VALIDEA

2008 GURU PORTFOLIO PERFORMANCE REPORT

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

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2008 MARKET OVERVIEW

The past year was one of the worst in the history of the U.S. stock market. While investors and analysts entered 2008 hoping that the subprime mortgage mess could be contained, it quickly became clear that the problem's tentacles reached much farther than many thought. First came the demise of one of the nation's most well-known financial firms, Bear Stearns, in March, and by summer the billion-dollar writedowns were pouring in and IndyMac Bank had become the fourth-largest bank to fail in U.S. history. The economic woes really spilled over in September, as mortgage lenders Freddie Mac and Fannie Mae were taken over by the federal government, Lehman Brothers collapsed, and Merrill Lynch was sold in a fire sale. As the credit markets froze, only massive injections of federal money kept other financial titans -- including the country's largest insurer, AIG, and one of its largest banks, Citigroup -- from similar fates.

The credit crisis' September implosion sent stocks tumbling amid unprecedented volatility, pushing the stock market into the worst bear market since the Great Depression. It became evident that the credit crisis was not a short-term event, but instead the culmination of years and years of ramped-up leverage that allowed both corporations and consumers to live beyond their means. The bursting of the credit bubble and disappearance of "easy money" left banks hoarding cash and investors scrambling for whatever cash they could get their hands on. That hastened the market sell-off, with individual and institutional investors -- particularly large hedge funds -- selling whatever they could, including quality stocks, to scrounge up cash.

Even with a strong bounce-back over the past month-and-a-half of the year, the final numbers for 2008 were sobering: The S&P 500 ended the year down 38.5 percent, the Dow Jones Industrial Average fell almost 34 percent, and the Nasdaq Composite lost more than 40 percent of its value.

Many of our models were also hit hard. Nevertheless, operating in an extremely difficult environment for value strategies, half of our largely value-centric models outperformed the S&P 500. Our best performer, the Benjamin Graham-inspired Value Investor strategy, lost just 14.1 percent. Our worst performer for the year was the David Dreman-based Contrarian Investor strategy, which lost 54.9 percent. Still, all but one of our models (including the Dreman approach) remain well ahead of the S&P since their inceptions, with 11 posting positive returns during a period in which the S&P has been well in the red.

TOP 2008 VALUE STRATEGIES

The Benjamin Graham Strategy

While the broader market tumbled in 2008, the Graham strategy held up very well. It still lost ground -- 14.1 percent -- but those losses were a far cry from the broader indices 34 to 40 percent plunges. While the Graham model is based on the oldest strategy of all those that inspired my guru-based models, its 2008 performance was another example of Graham's continuing relevance today, almost 60 years after his classic *The Intelligent Investor* was published. From its July 15, 2003 inception through the end of 2008, the 10-stock Graham portfolio gained a total of almost 102 percent (13.7 percent annualized), making it the best performer of any of my strategies and far outpacing the S&P 500, which lost 6.9 percent (-1.3 percent annualized) in that time.

Part of the reason the Graham model fared so much better than the rest of the market in 2008 was that its strict value criteria essentially eliminate financial stocks from consideration. For example, the model requires that a company have a current ratio (that is, the ratio of its current assets to its current liabilities) of at least 2.0, and that its long-term debt be no greater than the value of its net current assets. Since most financial firms inherently carry a lot of debt because of the nature of their businesses, it is almost possible for most of them to pass the Graham strategy, so the model was shielded from one of the worst parts of the market in 2008.

The Graham model found big values in a couple areas during the year, especially retail. Jos. A. Bank Clothiers (+22 percent), Citi Trends (+25 percent), and The Dress Barn (+17 percent), all netted the portfolio some strong gains. It also had success with a retail financial firm, First Cash Financial Services, which gained 28 percent while the model held it (First Cash specializes in pawn services, so it was able to meet the Graham model's criteria because it had collateral to back up its debt). Not all retailers succeeded, however. The Men's Wearhouse, for example, plunged 53 percent over the ten months the Graham portfolio held it.

Another area in which the Graham-based model found big winners: business services. CRA International surged more than 40 percent during its three-month stint in the portfolio, and TrueBlue gained more than 20 percent over a three-month period.

