2013 GURU PORTFOLIO PERFORMANCE REPORT

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

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2013 MARKET OVERVIEW

If you were listening to some pundits, you might've mistaken the opening bell of 2013 for a death knell. When the year started, we were staring at a looming budget sequestration, a lingering debt crisis in Europe, and a slowdown in China. Many viewed the challenges as insurmountable, or close to it, for stocks.

But the market didn't get the message. Right from the get-go, stocks headed higher and the upward trend continued all year, with year-to-date returns for the S&P 500 never dipping into negative territory. By the end of the year, the index was up almost 30% -- its best annual gain in a decade and a half -- and most of our guru-inspired portfolios were up even more.

What was behind the unexpected surge in equities? A number of factors, to be sure, including, of course, the Federal Reserve's low-interest-rate, quantitative-easing environment. But it was more than just QE; on a broader level, it was that reality (while far from rainbows and butterflies) ended up being a good deal better than the dreary consensus expectations.

The housing market is a prime example. After appearing to slow, the market ended the year quite strongly, with housing starts in November (the latest data available) more than 33% above where they stood a year ago. New home sales, meanwhile, were up about 18% through November, according to the Census Bureau.

Manufacturing activity also surged in the second half of the year. The Institute for Supply Management said manufacturing activity increased in November for the 6th straight month, and did so at the fastest pace in two years. The group's manufacturing sub-indices for both new orders and employment rose significantly, with new orders remaining at a particularly high level. ISM also said the service sector expanded in November for the 47th straight month.

And consumers fared well in 2013. Retail and food service sales made significant gains, coming in 4.3% above where they stood a year ago in November. Personal income, while not growing at a gangbusters pace, rose in nine of the first eleven months of the year, doing so at a faster pace than inflation. In the third quarter it was nearly 4% above where it was in 2012's third quarter.

So, after 2012 ended with meager 0.1% GDP growth in the fourth quarter, growth accelerated significantly in each of 2013's first three quarters, reaching 4.1% in third

quarter -- the biggest quarterly gain in nearly two years. Moreover, Europe did not disintegrate, China did not implode, and Congressional leaders and the President actually came together -- gasp! -- to pass a budget. In a world in which crisis-weary investors still live in fear of another 2008-09-type event, decent growth, a lack of calamity, low interest rates, and reasonable valuations made for big stock market gains.

The gains were even better for our portfolios. Ten of the fourteen 10-stock portfolios we track beat the S&P 500, most by a wide margin. These 14 portfolios averaged a 38.8% return this year, 9.2 percentage points better than the S&P 500. Several of the portfolios have had truly exceptional years, with three returning more than 60% and another three returning between 47% and 52%. Leading the way was the Peter Lynch-inspired portfolio and the Martin Zweig-based portfolio, with the Lynch strategy putting up the best-ever annual return for one of our ten-stock, monthly rebalanced portfolios.

Here's a look at a few of the notable strategies' performances for the year (returns are without dividends, through the end of 2013).

TOP 2013 GROWTH STRATEGIES

The Peter Lynch Strategy

In producing the best year ever for one of our 10-stock portfolios -- a 68.6% gain -- the Lynch strategy was accurate (meaning that it made money) on close to 85% of its picks in 2013, an exceptional rate. The strategy, which looks for conservatively financed, cash-generating firms with low P/E-to-growth ratios, found several huge winners in 2013, three of which ended the year in the portfolio. HCI Group gained more than 90% after joining on April 12; Bridgepoint Education, which joined a week and a half before the start of 2013, gained more than 60%; and Green Dot Corporation, a provider of prepaid debit cards, gained about 70% after joining in mid-February. Another big winner was Volterra Semiconductor, which gained about 66% while in the portfolio from mid-April to the end of August. It was a beneficiary of the M&A market, with shares surging after it reached a deal to be acquired by Maxim Integrated in mid-August.

The missteps for the Lynch portfolio were few and far between. One of the bigger losing positions was small-cap telecom firm IDT Corporation. After joining the portfolio on November 22, its shares fell about 16%. Overall, however, the losers weren't nearly enough to derail an exceptional year -- an exceptional year that added to an exceptional track record. Since its mid-2003 inception, the Lynch portfolio is up about 200%, more than doubling the gains of the S&P 500.

