusted 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, stocks 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 new purchases, the excess receipts—up to 5% of the portfolio's value—are kept in cash until the next quarter. If the excess receipts are greater than 5% of the total portfolio value, the amount above 5% is distributed to smaller holdings that still qualify as buys. Efficient quantities are purchased: If over 10% of the portfolio is in cash, the price-to-book-value ratio can be moved up, but never over 0.90.
- At the end of a quarter, if receipts from stock sales are insufficient to buy all newly qualifying stocks, purchases are made in order of lowest bid/ask spreads.
- 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. Fourth-Quarter 2013 Transactions

Company	Reason
Buy	
Five Star Quality Care, Inc. (FVE)	
Purchased Additional Shares With Excess Cash	
LMI Aerospace, Inc. (LMIA)	
Sell	
Addus Homecare Corp. (ADUS)	exceeded value limit
Fab Universal Corp. (FU)	allegations of fraud & corporate misconduct

guidelines.

First, when we announce a purchase, enough AAII members may try to buy the stock that it moves the price up. This tends to even out and a little patience is usually rewarded. But as pointed out in the portfolio rules, you should not buy the stock if the price-to-book-value ratio goes higher than 0.80 (if there is a shortage of eligible stocks or you already have some of the stock, it is acceptable buy at a price-to-book-value ratio as high as 0.90). You can check the current price-to-book-value ratio in the Actual Portfolio table at the Model Shadow Stock Portfolio page on AAII.com, where the figures are updated in real time (go to www.aaii.com/model-portfolios/stock).

Second, you should also check the news about the stock to make sure a negative earnings or other disqualifying report did not come out between our purchase date and the date when you are buying. Yahoo! Finance (finance.yahoo.com) or your broker's website will list such news items. News can push the stock price up or down. If the stock is violating one of the buy rules, do not buy it. If it is not clear what the impact of the news item (tender offer, class-action lawsuit, etc.) will be, avoid the stock. Bad things will occasionally happen, but they tend to be offset by unexpected good things and a diversified portfolio reduces shocks significantly.

Table 3. Model Shadow Stock Portfolio: Annual Performance

	Average Annual Return (%)			Cumulative Value 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
YTD	55.6	29.0	34.2	329,136	61,467	80,887
Since Incep	**18.2**	**9.1**	**10.5**	**329,136**	**61,467**	**80,887**

Data as of 11/30/2013.

Rule Change

Due to the impact that the bull market is having on the overall market capitalization of stocks, we are increasing the maximum market cap buy criterion to $300 million.

This raises our selling point to $900 million (three times the initial maximum) and our warning level to $750 million (two and a half times the initial maximum).

Portfolio Changes

Table 1 shows the current holdings in the Model Stock Portfolio.

We sold Fab Universal on an emergency basis due to uncertainty about the validity of their data. In the past, we have eliminated Chinese stocks; in the future, we will eliminate U.S.-based companies whose main business is in China as well.

We also sold Addus Homecare Corp. (ADUS) because it went over the price-to-book limit of 2.40 (three times the initial criterion of 0.80) and is no longer a value stock.

We bought Five Star Quality Care Inc. (FVE) and added to our holding of LMI Aerospace Inc. (LMIA), which still qualified, because we had excess funds and did not have enough cash to buy a full position in September when it was initially added to the portfolio.

Because of the increase in the permissible market cap to $300 million, (raising the sell requirement to $900 million), we did not have to sell Standard Motor Products (SMP) this month.

Changes are summarized in Table 2.

Looking Ahead

As of this writing, we now know

President Obama's choice for Federal Reserve chairman, and the first reduction in quantitative easing (the Fed's bond-buying program) was announced just before we went to press. Many gurus believe the stock market will weaken with the tapering of quantitative easing because of investors switching from stocks to bonds. Given that continued tapering will depend on a strengthening economy, any hit to the stock market should be short-lived, particularly if earnings continue to be strong.

The election cycle indicator has been so far off the mark lately that I hesitate to even mention it, but the second year in the cycle (2014) has historically been slightly below the overall average at 11.5%. However, 2013 would have been up only 6.7% based on the first-year election cycle average since 1935, so I wouldn't take the cycle indicator too seriously.

The next column on the Model Shadow Stock Portfolio will be in the April *AAII Journal*. In the meantime, you can follow updates at AAII.com and through the AAII Model Portfolios Update email (sign up at www.aaii.com/email).

Happy New Year! ▲

James B. Cloonan is founder and chairman of AAII.

Trading Strategies

(continued from page 24)

pen and that could happen is already factored into prices. The markets discount everything.

Lastly, when performing trend analysis it's important to always be cognizant of one of the main tenets of Dow Theory, "trends exist until a definitive signal proves that they have ended." Dow Theory advises us to always assume that the trend is likely to continue until the weight of evidence dictates otherwise. The final question, of course, is: How much weight is enough to make an early but accurate call of a continuation or reversal of an established trend? This is where the relevancy and weighting of the evidence comes into play, and these are ultimately dependent on the experience and abilities of each individual investor. ▲

Ray Rondeau is president of the Boston AAII chapter and a member of the Market Technicians Association. Additionally, he is a former analyst for the website IndexUniverse where he wrote a weekly technical analysis column. For more on the author, go to www.aaii.com/authors/ray-rondeau.

Insurance Products and Annuities

(continued from page 28)

expenses, adding long-term care insurance premiums to the mix would not be advisable in most cases.

However, if you're reading this publication, chances are you're interested in investing wisely and having enough money to cover your expenses. Don't let the third act of your life play out in a different way than it could—or frankly should—by not factoring into your planning the potential costs of long-term care. ▲

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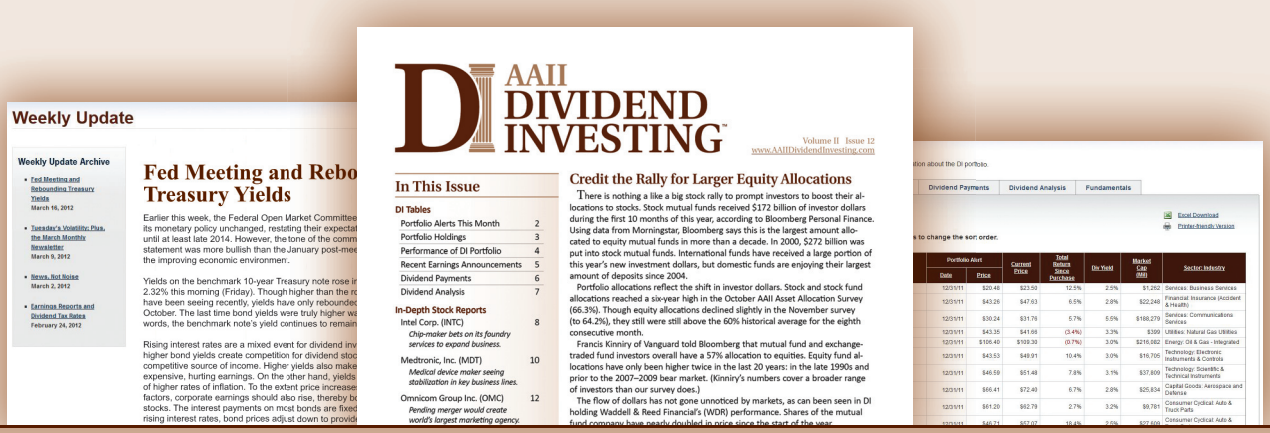

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