The Graham model did, however, latch on to some value traps in the industrial and basic materials areas of the market. It sustained significant losses on stocks like chemical producer Ashland, Reliance Steel & Aluminum, metal manufacturer Mueller Industries, and rubber/plastic maker Carlisle Companies.

The Kenneth Fisher Strategy

My Fisher-based Price/Sales Investor model entered 2008 coming off two exceptional years, having gained 40 percent (three times the S&P 500) in 2006 and 19.1 percent (more than five times the S&P) in 2007. Things looked good again through much

of 2008, but when the market crashed in the early fall, the Fisher model was hit particularly hard. For the year, the 10-stock portfolio still ended up ahead of the broader market, losing 36.9 percent compared to the S&P 500's 38.5 percent plunge. From its inception in July 2003 through 2008, the portfolio gained 76.15 percent while the S&P declined 6.86 percent, making it my third most successful strategy.

The Fisher model centers on the Price/Sales-focused approach Fisher laid out in his book *Super Stocks*. While the Price/Earnings ratio is probably the most well-known financial variable used by investors, Fisher found that earnings, even for good companies, can be highly volatile. Changes in accounting rules, the amount of research and development a company does, tax rates, and many other areas can affect earnings from year to year or quarter to quarter. But, Fisher found, sales rarely decline for top-flight businesses.

As a result, a company with troubled earnings but strong sales is a company Fisher may well want to own. If a company has a low Price/Sales Ratio (PSR), a slight improvement in margins can produce a big gain in earnings (and a big gain in stock price).

That approach had a lot of success in the first part of the year, with the portfolio making gains in six of the first eight months of 2008 as it found winners like Xyratex Ltd. (up 21 percent from late January through mid-April); CRA International (up almost 20 percent from March to April); Phillips-Van Heusen (a 20 percent gainer in July and August); Tennant Company (up 25 percent from July to September); and Jos. A. Bank (a 27 percent gainer in the same period). But later in the year, the portfolio took major hits on Abercrombie & Fitch (down 33 percent in November); Movado Group (down 43 percent in November and December); and Oil States International (down 21 percent in October). Longer-term holdings that had been in the black earlier in the year -- like Men's Wearhouse, Brush Engineered Material, and Skechers -- were also hit hard. But following the tough September-November period, the portfolio rebounded with a 6.6 percent gain in December. The major price declines we've seen make for fertile ground for the value-based Fisher model, and this proven winner should see strong bounce-back gains in coming years.

The Joel Greenblatt Strategy

In 2009, Validea will be adding a new Guru Strategy to its web site, a model based on the "Magic Formula" approach that hedge fund manager Joel Greenblatt disclosed in *The Little Book that Beats The Market*. While '09 will be the first year the strategy is available on Validea.com, we've been tracking it internally for several years. Like Greenblatt, we're finding that the strategy is indeed a market-beater. While the S&P 500 lost 26.3 percent from December 2005 (the Greenblatt portfolio's inception) through the end of 2008, the 10-stock Greenblatt-based "Earnings Yield" portfolio lost a total of 8.5 percent. In fact, the strategy has beaten the market in each of the past three years. In 2008, while the S&P 500 plunged 38.5 percent, this "Earnings Yield Investor" strategy had a much less severe loss of 26.3 percent. It also beat the market and posted positive returns in both 2007 (+9.1 percent vs. the S&P's +3.5 percent) and 2006 (+14.4 percent to +13.6 percent).

Greenblatt's approach is proof that, while beating the market is hard, it doesn't have to be complicated. His "Magic Formula" includes just two variables: earnings yield and return on capital.

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).

When it comes to return on capital -- which is similar to the more commonly used return on assets rate -- Greenblatt is concerned primarily with a company's underlying business. He wants to see how well that 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, he thus 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 in his book.

The final part of the strategy simply involves ranking all stocks by earnings yield and by return on capital. The stock with the best earnings yield gets a "1" in that category, for example; the same for the best stock in terms of return on capital. The model then adds a stock's earnings yield ranking to its return on capital ranking to get a total ranking. The ten stocks with the lowest combined numerical ranking make it into the portfolio.

