



2012 GURU PORTFOLIO PERFORMANCE REPORT

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

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2012 MARKET OVERVIEW

In 2012, the "Wall of Worry" was steep for the market -- and stocks climbed it with a stubbornness that surprised many. Despite being battered at various times by the European debt crisis, China's slowing growth, and U.S. policymakers' reckless game of budgetary and tax policy chicken, the S&P 500 jumped 13.4% for the year (16.0% including dividends), beating out both gold and bonds by significant margins. In fact, while there was significant volatility at times, the index didn't have one day where its closing price put it in the red, year-to-date. That's the first time that's happened since 1979, and just the ninth time it's happened since 1928.¹

A big reason for stocks successfully climbing the Wall of Worry was the policies of the Federal Reserve and other central banks around the globe, which kept the easy money flowing, and kept fixed-income investments from giving stocks much competition in terms of potential gains. But it was also because the economy continued to show resilience in the face of the negative headlines. The U.S. added close to 2 million private sector jobs in 2012, or about 160,000 a month, helping lower the unemployment rate from 8.5% to 7.8% -- the lowest it's been since January 2009. The so-called "U-6" unemployment rate, a broader figure (which, unlike the headline rate, includes part-time workers who want full-time work and discouraged workers who've given up looking for a job) remains high, ending the year at 14.4%. But that's also the lowest it has been since January 2009.

The housing market, meanwhile, gave the market a big shot in the arm in 2012. Through November (the latest month for which data is available), new home sales were up more than 20% year-to-date vs. 2011, with the median sales price up about 15%. That has the residential construction industry -- an important growth engine that has been largely absent from the economic recovery that started in 2009 -- buzzing again. Through December, housing starts were up 44% over the past twelve months, according to the Census Bureau, while permit issuance for new home construction was up 24%. That's extremely good news.

Elsewhere, the manufacturing sector -- which had expanded every month for three years -- finally slowed in the second part of 2012, contracting in four of the last seven months of the year, according to the Institute for Supply Management. But the contractions were quite minor -- the lowest reading on ISM's manufacturing index in of any of the four months was 49.5, just barely below the 50 mark that separates expansion

¹ Sommer, Jeff. "A Stock Market Streak That Has Drawn Few Cheers." *The New York Times*, Jan. 5, 2013.

from contraction. After three years of expansion, these minor dips didn't seem to be too much cause for concern.

More importantly, the service sector -- which is responsible for a much larger chunk of the U.S. economy -- expanded at a fairly rapid pace throughout 2012. It has now expanded for 36 straight months, according to ISM, and its growth was accelerating as the year came to a close. ISM's service sector index in December notched its highest reading since February, and its employment and new orders sub-indices also both were at their highest levels in several months.

U.S. consumers, meanwhile, continued to show their resilience in 2012. Retail and food services sales were up 2.5% over the past year, through December, according to the Commerce Department. That's not tremendous growth, but a decent improvement nonetheless. And after making minor gains for much of the year, real disposable personal income increased at an accelerating level toward the end of the year, with November's year-over-year gain coming in at 2.5%. Again, that's not spectacular, but it's solid. And the gains in disposable income allowed Americans to up their personal consumption expenditures by 2.1% in the 12 months ending in November, while also upping their personal savings rate from 3.2% to 3.6%. One largely untold story of the past few years is the way that Americans have gotten their financial houses in order; their financial obligations ratio, which compares a wide array of debt payments to disposable income, is the lowest it has been since the first quarter of 1984.

Elsewhere in the world, the picture also improved as the year wore on. It appeared that the Chinese government had engineered a soft landing, and that a turnaround was beginning there. And though still dealing with its debt woes, Europe remains alive and kicking, no doubt in part due to the European Central Bank's mid-year decision to finally undertake a bond-buying program to support financial markets. All of that helped push stocks much higher at home and globally. Our guru-inspired portfolios overall also had a solid year. Overall, the 14 ten-stock portfolios averaged a 12.5% gain for the year (all portfolio returns are without dividends), while the ten 20-stock versions of these portfolios averaged gains of 15.8%. Overall that made for a total average of about 14.2%, slightly ahead of the broader market. Our consensus portfolios, which use multiple strategies to pick stocks, fared particularly well, with all four returning at least 20%. Here's a look at a few of the notable strategies' performances (with returns are without dividends, through the end of 2012).

