2014 GURU PORTFOLIO PERFORMANCE REPORT

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

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2014 MARKET OVERVIEW

When 2014 began, most forecasters were expecting another year of tepid US growth. Most believed interest rates finally would rise, and oil prices would also push higher. And, given the huge gains in US markets in 2013, it seemed most were predicting that stocks would pull back, or perhaps eke out meager gains.

By year-end, however, the market and economy had thrown a bucket of cold water on all of those predictions. The US economy had perhaps its best year since the recovery began in 2009. In terms of job growth, it was the best year since well before then. Nonfarm payrolls rose by an average of 246,000 per month -- the best yearly average since 1999. The unemployment rate has fallen 1.1 percentage points since the end of 2013, with December's 5.6% reading the best since June 2008. Industrial production jumped 4.2% in 2014, the highest annual gain since 2010 and the second highest since 1998. The manufacturing sector expanded in each month of 2014, according to the Institute for Supply Management, with output really picking up in the summer and fall. The service sector also expanded in each month of the year, in most months by a significant amount. That makes it 59 straight months that the sector has expanded, according to ISM. All of this helped the US post gross domestic product growth of 5.0% in the third quarter -- its strongest quarterly growth rate since 2003.

Interest rates, meanwhile, surprised just about everyone by falling despite the Federal Reserve winding down its quantitative easing program. The 10-year Treasury, for example, started the year yielding 3%; by year-and, its yield was down to 2.17%. A number of factors seem to be involved. The turmoil in Ukraine and the Middle East created a lot of fear in markets, which drove investors toward the safety of Treasurys. In addition, while the Fed was curtailing its bond-buying programs, foreign central banks and individuals were picking up the slack. And, with the Fed backing out of the picture, there were fewer new Treasurys on the market, and the lower supply helped drive prices up and yields down.

Just as surprising as the decline in rates was the plunge in oil prices. In part because the US economy has fared so much better than much of the rest of the world, and in part because the Fed stopped pumping trillions of dollars into the economy through QE, the dollar surged in 2014. That has had a number of impacts, one of which is downward pressure on prices of commodities measured in dollars -- like oil. Plants coming back online in the Middle East, slowing growth in emerging markets like China, and the US's fracking boom have also greatly altered supply/demand dynamics. While many have fretted about whether the declines are a harbinger of broader economic trouble, the sharp declines in oil and gasoline prices for now are giving a nice boost to the US economy. With gas prices falling nearly 40% from their late-April high to the end of the year, consumers saved $14 billion on gasoline in 2014 (vs. 2013), according to AAA. And they appear to be putting that money to use: Real personal consumption expenditures on durable goods rose by 14.1% in the second quarter and 9.2% in the third quarter, according to the Bureau of Economic Analysis.

All of these issues made for a fairly turbulent year for stocks, with a few "stealth corrections" occurring in the biotech industry and among momentum and small-cap stocks. But in the end, the market notched some solid gains, with the S&P 500 rising 11.4% (not including dividends). Generally, our guru-inspired portfolios did not fare as well. Only 2 of our 12 individual 10-stock guru portfolios beat the S&P, and neither of our consensus-based portfolios beat the index. The small-cap struggles were perhaps the biggest reason behind our portfolios' subpar year. In part because some have explicit variables that target smaller stocks (as is the case with The Motley Fool-based portfolio), and in part because they generally look for fundamentally sound stocks that others are overlooking, our strategies tend to find more of their picks in the small- and mid-cap areas of the market than they do in the large-cap space. And, in 2014, smaller stocks as a group significantly lagged larger stocks. Nevertheless, over the long haul, all but 2 of our 14 strategies are beating the S&P 500 (through Jan. 19, 2015), with half of them more than doubling the index since their inceptions.

Here's a look at some of our strategies' performances for the year. (Returns are without dividends.)

NOTABLE 2014 VALUE STRATEGIES

The John Neff-Based Strategy

The Neff portfolio had a great 2014, rebounding nicely from a stretch of underperformance. It gained 24.8% for the year, while being less volatile than the broader market (beta of 0.93). It was accurate on 70% of its picks, meaning 70% of its picks made money.