One crucial, non-quantitative note about this approach: While Greenblatt's back-testing found that the "Magic Formula" produced excellent returns (30.8 percent per year from 1988 through 2004, about two-and-a-half times the S&P 500's 12.4 percent gain), he also found that it doesn't beat the market every year -- and that's precisely why it works. The approach focuses on buying stocks of quality companies at low prices, and the reason you can get those low prices are that most investors abandon the strategy in market-lagging years. That lowers demand and means that you can then scoop up great stocks on the cheap, and over the long haul that should result in major market-beating gains. It takes discipline, but the long-term results are worth any short-term pain.

2008 GROWTH STRATEGIES

The Motley Fool Strategy

Tom and David Gardner, creators of The Motley Fool investment newsletter, are known for their irreverent senses of humor. But the brothers' real appeal to investors shouldn't be their humor; it should be their solid stock-picking strategy.

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*. I used that book to create my Small-Cap Growth Investor Strategy more than five years ago, and since then I've had excellent results. The strategy continued to outperform the broader market during the difficult year of 2008, losing 25 percent while the S&P 500 tumbled 38.5 percent. The Fool strategy remains one of my best performers over the long haul. From its July 2003 inception through the end of 2008, the 10-stock Fool-based portfolio gained 83.6 percent (11.7 percent annualized), while the S&P 500 fell 6.86 percent (-1.29 percent annualized).

While no strategy will beat the market every year, my Fool-based approach has yet to run into a market-lagging year. In fact, it's the only one of my eight original models to beat the S&P 500 every year since its inception -- and the spreads have been significant. The portfolio's returns have exceeded the S&P's by at least 6.6 percentage points (and as many as 19.8) in every year.

The Fool 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. Because it is a growth strategy that focuses on small-capitalization stocks, the Fool approach tends to be one of my more volatile models. Its beta coming into 2008 was 1.45, fairly high compared to the broader market. Interestingly, however, the strategy's beta fell dramatically in 2008, and by year-end it was just 1.08 since inception. That signals that the portfolio was either significantly less volatile than the market during the year, or that it was significantly uncorrelated with the market.

The latter certainly seems to be part of the equation, as the Fool-based portfolio acted quite differently than the broader market during several periods over the past year. In December, for example, it surged 14.6 percent while the broader market was up just 0.78 percent. In May, it gained 11.4 percent while the S&P gained about 1.1 percent. And in March, it lost more than 7 percent while the S&P lost just 0.6 percent. Those discrepancies aren't too surprising, given the market's wild volatility and the strategy's focus on lesser-known, smaller stocks.

As you might expect with a small-cap-focused strategy, the Fool approach will find winners among stocks you've probably never heard of. In 2008, for example, AsiaInfo Holdings, a Chinese telecom software firm, gained 28 percent during its three months in the portfolio. Other big winners: True Religion Apparel, which gained almost 35 percent

in four months; The Buckle, another clothing retailer, which gained 23 percent over two months while in the portfolio; and Odyssey Re Holdings, which picked up 28 percent after being added to the portfolio in early October.

The Martin Zweig Strategy

In 2008, for the first year since its mid-2003 inception, the 10-stock portfolio picked using my Martin Zweig-based model lagged the market. For the year, the portfolio was down 48.5 percent, trailing the S&P 500 by 10 percentage points. The strategy took some big hits as the market crumbled in September and October, particularly in the tech sector. It lost 56 percent on Sapient Corporation from early September through late November, 43 percent on Research In Motion from early September to early October, and 30 percent on NetGear, which it picked up in early August and sold at the end of October.

The Zweig model did make some strong plays earlier in the year, however. Baldor Electric Company gained more than 20 percent during its three months in the portfolio; Hudson City Bancorp gained 18 percent in four months; and National Instruments Corp. gained 20 percent in two months. The strategy also rebounded in December, gaining 4.3 percent, led by BanColombia and its 15 percent gain from Nov. 28 through the end of the year.

The Zweig strategy targets stocks whose Price/Earnings ratios aren't too high or too low (Zweig believed a very low P/E wasn't necessarily a sign of a bargain, but potentially a sign of a weak company). It is heavily focused on earnings, looking for companies that have posted several years of strong profits that have been accelerating of late. In addition, it looks for companies that are generating profit growth without excessive use of leverage, targeting firms with debt/equity ratios that are lower than their industry average. For that reason, it is something of a "conservative growth investor" approach.

While it struggled in 2008, the Zweig-based model remains a top performer over the long haul. From its July 2003 inception through the end of 2008, it gained 41.24 percent, while the S&P 500 lost 6.86 percent. I expect it will bounce back strong, and continue to produce solid long-term results.

