

VALIDEA.COM

# **2009 GURU PORTFOLIO PERFORMANCE REPORT**

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REVIEW AND ANALYSIS OF VALIDEA'S  
GURU-BASED MODEL PORTFOLIOS

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# GURU PORTFOLIO PERFORMANCE REPORT

## REVIEW AND ANALYSIS OF VALIDEA'S GURU-BASED MODEL PORTFOLIOS

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### 2009 MARKET OVERVIEW

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The contrast between the stock market at the start of 2009 and at the end of 2009 was about as stark as it gets, and not just in terms of price level. When the year started, fears of financial Armageddon hovered over equities. The banking system was still in the throes of crisis, with several of the biggest players getting government bailouts that were measured in billions. The housing market continued to weaken, with prices and sales plummeting with each new report. Corporations were cutting back on both employees and inventory, and manufacturing levels were falling to the lowest levels in decades.

Amid this fear-dominated climate, stocks quickly gave up the gains they'd made in the past six weeks of 2008, losing close to 30% through early March -- and that was after they'd lost almost 40% the previous year.

But in March's second week, the pendulum swung, and it swung quickly and dramatically. News that troubled financials like Citigroup and General Electric's finance arm were on track to post first-quarter profits signaled that the economy wasn't going to collapse. The American consumer showed some resiliency, with new data indicating that retail sales declined significantly less than expected in February. And, perhaps most importantly, the government announced a \$1 trillion plan to buy up Treasury bonds and mortgage-backed securities as a way to free up the frozen credit markets. Finally, lights were appearing at the end of a very dark tunnel, and the stock market responded.

Stocks surged, with the S&P 500 gaining about 65% from its March low through the end of the year, and the Nasdaq Composite jumping close to 80% over that span. Along the way, they were helped by the Federal Reserve, which kept interest rates at or near historically low levels, and the federal government, whose \$787 billion stimulus plan began to unfold as the year wore on. The economy began to grow again, and manufacturing, industrial, and housing data all turned around and showed sustained upward trends through the end of the year. By the time 2009 had finished, analysts and pundits were debating how strong the recovery would end up being -- a far cry from the "Is America Doomed" debates that dominated the news a year earlier.

All in all, stocks enjoyed one of their best years in some time, with the S&P 500 gaining 23.5% for the full year. Validea's guru-based portfolios in general fared much better. All but three of our 14 ten-stock portfolios beat the market, with all 11 of those market-beaters returning more than 30%. Of our 14 twenty-stock portfolios, 12 beat the market.

The 10-stock portfolios on average returned 36.4%, almost 13 percentage points more than the broader market. The Joel Greenblatt-inspired model was the top performer, gaining 63.1% for the year (vs. 23.5% for the S&P 500); the worst performer was the Joseph Piotroski-based portfolio, which gained 6.8%.

The 20-stock portfolios, meanwhile, averaged a 36.1% return. The Peter Lynch-based model led the way, generating a 62.3% return. The worst 20-stock performer: Our Momentum Investor approach, which lost 1.2% as market leadership shifted swiftly and strongly after the March 9 low.

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## TOP 2009 VALUE STRATEGIES

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### The Benjamin Graham Strategy

The Graham approach is based on the oldest strategy of all those that inspired my guru-based models, drawing on the stock-picking advice Graham laid out in his 1949 classic *The Intelligent Investor*. But while it may be six decades old, 2009 was another example of just how timeless Graham's value-centric approach is. The 10-stock Graham-based portfolio gained 31.4% for the year, while the 20-stock version jumped 36.5%, both handily beating the S&P 500's 23.5% return. The strong year left the 10-stock Graham portfolio up 154.2% (15.5% annualized) from its July 2003 inception through the end of 2009, and the 20-stock version up 177.6% (17.1% annualized). Both figures rank #1 in their respective groups. In the same period, the S&P has returned a total of 11.5%, or 1.7% annually.