TOP 2012 GROWTH STRATEGIES

The Kenneth Fisher Strategy

After having only its second market-lagging year ever in 2011, the Fisher-based ten-stock portfolio bounced back strong in 2012, gaining 15.1%. It was accurate (meaning it made money) on 62.3% of its picks, and continues to have a stellar long-term track record. Since its mid-2003 inception, the portfolio is up close to 200%, or 11.9% annualized. During the same period, the S&P 500 has returned just 3.8% annually.

The Fisher-based approach is really a growth/value hybrid. It looks for companies with strong growth (they must have an inflation-adjusted earnings per share growth rate of at least 15% over the long term), and strong profit margins (at least 5% net, on average, over the past three years). But it also uses a key value metric that Fisher pioneered back in the 1980s, the price/sales ratio. In addition, it looks for companies that are generating cash, not consuming it -- the firm should have positive free cash per share and a debt/equity ratio below 40%.

In 2012, the strategy found some big winners using those criteria. Home décor retailer Kirkland's Inc. gained nearly 30% from the start of the year until being sold on March 16; clothing retailer Aeropostale gained about 34% over the same period. The portfolio ran into some trouble in the middle of the year, thanks in part to some losing bets on for-profit education firms like Apollo Group (a 26% loser), and DeVry Inc. (a 49.3% loser). Later in the year it got back on track, however, finding such big winners as Western Digital, which gained about 25% from Oct. 26 through year-end, and Nu Skin Enterprises, which surged more than 20% from Dec. 21 through year-end.

The 20-stock Fisher-based portfolio didn't fare as well, lagging the market with a 9.6% gain in 2012. But its long-term track record remains stellar, with its annualized return of 10.7% since its mid-2003 inception nearly tripling that of the S&P. The Fisher portfolios thus continue to be some of our top performers, and I expect that to continue going forward.

The Motley Fool Strategy

Based on the writings of brothers Tom and David Gardner, creators of The Motley Fool investment service, The Fool-based 10-stock portfolio had a rather remarkable run of beating the market in each of its first nine years. But in 2012, that run came to an end. The portfolio did make positive gains, but its 4.7% advance was only about a third of what the S&P 500 gained.

Still, the Fool-based strategy is included here for two reasons: One is its outstanding long-term track record. The Fool-based 10-stock portfolio has averaged gains of 13.0% since its July 2003 inception. The second reason is the 20-stock Fool-based portfolio actually had quite a good year. It nearly doubled the S&P's gains, returning 24.2%. Those are signs that the strategy is still working quite well, and that the 10-stock portfolio's underperformance in 2012 was due to some stock-specific issues rather than any sort of long-term problem.

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-to-Growth ratio to help avoid fast-growing but overpriced stocks.

In 2012, the 10-stock portfolio got hit hard by a handful of stocks, including Adams Resources & Energy, which fell 36% in just one month (April 13-May 11); Richmond Mines, which tumbled about the same from the start of the year until it was sold in April; and MarketAxess Holdings, which fell about 24% from March 16-July 6. It did find some nice winners, including lululemon athletica, the yoga-focused sporting apparel store. The portfolio picked up the stock way back in November 2009. In 2012, it gained about 28% before it was sold in early July. That made for a total gain of more than 350% from that late-2009 purchase date. Another big winner was Altisource Portfolio Solutions, which gained 23.8% from Jan. 20-March 16, then rejoined the portfolio from May 11-Aug. 31 and jumped another 48.5%. Those types of gains helped keep the portfolio in the black for the year, but weren't enough to catch up to the broader market.

The 20-stock model found some more winners, however. Among them were specialty chemical maker American Vanguard Corp., which jumped 36.4% from March 16-Aug. 3; small-cap tech firm EPAM Systems, a 34.8% gainer over just one month from mid-March to mid-April; and Ocwen Financial Corporation, which jumped 34.2% from Aug. 31-Nov. 23.