The "Low-PE" Neff approach looks for companies whose price/earnings ratios are 40% to 60% of the market average. It also looks for solid, sustainable growth -- EPS should have risen between 7% and 20% over the long term, and long-term sales growth should be at least 7% or 70% of EPS growth. In addition, Neff used the "total return/PE" ratio, which takes the sum of a stock's earnings growth and dividend yield and divides that by its P/E ratio. This figure should be at least double the market average or the stock's industry average.

In 2014, the Neff-inspired approach found several big winners over short spans, including Banco Bradesco, which gained more than 34% from February 14 to April 11. The portfolio also notched nice gains on two stocks that it held for just one month: Warren Resources, which jumped 31.8% from June 6 to July 3, and AmTrust Financial Services, which jumped 27% from September 26 to October 24. The portfolio did run into some significant losers, too, most notably Employers Holdings, which lost 24% from the start of the year to mid-February. But the winners far outpaced the losers, resulting in a very strong year.

The strong 2014 helped the Neff-based portfolio, which has had a very up-and-down history, move ahead of the market since its inception. Since that early 2004 start date, the portfolio is now up 85.0%, compared to 79.2% for the S&P 500. (Long-term performance figures here and below are through Jan. 15, 2015.) Given the sound logic behind the strategy -- buy shares in firms that have steady, sustainable growth, and do so at good prices -- the portfolio would seem to be a good bet to extend that outperformance over the long haul.

The Benjamin Graham-Based Strategy

The 10-stock Graham portfolio has been one of our top performers over the long term, but in 2014 it struggled mightily, losing 22.9%. The portfolio found big losers in CTC Media, which fell 38% from Sept. 26-Oct. 24; luxury retailer Coach Inc., which lost almost 30% from Feb. 14-Aug. 1; and gun maker Smith & Wesson Holding Corp., which lost 29.7% from July 3-Oct. 24.

The Graham-based model is based on the "Defensive Investor" approach that Graham laid out 65 years ago in his classic book, *The Intelligent Investor*. It looks for companies with strong balance sheets, long histories of solid, steady growth, and cheap shares. In 2014, it did find some nice winners. Discount retailer Big Lots surged 38.6% from Feb. 14-March 14; Cheung Kong Holdings jumped 18.2% from mid-March-early July; and USANA Health Sciences gained 11% during its one-month stint in the portfolio in August. But overall, those winners could not keep the portfolio from having its worst year since its mid-2003 inception.

Despite its 2014 struggles, the 10-stock Graham-based portfolio still has an excellent long-term track record. Since its inception, it has averaged annualized returns of 11.0%, vs. 6.2% for the S&P. The Graham-inspired approach doesn't involve gimmicks or complicated techniques; it is based on basic, enduring investment principles: Buy stock in profitable, financially sound companies, and do it at a good price. Those principles have existed since the dawn of investing, and I see no reason why they won't continue to exist over the long haul, making the Graham-based strategy a good bet to bounce back and return to its outperforming ways.

NOTABLE 2014 GROWTH STRATEGIES

The Momentum Investor Strategy

Our second-best performer in 2014 was the Momentum approach, which gained 15.2% after returning more than 51% in 2013. The portfolio was accurate on just over half its picks (51.5%) throughout the year, proving once again that you don't need to be right anywhere close to all the time to notch nice gains.

The Momentum approach, which looks for firms with strong short- and long-term earnings growth and high relative strengths, as well as high returns on equity and low or declining debt/equity ratios, found some big winners. Among them: Taro Pharmaceuticals, which gained 47% from June 6- Aug. 29; Internet banking firm BofI Holdings, a 35% gainer from Jan. 1-March 14; and Carmike Cinemas, up 20% from Jan. 17-March 14.