The Graham model reflects the conservative approach that Graham -- called the "Father of Value Investing" -- used. Having lived first through his own family's financial woes and then through the Great Depression, Graham focused as much on preserving capital as he did on generating big gains. He thus used some rigorous balance sheet tests to assess a businesses in which he was looking to invest. For example, my Graham-based model requires that a company have a current ratio (that is, current assets/current liabilities) of at least 2.0, a sign of strong liquidity. It also requires that a firm's long-term debt be no greater than the value of its net current assets.

Those requirements helped the Graham approach find financially stable companies during the financial crisis, allowing it to minimize losses in what was a dreadful year for stocks. In 2009, as fears subsided, the model's strict valuation metrics helped it target the best buys in a rejuvenated market. The strategy looks at a stock's price/earnings ratio using both trailing 12-month earnings and three-year average earnings; neither P/E can be greater than 15. It also requires that the product of a stock's P/E and price/book ratio be no greater than 22.

Those criteria helped the strategy find some great bargains that surged as the market rebounded, including The Dress Barn (which gained more than 70% while in the 10-stock portfolio from Jan. 23-April 17), Schnitzer Steel (up more than 65% from Jan. 17-June12), and Jos. A. Bank Clothiers (up 66.9% during its Feb. 20-April 17 stint). It was particularly successful in the retail/consumer discretionary arena, no surprise given that that was one of the places hit hardest during the downturn, creating a wide variety of bargains.

The results of the past two years -- one of which involved a historically bad bear market, the other which included one of the best rallies ever -- shows that Graham's approach can still protect capital when times get tough, and also outperform during bull markets. That's something a myriad of strategists have tried -- and failed -- to do in the decades since Graham was managing money, another example of just how great and lasting Graham's legacy is.

## The Joel Greenblatt Strategy

The Greenblatt strategy enjoyed an excellent debut on Validea.com in 2009, with the 10-stock portfolio gaining 63.1% and the 20-stock version gaining 58.6% -- both more than doubling the S&P 500's 23.5% return for the year. The smaller portfolio was actually the best performer in the 10-stock class, while the larger portfolio came in second among our 20-stock portfolios.

The Greenblatt-based model is based on the "Magic Formula" approach that Greenblatt, a highly successful hedge fund manager, disclosed in *The Little Book that Beats The Market*. The two-variable formula is proof that while beating the market is hard, it doesn't have to be complicated.

The first variable the Greenblatt approach examines is earnings yield. Typically, earnings yield is calculated by dividing a company's trailing 12-month earnings per share by its current price per share -- the earnings-price (E/P) ratio, which is essentially the inverse of the P/E ratio. Greenblatt makes some slight adjustments here, however. First, he uses *earnings before interest and taxes* (EBIT) rather than simple earnings. The rationale: Failing to take debt payments and taxes into account can obscure the real health of a business. Second, he divides EBIT not by price but by "enterprise value," which includes not only the price of the company's shares, but also the amount of debt it uses to generate earnings. Here, you are really measuring how much of a return, or yield, you could expect to get if you were to buy the whole business -- including all of its debt. Looking at a simple E/P ratio can be misleading, Greenblatt says, because it doesn't take that debt into account. (In my model, I calculate earnings yield in the same method that Greenblatt lays out).

The other variable this strategy uses: return on capital. This allows you to see how well a business is using what it has to generate profits. Rather than using a company's reported earnings, as is usually done when calculating return on assets, Greenblatt again uses EBIT, so that debt levels and tax rates don't obscure the actual performance of a firm's operating business.

Greenblatt also doesn't divide the earnings portion of the equation by total assets, as is done when calculating ROA. Instead, he divides it by "tangible capital employed," which is equal to net working capital plus net fixed assets. That is a better way to see how much money the company needs to conduct its business, he explains. In my Greenblatt-based strategy, I calculate return on capital in the same ways that Greenblatt does.

While 2009 was the first year our Greenblatt-based approach was included on Validea.com, we've been tracking it internally for several years, and its long-term track record is excellent. Since their inceptions in December 2005, the 10- and 20-stock Greenblatt-based portfolios have produced annualized returns of 10.6% and 7.7%. Over the same period, the S&P has *declined* at a rate of 2.6% per year.