TOP 2012 VALUE STRATEGIES

The Warren Buffett Strategy

The Buffett-based approach had another solid year, coming in as the second-best 10-stock performer in 2012. It gained 15.1% for the year, while being only slightly more volatile than the broader market (beta of 1.06). It was accurate on more than 63% of its picks. The Buffett-inspired portfolio has beaten the S&P in five of its nine years (not including 2003, since its inception date was less than a month before the end of that year).

The Buffett-based model tends to hold on to stocks for longer than many of my other models, like Buffett himself does. And in 2012, one of its top performers was discount retailer The TJX Companies, which it held for the entire year while the stock gained more than 30%. The portfolio also notched nice gains on two stocks that it held from March 16-July 6: Monster Beverage Corp., which gained 23.3%, and Raven Industries, which gained 21.0% (though Monster was a loser when it rejoined the portfolio from Aug. 3 through year-end). It also found some impressive shorter-term winners, like USANA Health Sciences (which gained about 25% from the start of the year until it was sold on Feb. 17) and Aeropostale Inc. (which gained more than 30% from the start of the year until it was sold on March 16).

The 20-stock Buffet-based portfolio also had a solid year, gaining 15.9%. It has beaten the S&P in six of its nine years.

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.

The Benjamin Graham Strategy

Graham, known as "The Father of Value Investing", continues to amaze decades after his death. The model I base on the Defensive Investor strategy he laid out in *The Intelligent Investor* more than six decades ago was our best performer in 2012, with the 10-stock Graham-based portfolio returning 33.8%. The portfolio made money on 66.9% of its picks, and did so with a bit more volatility than the broader market (beta of 1.14). As it has for much of the past few years, the Graham-based portfolio is currently the top long-term performer of all the individual guru 10-stock portfolios we track. Since its July 2003 inception, it has posted annualized gains of 13.7%, far outpacing the 3.8% annualized returns of the S&P 500. The portfolio has beaten the index in eight of the 10 years of its existence.

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 business 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.

Of course, since Graham is the "Father of Value Investing", the strategy looks at valuation in several ways. A stock's price/earnings ratio using both trailing 12-month earnings and three-year average earnings should be no greater than 15. It also requires that the product of a stock's P/E and price/book ratio be no greater than 22.

In 2012, the Graham-based model found some of its biggest winners in the retail and energy sectors. They included oil and gas driller Helmerich & Payne, which jumped 22.8% while in the portfolio from May 11-December 21; True Religion Apparel, which gained 21.1% in just one month in the portfolio this fall; and Walgreen Company, a 20.9% gainer during its one-month stint in the portfolio in July and early August. Several of its other picks also produced strong gains over short periods. GameStop Corp. gained nearly 18% while in the portfolio from October 26-November 23; energy firm HollyFrontier Corp. gained nearly 17% over the same one-month timeframe; and in the week-and-a-half between when it picked up Deckers Outdoor Corp. (Dec. 21) and year-end, Deckers shares jumped nearly 17%.

The 20-stock Graham-based portfolio also had an excellent year, returning 31.9%. Since its inception (also July 2003), it has fared even better than the 10-stock Graham portfolio, averaging annualized returns of 16.6%.

The Graham approach continues to work so long after Graham developed it because of the types of variables that it looks at. Those variables -- valuation metrics like the price/earnings ratio and price/book ratio, and debt-related metrics like the current ratio and the relationship between net current assets and long-term debt -- are variables that get to the heart of good business and good investing. The fundamental concept behind the strategy -- invest in financially sound, stable firms whose shares are cheap -- is timeless. That's why the Graham model has worked so well, and why I think it will continue to post strong returns over the long haul.