CONSENSUS STRATEGIES

The Top 5 Gurus Strategy

The Top 5 Gurus Strategy had a down year compared to its historical track record, but it still managed to beat the S&P 500 by a significant margin in 2008. The 10-stock

portfolio, which takes the five strategies that have the best historical risk-adjusted performance and selects each of those models' two highest-rated stocks, fell 31 percent for the year, while the S&P lost 38.5 percent. Despite the decline, the portfolio's long-term track record is still very solid. From its July 2003 inception through 2008, it gained 53.4 percent; during that same period, the S&P declined 6.86 percent.

As you might expect with a multi-guru model, the Top 5 Gurus approach finds value in a variety of areas in the market, and 2008 was no different. It found big winners in Insight Enterprises (a small-cap information/technology firm that gained 27 percent over a four-month period); TelMex Internacional (a Mexican telecom firm that gained 20 percent in the one month the portfolio held it); Baldor Electric Company (which gained 20 percent over three months); and Brush Engineered Material (which surged more than 28 percent in the one month it was in the portfolio.

The portfolio also picked up some big losers, too -- particularly when the market got extra rough in the fall. Koninklijke Philips Electronics fell 46 percent from early August to the end of October; Jos. A. Bank Clothiers fell 41 percent while in the portfolio from early October through late November; and Movado Group lost 43 percent from the end of October until it was sold in late December.

The Validea Hot List

Like the Top 5 Gurus portfolio, the Validea Hot List -- our flagship portfolio -- also had a tough 2008 but still managed to stay ahead of the broader market. It lost just under 35 percent for the year, while the S&P 500 tumbled 38.5 percent. That outperformance increased the portfolio's sizeable lead on the S&P over the long haul. From its July 2003 inception through 2008, the Hot List gained 71.34 percent (10.34 percent annualized), while the S&P lost 6.86 percent (-1.29 percent annualized).

The Hot List is a 10-stock portfolio 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.

In 2008, the Hot List was in positive territory as late as late-August, at which time it was 15 percentage points ahead of the broader market. A number of strong picks, including Brush Engineered Materials (+28 percent in a month), WellCare Health Plans (+48 percent in a month), and Jos. A. Bank Clothiers (+27 percent in two months) gave the portfolio some big, quick gains. But as the market broke down in September, the portfolio went down with it, posting double-digit losses in September, October, and November. The Dress Barn (down 40 percent from early October through late November), TrueBlue Inc. (down 42 percent in a four-week period during October), and The Men's Wearhouse (down 53 percent from early September through late November) were among the Hot List holdings that were beaten up.

In December, however, the portfolio made a pretty dramatic turnaround, gaining back 10.4 percent. While others fled the market, the Hot List picked up a number of stocks that posted solid bounce-back gains, including The Timken Company, Guess? Inc., and Circor International.

Looking Ahead

There's no way around it: Watching your portfolio fall significantly in value always hurts, no matter how good your past returns have been or how many other people are in the same boat. It's hard to be happy when even your best strategy takes a sizeable hit for the year.

That being said, the 14 Guru Strategies I use -- which tend to produce their most significant outperformance during bull markets -- held their own against the S&P 500 benchmark during one of the worst bear markets in history (the average loss for the 14 models was a shade better than the S&P's 38.5 percent loss).

Now, as we move beyond a trying 2008, I believe my models are positioned for some very significant outperformance. Why? In most cases, the gurus upon whose approaches I based these strategies fared extremely well coming off big downturns, including the two to which the current bear is most often compared -- 1973-74 and 1980-82. My strategies themselves also outperformed significantly coming out of the 2000-02 bear market. A big part that trend has to do with the fact that the gurus stuck to the numbers -- and stuck to their strategies -- even when things got tough. By doing so, they were able to use their stock-picking expertise to snatch up great bargains amid the market rubble, while many other investors succumbed to fear and waited on the sidelines. While each bear market is different, that pattern of success -- which is based as much in basic human psychology as it is in market specifics -- has held up following just about any bear. I believe that will again be the case when the current bear turns upward, and I expect my models to reap the rewards.

To view the 2008 model portfolio results, as well as the full historical record of all of Validea's strategies, please [click here](#) to view our model portfolios.