In 2009, the strategy really excelled after the market bottomed in March. The 10-stock portfolio found big winners in stocks like The McGraw-Hill Companies and Heartland Payment Systems, which gained 55.8% and 50.8%, respectively, while held from March 20-April 17. The strategy continued to find winners throughout the rest of '09, including HerbaLife Ltd., which gained 67.6% while in the 10-stock portfolio from mid-April through mid-June, and LHC Group, which surged 55.1% from mid-June through late December.

While the Greenblatt method employed a simple approach to find those big winners, don't be fooled into thinking it's a simple strategy to follow. Greenblatt strongly stresses discipline in his writings, saying that you need to stick to the "magic" formula through tough times in order to snatch up the great bargains it eventually uncovers. I agree, and 2009 was a great example of just that. Many

who had bailed early in the year when the market was falling missed out on the great profits that others who stuck to their long-term strategies reaped when the bullish turn came.

### **The Warren Buffett Strategy**

Based on the most famous -- and perhaps greatest -- investing guru of all, the Buffett-based approach lived up to its namesake in 2009. The 10-stock Buffett-inspired portfolio gained 50.3%, more than doubling the S&P 500's 23.5% rise, and the 20-stock portfolio also far outpaced the index, gaining 35.9%.

The Buffett model is based on the book *Buffettology*, written by Buffett's former daughter-in-law Mary Buffett, who worked closely with "The Oracle of Omaha". It is one of my most rigorous approaches, digging a full decade back into a firm's history to make sure it has the track record worthy of a Buffett-type pick. For example, the model requires that a company have produced an average return on equity of at least 15% over the past 10 years, with none of those years coming in below 10%. It also targets firms that have upped earnings per share in every year of the past decade, and those that have 10-year average returns on total capital of at least 12%.

The Buffett-based model also looks for stocks with strong balance sheets. It requires that a company have enough annual earnings that it could, if need be, pay off all debt within five years, and preferably within two years.

In 2009, those strenuous tests helped the Buffett-based portfolios turn up a number of strong stocks that had been beaten down during the bear market. Among them were Russian telecom Mobile Telesystems OJSC, which jumped 85.8% while in the 10-stock portfolio from Feb. 20-June 12. GPS giant Garmin also gained more than 50% after being added to the portfolio (where it would stay the entire year) in March. And Infosys Technologies surged more than 55% while in the portfolio from July 10-December 24.

The Buffett-based approach also enjoyed an extremely accurate year. The 10-stock portfolio made money on 70.8% of its picks, the best of any of my individual guru 10-stock portfolios. The 20-stock version, meanwhile, made hay on 69.2% of the stocks it bought, ranking second-best of all my individual guru 20-stock portfolios.

The 10-stock Buffett-based portfolio's big 2009 followed two underperforming years, and put the portfolio well ahead of the broader market for the long haul. From its December 2003 inception through the end of 2009, the portfolio gained 23.8%. While that's not as big a return as some of my other models, it was still more than quadruple what the S&P 500 returned in that time (5.0%). The 20-stock portfolio hasn't fared as well, returning 3.9% since inception compared to that 5.0% figure for the S&P. Given the strategy's rigorous criteria, however, I expect that over the longer-term it will outperform the broader market.

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## TOP 2009 GROWTH STRATEGIES

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### **The Motley Fool Strategy**

Based on the writings of brothers Tom and David Gardner, creators of The Motley Fool investment newsletter, The Fool-based strategy in 2009 continued to build on its exceptional long-term track record. While no strategy will beat the market every year, the 10-stock Fool-inspired portfolio is trying its best to do so, easily outpacing the S&P 500 for the seventh straight year (including the partial 2003 year). Its 38.5% return beat the S&P by 15 percentage points, making the portfolio the only one of Validea.com's original portfolios to beat the market every year since inception. The 20-stock portfolio also fared well, gaining 25.9% for the year.

The Gardners' laid out their approach in the *Motley Fool Investment Guide: How the Fools Beat Wall Street's Wise Men and How You Can Too*, the book I used to develop my Small-Cap Growth Investor strategy. The approach centers on finding the stocks of small, fast-growing companies that have solid fundamentals. Healthy profit margins, low debt, strong cash flows, and good research and development budgets are all important to the strategy, which also uses the Price/Earnings/Growth ratio to help avoid fast-growing but overpriced stocks.