2012 CONSENSUS STRATEGIES

The Validea Hot List

Our flagship portfolio had a very nice bounce-back year, outperforming the S&P 500 by more than 6.5 percentage points after a rough 2011. You don't have to be right on much more than 50% of your picks to do quite well in the market, and the Hot List showed that in 2012. It was accurate (meaning it made money) on 53.8% of its picks, which was enough to post that 20% gain for the year. The portfolio was about 19% more volatile than the broader market, with a beta of 1.19, but the extra volatility proved worth it.

Among the biggest winners for the Hot List were small-cap financial firm Altisource Portfolio Solutions, which gained about 14% while in the portfolio from Jan. 20-April 13, and then jumped nearly 30% during a second stint from June 8-Aug. 31; Aeropostale, which gained about 34% from Jan. 1-March 16; and Western Digital, which gained 21.1% in only about five weeks after the portfolio snatched it up on Nov. 23. The portfolio did have some sizeable losers, with Body Central Corp. tumbling 44.2% from March 16-May 11 and for-profit education firm Apollo Group falling 46% from July 6-Oct. 26. But it also found a number of other winners in the 10% to 20% range, helping it post that strong 20% gain for the year.

The 20-stock version of the Hot List fared even better than its smaller counterpart, gaining 22.1% to beat the index by nearly 9 percentage points. Since its 2003 inception, the 20-stock version has averaged annualized gains of 10.1%, while the 10-stock Hot List has averaged 11.1% per year. Both of those easily beat the S&P 500's 3.8% annualized return over that same period.

The Top 5 Gurus Strategy

The Top 5 Gurus portfolios had a strong 2012, building on their stellar long-term track records. The 10-stock portfolio gained 25.5%, nearly doubling the S&P 500's gain and bringing the portfolio's annualized return since its 2003 inception to 14.2%. It has now beaten the S&P in 8 of its 10 years.

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). Interestingly, in 2012, the portfolio was accurate on only 48.5% of its picks throughout the year. It found some big winners, though, which helped it post those strong gains for the year. Among them: Latin American steel firm Ternium, which gained 35% from the start of the year until the portfolio sold it on March 16; Altisource Portfolio Solutions, which gained nearly 40% from July 6-Nov. 23; and employment website company Monster Worldwide, which surged 36.5% during a one-month stint in the portfolio in February and March.

The 20-stock Top 5 Gurus portfolio, meanwhile, gained 20.3% in 2012. It has been a strong performer over the long term, though not nearly as strong as its smaller 10-stock counterpart, posting annualized gains of 9.5%

Looking Ahead

As we head into 2013, there are a number of bullish factors working for stocks. The housing market seems to have turned the corner; the President and Congress have finally made some progress on fiscal and tax policy; the broader economy continues to grow; and valuations remain reasonable for the broader market and downright cheap for many high-quality stocks.

To be sure, there are concerns and risks as well. While Europe seems to have stabilized and China seems to have started to rebound, neither is out of the woods quite yet. At home, though policymakers have made some key steps forward, much remains to be done in dealing with the country's deficit and debt, and our leaders' track records in dealing with those issues so far doesn't inspire confidence. There's also the issue of the unknown impact of the Federal Reserve's loose monetary policies -- so far, its policies have helped stabilize the U.S. economy, but it's still unclear how the Fed will unwind all the liquidity it has provided. And then there are the lingering scars from the 2008-09 financial crisis, which still have many investors flexing their itchy "sell" trigger fingers anytime a short-term issue pops up.

Those issues aren't new, though. We've been dealing with them for years now, and because of that some pretty bad scenarios are likely already baked into stock prices (despite the fact that we've made significant progress on a number of those issues). The lingering worry and fear left over from the 2008-09 crisis is also keeping valuations in check -- though the market posted some strong gains in 2012, I don't think anyone can say we are anywhere near the "irrational exuberance" environment that leads to market crashes. Instead, the combination of improving fundamentals (both for the economy and Corporate America) and lingering pessimism is providing a good environment for long-

term, value-focused investors. In the short term, of course, anything can happen. But over the long haul, I think stocks are priced to produce some nice gains for those who stick with them.

To view the 2012 model portfolio results, as well as the full historical record of all of Validea's strategies, please [click here](#) to view our model portfolios.