The Momentum portfolio also found some losers, like Lannett Company, down 28% from March 14-April 11, and Middleby Corp., down 19% from March 14-May 9. But while it found almost just as many losers as winners, the magnitude of the winners helped it to a solid year.

Since its mid-2003 inception, the Momentum Investor portfolio is up 164.3% vs. 99.2% for the S&P 500. That's an 8.8% annualized gain vs. 6.2% for the index, even though it has been accurate on less than half of its picks (46.3%). Its ability to find and ride big winners has helped it notch those nice long-term gains.

The Motley Fool-Based Strategy

After a tremendous 2013 in which it returned more than 61%, the Fool-inspired portfolio came back to earth in 2014. It returned 1.6%, representing its worst relative performance to the S&P 500 since its mid-2003 inception.

The Fool strategy is based on the approach that Fool co-creators Tom and David Gardner laid out in the *Motley Fool Investment Guide: How the Fools Beat Wall Street's Wise Men and How You Can Too*. The Fool-based 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 P/E-to-Growth ratio to help avoid fast-growing but overpriced stocks.

The portfolio's small-cap approach led it to some sizable losers in 2014, including one that was a big winner the year before. Property and casualty insurer HCI Group joined the portfolio in February 2013 and was up more than 150% when 2014 started. But from the start of the year until it was sold in April, it fell 36%. Other significant losing positions included Alliance Fiber Optic Products, which fell 28.6% in just one month (July 3-Aug. 1) and NetScout Systems, a 24% loser in September and October.

The portfolio did find some nice winners, including Spirit Airlines, which started the year in the portfolio and gained about 22% before it was sold in May. Financial firm Piper Jaffray returned almost 24% from May 9 to July 3, and China Distance Education Holdings jumped almost 23% from April 11 to June 6.

Overall, the Fool-based portfolio still has an impeccable track record. In fact, it is our best-performing individual guru 10-stock portfolio over the long haul, averaging annual gains of 14.9% since its inception vs. 6.2% for the S&P. It thus seems a likely candidate for a strong bounce-back going forward.

2014 CONSENSUS STRATEGIES

The Validea Hot List

It was rough sledding right from the start for our flagship portfolio, which lagged the S&P by the widest margin in any year since its inception. The portfolio was accurate on 40% of its picks, hurt greatly by the sell-off in small-caps. As that sell-off progressed, investors seemed to be ditching fundamentally sound, reasonably valued small caps along with the bloated, overpriced little guys. This guilt by association effect meant that even the Hot List's rigorous fundamental tests couldn't help it avoid major losses.

The Hot List portfolio looks for stocks that get the best consensus scores from all of my guru-inspired models, with the models with the best risk-adjusted long-term performance being weighed more heavily. It did find some nice winners in 2014. Among the biggest were Rex American Resources -- a one-time retailer that morphed into an ethanol production firm a few years back -- which gained about 38% while in the portfolio from July 3-Aug. 29; Silicon Motion Technology, which gained about 15% from Aug.1-Aug. 29; and Monster Beverage, which gained 12% from Oct. 24-Nov. 21. The winners weren't enough to overcome some sizeable losers, however. Russian media firm CTC Media tumbled almost 30% from Sept. 26-Oct. 24, thanks to news of unfavorable Russian legislation about foreign ownership of media firms. Lannett Company was hit hard amid the biotech bust earlier in the year, falling 28.4%. And BBVA Banco Frances fell 19.2% during its one-month stint in the portfolio in August.

Despite the difficulties in 2014, the Hot List still has a very strong long-term track record. Since its mid-2003 inception, the portfolio has returned 213.7%, more than doubling the S&P 500's 99.2% return over that span. That's a 10.4% annualized return compared to 6.2% for the index. Given that long-term track record, I fully expect that the Hot List will bounce back strong and continue to beat the market by a significant margin over the long haul.

The Top 5 Gurus Strategy

Like Hot List portfolio, the Top 5 Gurus portfolio has a stellar long-term track record but underperformed in 2014. It notched a 7.2% gain, marking just the third time since its mid-2003 inception that it lagged the S&P 500.