The Fool approach found a number of winners in 2009, many of which produced substantial gains while in the portfolios for brief periods. The 10-stock portfolio, for example, benefited from a 37.3% gain by American Science & Engineering, which it held from mid-March to mid-June, and a 36.9% gain by Marvel Entertainment (March 20-May15).

The Fool-based 10-stock portfolio also found winners in a number of foreign stocks, particularly Chinese stocks. Fuqi International, a Chinese jeweler, gained 58.3% in a two-month stay in the portfolio; VisionChina Media gained 24% in just one month; and Sohu.com jumped 21.7% in one month.

Over the long-term, the 10-stock Fool-based portfolio has not only beaten the market each year since inception; it has also done so by a very wide margin. It has outperformed the S&P by at least 6.6 percentage points every year, and through the end of 2009 it had returned 151.5% (15.3% annualized) vs. 11.5% (1.7% annualized) for the S&P 500. The 20-stock portfolio hasn't performed as well, but it has still easily beaten the market over the long haul, returning 61.8% (7.7% annualized) vs. those same S&P figures.

### **The Peter Lynch Strategy**

The Lynch-based model had a very strong bounce-back year in 2009, with the 10-stock portfolio jumping 45.7% and the 20-stock version surging 62.3%, the best performance of any of our 20-stock portfolios.

Lynch is known as something of a growth investor, but his methodology is really a growth/value blend. He pioneered the use of the P/E/Growth ratio -- a value metric -- as a way to find growth stocks selling on the cheap. The P/E/G divides a stock's price/earnings ratio by its historical growth rate; the model I base on Lynch's writings looks for P/E/Gs below 1.0, and really likes stocks whose

P/E/Gs are below 0.5. The method also looks for stocks with solid financing (debt/equity ratios can't be greater than 80%), decreasing inventory/sales ratios, and lots of cash on hand.

Given that the P/E/G brings a major value component to the Lynch approach, it's not surprising that the Lynch-based portfolios found a number of bargains in the wake of the market meltdown of late 2008 and early 2009. Among the big winners in '09 were health insurer Humana, which joined the 10-stock portfolio in mid-April and gained more than 50% through the end of the year; Comtech Telecomm. Corp., which jumped 51.7% while in the portfolio from March 20-Oct. 2; Deckers Outdoor Corporation, which gained 46.2% in just one month; and SPSS Inc., a software maker that gained 61% during its one-month stint in the portfolio. (The Lynch-based model wasn't the only one who liked SPSS -- IBM acquired the firm just a few weeks after the Lynch portfolio bought the stock.)

The 20-stock Lynch portfolio found several of the same winners, as well as a huge 178.2% gainer in Discover Financial Services, which it held from March 20-Oct. 2.

Both Lynch-based portfolios have excelled over the long term, with the 10-stock version gaining 79.3% (vs. 11.5% for the S&P 500) from its July 2003 inception through the end of 2009. The 20-stock version has been even better, gaining 148.9% over the same period. The larger portfolio has beaten the index in every year except 2007, when it returned 1.1% and the S&P gained 3.5%.

While the 20-stock portfolio beat the 10-stock portfolio in what turned out to be a very strong 2009 for the broader market, it also provided more downside protection in both 2008 and 2007, posting positive returns in '07 and beating the S&P by almost 5 percentage points in 2008.

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## 2009 CONSENSUS STRATEGIES

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### **The Top 5 Gurus Strategy**

After beating the S&P 500 by 7.5 percentage points in a rough 2008, the Top 5 Gurus Strategy had an excellent 2009 as the market roared back. The 10-stock portfolio more than doubled the market's gains, jumping 55.3%. The 20-stock version also fared very well, returning 37.2% for the year.