The Martin Zweig Strategy

In posting 60%-plus returns, the Zweig-inspired portfolio was accurate on about 73% of its picks. The strategy, which looks for companies with strong, accelerating earnings growth, low debt, and shares that haven't gotten too pricey, didn't find as many huge gainers as the Lynch model did, save for USANA Health Sciences, which gained about

67% while in the portfolio from mid-February to November 22. But while it didn't have as many huge gainers, it did have a number of stocks that posted strong gains over relatively short periods. Sturm, Ruger & Company gained over 30% after joining the portfolio on August 2; Chinese tech firm NetEase gained over 24% while in the portfolio from mid-February until June 7; and Questcor Pharmaceuticals gained more than 27% while in the portfolio for less than three months in the first half of the year.

The Zweig portfolio did run into a couple significant losers. They included Alliance Fiber Optic Products, which lost about 25% after joining the portfolio in late October, and Amtrust Financial Services, which lost about 12% from late August until being sold in December. As with the Lynch portfolio, though, the winners far outweighed the losers this year.

The strong 2013 year has helped push the Zweig portfolio's already solid long-term performance even higher. Since its 2003 inception, the portfolio is up over 200%, more than doubling the returns of the S&P 500. Over that period, it has been accurate on about 59% of its picks, a figure exceeded by only three of our other 10-stock portfolios.

The Motley Fool Strategy

Another stellar year from this portfolio (+61.1%), inspired by the writings of Fool co-creators Tom and David Gardner, has helped it climb close to the top position of all my 10-stock monthly rebalanced portfolios on a long-term basis. It's up more than 400% since its 2003 inception, generating nearly five times the returns of the S&P 500 over that decade-plus period. That's an annualized gain of more than 16%.

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 2013, the Fool-based portfolio found several big winners, one of which really stood out above the rest. HCI Group, the property and casualty insurer that helped boost the Lynch portfolio, did even more for the Fool portfolio. After joining in mid-February, HCI gained about 150% while remaining in the portfolio the rest of the year. Other big winners include Noah Holdings Limited, a small-cap financial that serves high wealth clients in China. It gained more than 60% while in the Fool portfolio from early August to November 22. Generic pharmaceutical company Lannett Company, meanwhile, gained close to 40% from September 27 through December 18.

The Fool portfolio was accurate on 60% of its picks during the year, so it did also run into a number of losing positions. One of the larger ones: Virtus Investment Partners, which lost about 24% while in the portfolio from May 10 to September 27. Overall, however, the Fool model again showed that you don't have to be right on much more than 50% or 60% of your picks in order to generate very strong returns. In fact, while it's one if our best long-term performers, it has been accurate on just 51.9% of its picks over

the long haul. When the winners are stocks like HCI Group, though, that can make for exceptional gains.

2013 VALUE STRATEGIES

The Joel Greenblatt Strategy

A standout hedge fund manager and bestselling author, Greenblatt often preaches the importance of discipline, saying that even good strategies go through periods of underperformance, and that you need to stick with a strategy for several years to reap its benefits. In 2013, the Greenblatt-based portfolio was a great case in point. After two market-lagging years, it roared back by gaining more than 50%, extending its wide lead on the broader market. Since its late 2005 inception, the portfolio has more than doubled the S&P 500.

In 2013, the Greenblatt model found several big winners. AmSurg, a group of ambulatory surgery centers, joined the portfolio in January and stayed the whole year, jumping about 80%. Questcor Pharmaceuticals jumped about 63% while in the portfolio from mid-February to early July. And USANA Health Sciences, which joined in late December 2012, gained nearly 70% before being sold in May. There were some losers, too, including Perion Network, which tumbled more than 20% while in the portfolio from Oct. 25 to Nov. 22. But all in all, the portfolio made money on about 75% of its picks during a stellar year.

The David Dreman Strategy

Most years, a 5% return would not land you in the basement. But with stocks surging in 2013, the Dreman portfolio brought up the rear. The strategy looks for unloved, beaten down shares by examining the price/book, price/earnings, price/cash flow, and price/dividend ratios, at least two of which must be in the market's cheapest 20%. Then it applies a number of financial strength tests to separate stocks that are beaten down because of fear or apathy from those that are in financial trouble, looking at return in equity, profit margins, debt levels, and more.

Though it lagged in 2013, the Dreman strategy didn't have a lot of big losers. Telecom Corporation of New Zealand lost about 20% during a two-month stay in the portfolio, and Annaly Capital lost 11% in one stint and 13% in another. But its other major losers were barely in double digits. The problem seemed to be that the portfolio was accurate on only about 48% of its picks, and it lacked the huge gainers of some other portfolios. One of its better picks was Brazil energy giant Petrobras, which gained about 26% in a two-month stint.