The portfolio (which uses the top two picks from five of my best-performing strategies) was accurate on about 55% of its picks throughout the year. It found some big winners, including magicJack VocalTec, which gained 39% from Jan. 17- April 14; insurance industry software provider Ebix which gained nearly 25% from Aug. 1-Aug 29; and surgical center firm AmSurg, which surged 21% from Feb. 14-June 6.

But the Top 5 Gurus portfolio also found a number of significant losers. Like The Motley Fool portfolio, it took a big loss on HCI Group, which was one of its biggest winners in 2013 but lost 31% while in the portfolio for the first two and a half months of the year. Barrett Business Services was worse, falling 43.5% from Sept. 26-Nov. 21.

The Top 5 Gurus portfolio still has a great long-term track record, though -- in fact, it's been my best performer over the long haul, putting up annualized gains of 15.2% since its mid-2003 inception to more than double the S&P's annualized return. That's an overall 412.2% gain vs. 99.2% for the index.

LONG-TERM OUTLOOK

Despite the 2014 struggles, we remain very confident in our portfolios' long-term positioning. For one thing, the type of smaller stocks that our models key on are significantly cheaper than they were at the beginning of last year. At the start of 2014, small- and mid-caps were trading at a 26% premium to mega-caps. At the start of 2015, the premium was down to 23%. That's good news. Since the end of 2005, when the small stock premium has been below 25% at the start of the year, small stocks have significantly outperformed. In such years, the Russell 2000 index of smaller stocks has beaten the S&P 500 each time, doing so by an average of nearly 5 percentage points. In addition, while we focus on only the most fundamentally sound stocks, investors seemed to be dumping shares of smaller stocks (and momentum stocks) indiscriminately as the struggles in those areas occurred last year. That made for a painful year if you held a lot of small stocks or momentum stocks, but it made for a good environment for bargain-hunting that should pay off going forward.

Just as importantly, we realize that all strategies go through short-term periods of underperformance. Joel Greenblatt, one of gurus upon whom I base a strategy, found that his approach lagged the market in five of every twelve months. It also did poorly for more than two years in a row in one out of every six periods tested. There were even times when it underperformed for three years in a row. The key to long-term success, Greenblatt said, is having the mental toughness to stick with the strategy, even during bad periods. If a strategy worked all the time, everyone would use it, which would eventually cause the stocks it picks to become overpriced and the strategy to fail, he explained. But because the strategy struggles once in a while, many investors bail, allowing those who stick with it to get good stocks at bargain prices. In essence, the strategy works because it doesn't always work -- a notion that is true for any good strategy.

So, just as the worst time to ditch stocks is usually after major declines, the worst time to ditch a good strategy is after a bad stretch. Essentially, it means you're selling low. (Key to all of this, of course, is using a good strategy, and we remain confident that ours are good approaches. The gurus who developed them used them to great success, and our long-term track record with them has been strong.) It can take time for a strategy to get back on track, which means short-term pain. Such periods are trying on one's psyche, but how you deal with these periods is what separates successful investors from the also-rans. Remember what James O'Shaughnessy (another of the gurus upon whom I base a strategy) said in his updated version of *What Works on Wall Street*, which details one of the most extensive studies of investment strategies ever done: "Consistency is the hallmark of great investors and is what separates them from everyone else. If you use even a mediocre strategy consistently, you'll beat almost all investors who jump in and out of the market, change tactics in midstream, and forever second-guess their decisions." O'Shaughnessy says that the key to success is having the discipline to "consistently, patiently, and slavishly stick with a strategy".

We agree. History shows that the road to investment failure is littered with those who thought they could time or outsmart the market. The gurus we follow succeeded because they didn't play that short-term guessing game. Instead, they based their buy and sell decisions on fundamentals and value. Over time, that sort of rational, disciplined approach wins out, and that's why we believe our models will continue to outperform the market over the long haul.

To view the 2014 model portfolio results, as well as the full historical record of all of Validea's strategies, please click here to view our model portfolios.