The Top 5 Gurus approach takes the five strategies that have the best historical risk-adjusted performance and selects each of those models' two highest-rated stocks (or four highest stocks, in the case of the 20-stock portfolio). This consensus-based approach has a very strong long-term history, with the 10-stock portfolio gaining 128.5% from its July 2003 inception through the end of 2009, compared to the S&P's 11.5% gain in that time. The 20-stock portfolio also easily beat the index, gaining 76.5% in the same timeframe.

The 10-stock Top 5 Gurus portfolio was remarkably accurate in '09, making money on 72.3% of its picks, the best rate of any of my 10-stock portfolios. The 20-stock version was accurate on 62.3% of its purchases.

Within those money-making picks were several big gainers, including Petroleum Development Corporation, which jumped 47.7% during a two-month stint in the 10-stock portfolio. Jos. A. Bank Clothiers, which the portfolio picked up less than a week before the start of '09, gained more than 50% by the time it was sold in mid-April; Deckers Outdoor Corporation gained 46.2% in a month;

Pre-Paid Legal Services jumped more than 30% in two months; and Net 1 UEPS Technologies surged 34.5% in three months.

While not quite as accurate as its 10-stock cousin, the 20-stock portfolio found some even bigger individual winners in '09. Among them: Garmin Ltd., a 61.1% gainer, and Banco Bilbao Vizcaya Argentaria, a 56.7% gainer.

### **The Validea Hot List**

Our flagship portfolio had a big year in 2009. The 10-stock Hot List portfolio jumped 47%, doubling the S&P 500's return and increasing its already sizeable long-term lead over the index. The 20-stock Hot List portfolio also fared well, gaining 43.3%.

The Hot List is a consensus approach that identifies the top stocks in the market using a blend of all my individual guru strategies, giving more weight to those models that have had the best risk-adjusted historical results. By looking for overlap among these proven, diverse individual strategies, the Hot List limits the amount of risk that it's susceptible to should one particular approach go out of style for a period. And, by using a varied group of models that focus on a wide array of fundamentals, it is designed to pick only the most fundamentally sound stocks in the market.

The approach has worked quite well over the longer term. At the end of 2009, the 10-stock Hot List portfolio was up 141% since its July 2003 inception, more than 12 times the gain of the S&P. The 20-stock portfolio was up a total of 112.1% over the same period, notching almost 10-fold the gains of the S&P.

In 2009, the Hot List found winners in a number of areas. Retail and consumer discretionary-type stocks treated it particularly well as the market bounced off its March lows -- Jos. A. Bank Clothiers gained 78.2% while in the 10-stock portfolio from Feb. 20-Oct. 2; The Dress Barn jumped 70.1% from Jan. 23-April 17; Chinese jeweler Fuqi International rose 64.1% in a three-month span; and Deckers Outdoor Corporation gained 46.2% in a one-month stint in the portfolio.

The Hot List also found big winners in commodity-related stocks in 2009. Schnitzer Steel jumped 65.9% in its five months in the portfolio, for example, and Oil States International gained 59.3% from March 20-May 15.

### **Looking Ahead**

As we move into 2010, a number of factors are painting a good picture for the stock market. While valuations aren't as low as they were in early 2009, they are by no means outlandish. The economy is steadying itself, and, while it benefited from government stimulus in 2009, huge amounts of that stimulus money have yet to make their way into the system. Interest rates remain at such low levels that even if the Federal Reserve raises rates a bit, Treasuries and other fixed income investments likely won't offer anywhere near the upside gains that stocks will.

Of course, the economy is still working through a number of issues. The housing market remains a big question mark, unemployment is high, and it's still not totally clear how healthy some of the big financial firms are. A number of top strategists are saying we'll see a correction in 2010, and they may well be right.

A number of top strategists are also saying we're seeing a shift in market leadership as we move into the new year. In 2009, so-called "junk" stocks -- those with poor fundamentals and weak balance sheets -- led the rally. That's no surprise; such stocks tend to get hit hardest during financial crises like the one we've just been through, since they are most likely to go out of business when times get very tough. Their stock prices plunge -- sometimes too far. When the fears subside and investors realize many of those "junk" stocks will survive, however, they pour back into the Armageddon-priced shares.