The Dreman portfolio remains ahead of the S&P since its 2003 inception. Perhaps it's not surprising that it struggled a bit four years into a bull market -- deep value approaches tend to fare quite well coming out of recessions and crises, but as bulls

mature leadership often turns to growth-type stocks. That being said, the Dreman-based portfolio's decade-long track record makes it a good bet to rebound and continue to produce market-beating returns over the long haul.

2013 CONSENSUS STRATEGIES

The Validea Hot List

It by and large was a very solid year for our flagship portfolio, which topped the market for the eighth time in 11 years. It was accurate on about 62% of its picks, led by USANA Health Sciences, which joined the portfolio in late December of 2012 and remained there for all of 2013, gaining about 130%. The Hot List also found big winners in two other stocks it held through year-end, property and casualty insurer HCI Group, up over 50% since joining the portfolio in June, and Lear Corporation, up over 30% since joining in May. In addition, it picked up a number of stocks that produced solid gains over shorter periods, like small-cap trucking firm SAIA Inc., which gained more than 21% while in the portfolio for just one month in parts of April and May.

The Hot List wasn't perfect, however, choosing some stocks that hurt returns. One was Inter Parfums, which lost more than 20% while in the portfolio for just one month in August. Another is Amtrust Financial Services, which had been faring well until running into some recent trouble, as its accounting methods have come under scrutiny. The portfolio picked it up in early July, and sold it on Dec. 20 at a 12% loss.

All in all though, the year was another good one for the Hot List. Its overall returns since its mid-2003 inception are tripling the S&P 500.

The Top 5 Gurus Strategy

For the ninth time in 11 years, the Top 5 Gurus Strategy beat the market in 2013, and it did so by a handy margin, returning close to 50%. The portfolio was accurate on over 72% of its picks.

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. In 2013, the portfolio found big winners in some unloved plays. HCI Group, a Florida property and casualty insurer, joined the portfolio in April and stayed there all year, while gaining more than 90%. USANA Health Sciences joined in February and gained about 80% through year-end. And Bridgepoint Education, from the much maligned for-profit education industry, joined in late December 2012 and gained more than 70% before the portfolio sold it in late November.

There were also some losers, including Perion Network, which fell more than 20% during a one-month stint in the portfolio on October/November, and Harmony Gold Mining Co., which lost about 30% from March 15-May 10. But overall the portfolio

extended an exceptional track record, which includes a return of more than 400% since its mid-2003 inception. That puts it neck-in-neck with the Motley Fool-based strategy for the top spot among our portfolios over that period.

Looking Forward

One of the biggest lessons to take from the 2013 results is the importance of discipline. While it has been a juggernaut in 2013, the Lynch portfolio lagged the S&P 500 by about two percentage points in 2012, and had a rough 2011 in which it lost 21.4% while the broader market was flat. If you'd given up on the strategy heading into this year, you'd have missed out on tremendous gains. Similarly, the Zweig portfolio was about flat last year, while the S&P was gaining 13.4%. If you stuck with the strategy, you'd have been rewarded with 60%-plus gains. Even the Fool portfolio, despite its exceptional long-term track record, came into 2013 on a down note. It had gained just 1% in 2011 and 4.7% in 2012, with the latter ending its streak of having beaten the market every year since its 2003 inception. Rather than a sign that the strategy was losing its effectiveness, however, the subpar performance turned out to be a great buying opportunity.

That's nothing new. History's best investors (and our guru-inspired strategies) often produce exceptional bounce-back gains following short-term periods of underperformance. If you can stay disciplined through those short-term hiccups, you can reap the benefits later, as some of our portfolios did this year. It's hard to do, of course, when things are going badly. But it's an approach that we believe wholeheartedly in, having seen just how successful it can be over more than a decade of implementation. That's why we certainly won't give up on 2013 laggards as we head into 2014. While it's no guarantee, it wouldn't surprise us to see the Dreman portfolio and some of the other laggards from this year bounce back very strong next year.

Overall, while it is nearly impossible to predict short-term market moves, the long-term picture looks good for stocks. Yes, valuations are much higher than they were in 2008 or 2009, but that's what happens in bull markets -- valuations rise. The problems arise when they reach extremely high levels, and we're not seeing anything like that right now. The economy, meanwhile, continues to recover and seems to be picking up steam, which should enable the U.S. to handle the tapering of the Federal Reserve's quantitative easing program. Amid all of this, our guru-inspired models should continue to find long-term value in the market.

To view the 2013 model portfolio results, as well as the full historical record of all of Validea's strategies, please click here to view our model portfolios.