But such junk rallies don't last forever. Eventually, quality will be rewarded, and we're already seeing signs of a return to quality in recent months. That bodes well for my guru-based approaches, since they target the most fundamentally sound, financially secure stocks in the market. If quality is indeed rewarded in 2010, these strategies should excel. And, over the long haul, I expect that they'll continue to generate returns that well outpace the broader market.

*\*For the historical performance of Validea's 10-stock model portfolios, please see the accompanying table on the next page. The 10 and 20-stock guru portfolios can be accessed in real-time with updated performance on [Validea's Model Portfolio page](#).*

## VALIDEA'S MODEL PERFORMANCE CHART

10-Stock, Monthly Rebalanced Model Portfolios		Annual Portfolio Return (excluding dividends)							Risk
Portfolio	Based on Book by or About	2003	2004	2005	2006	2007	2008	2009	Beta
Value Investor	Benjamin Graham	45.1%	21.5%	10.4%	26.0%	-8.1%	-14.1%	31.4%	1.20
Price/Sales Investor	Kenneth Fisher	30.7%	26.0%	-2.7%	40.0%	19.1%	-36.9%	30.2%	1.22
Small-Cap Growth Investor	Motley Fool	19.8%	22.5%	9.6%	22.2%	23.3%	-25.0%	38.5%	1.05
Growth Investor	Martin Zweig	32.1%	54.8%	5.8%	17.3%	5.2%	-48.5%	14.3%	1.04
Contrarian Investor	David Dreman	36.2%	30.0%	18.4%	34.3%	-12.0%	-54.9%	37.6%	1.26
Growth/Value Investor	James P. O'Shaughnessy	51.6%	1.0%	22.4%	24.0%	-3.9%	-46.8%	32.0%	0.99
P/E/Growth Investor	Peter Lynch	39.6%	34.7%	8.4%	23.3%	-13.5%	-43.4%	45.7%	1.13
Patient Investor	Warren Buffett	2.0%	37.3%	-4.6%	16.5%	-12.2%	-39.8%	50.3%	1.08
Momentum Investor	Validea	31.6%	5.9%	13.7%	-15.2%	37.0%	-45.0%	12.5%	0.96
Book/Market Investor	Joseph Piotroski	N/A	39.9%	9.0%	17.9%	-4.9%	-37.3%	6.8%	1.38
Low PE Investor	John Neff	N/A	21.2%	15.1%	22.3%	-1.9%	-48.4%	45.4%	1.19
Earnings Yield Investor	Joel Greenblatt	N/A	N/A	-2.8%	14.4%	9.1%	-26.3%	63.1%	1.02
Validea Hot List	Validea/Consensus Model	56.9%	23.5%	14.5%	28.5%	-11.6%	-35.0%	47.0%	1.18
Top Five Gurus	Validea/Consensus Model	46.4%	29.5%	8.8%	-2.1%	5.5%	-31.0%	55.3%	1.07
S&P 500	N/A	11.1%	9.0%	3.0%	13.6%	3.5%	-38.5%	23.5%	1.00

- All Models except for and Earnings Yield Investor, Book/Market Investor, Low PE Investor, Patient Investor portfolios began on July 15th, 2003. Inception Dates for: Earnings Yield Investor (12/2/2005), Book/Market Investor (2/27/2004), Low PE Investor (1/2/2004) and Patient Investor (12/5/2003)
- All Models based on 10-stock portfolios that are rebalanced monthly. Rebalancing occurs once every 28 days and constructs an equally weighted portfolio.
- Validea Hot List and Top Five Guru Models are based on a blend of individual guru models.
- Returns do not include dividends or transaction costs.

The names of individual investment advisors (i.e., the 'gurus') appearing in this list and on Validea.com are for identification purposes of his methodology only, as derived by Validea.com from published sources, and are not intended to suggest or imply any affiliation with or endorsement or even agreement with our reports personally by such gurus, or any knowledge or approval by such persons of the content of our site. As with any investment strategy, there is potential for profit as well as the possibility of loss and investors may incur a loss despite a past history of gains. Results will vary with economic and market conditions. The information contained within this report and throughout Validea.com is not investment advice. Please consult a financial professional before investing.