2015 GURU PORTFOLIO PERFORMANCE REPORT

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

GURU PORTFOLIO PERFORMANCE REPORT

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

2015 MARKET OVERVIEW

Overall, 2015 was a mixed year for stocks, and while the S&P 500 came in essentially flat for the year, there was a lot of damage underneath the surface in small- and mid-caps and value stocks. Based on our own internal figures, 56% of all stocks in our investable universe fell in price during the year. Many of the large-gaining positions came from a handful of stocks. In 2015, we saw the term FANG (Facebook, Amazon, Netflix and Google) get introduced, and if you didn't have exposure to these growth names or some of the high-flying biotechnology firms, your portfolio may have been left in the dust. A recent Barron's article points out the wide divergence in stocks this year and how the market-cap-weighted S&P 500 was misleading in terms of how many stocks performed in 2015. According to the article, "as of Dec. 28th, 30% of the stocks in the S&P 500 index were in bear territory. That level has risen steadily: 23%, when the market peaked on Nov. 3, 19% in July, 15% in June, and 12% at the May peak … [further] big-cap gains are masking poor performance elsewhere. About 37% of stocks in the S&P 400 Midcap index are down 20% or more [from their peak], as are 46% of those in the S&P 600 Smallcap index."

Since the 2007/2008 financial crisis, growth-oriented stocks have trumped value (low P/E, low P/B) stocks by a few percentage points per year. In 2015, the growth over value trend continued, and by a wide margin. For instance, the S&P 500 Growth Index returned 3.76%, while the S&P 500 Value Index declined 5.59%. This multi-year period of growth beating value is the longest such period in the last 35 years. The other trend in the market that influenced many active strategies was the underperformance of small- vs. large-cap stocks. Indices focused on small-cap companies lagged large-cap benchmarks by a wide margin in 2015. The combination of the underperformance of value and the underperformance of small caps made for a very difficult market for stock-pickers in 2015.

One of the biggest economic stories during the year was the continuing plunge in the prices of commodities – particularly oil. The price of a barrel of West Texas Intermediate sunk close to $35 by the end of December, levels unseen since the height of the 2008-09 financial crisis. Although low oil prices were beneficial for the consumer and the US economy, the commodity declines created some casualties, with energy and materials companies suffering greatly.

The year also marked one of the few times that being diversified didn't help and all major assets classes – US equities, international equities, bonds, gold, real estate, hedge funds and commodities – were flat to down for the year. CNBC ran a segment, "2015 was the hardest year to make money in 78 years" because the last time all major asset classes failed to make money was 1937. In addition, many successful investors, including Warren Buffett and high-profile hedge fund managers like Dan Loeb and Bill Ackman had difficult years. For Buffett and Berkshire Hathaway, it was the firm's worst year relative to the S&P since 2009.

Markets go through these periods, and a narrowing of returns in a small group of stocks makes stock-picking, or "go-anywhere" models like the ones we run here at Validea, a humbling experience. Still, we had some winning strategies in 2015, and we will highlight both the winners and losers in this report.

Continue reading to see some of our best, and not-so-great, performers of 2015. (Returns are without dividends and most of the portfolio performance in this report refers to Validea's 10-stock monthly rebalanced portfolios.)

NOTABLE 2015 GROWTH STRATEGIES

The Motley Fool-Based Strategy

The Motley Fool model has done it again – outperformed the market by a wide margin for another year. After a somewhat disappointing 2014, the model got back to its winning ways in 2015 and put up a 9.0% gain, compared to a 0.7% loss for the S&P 500. Overall, the Fool-based portfolio has an impeccable 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. 5.9% for the S&P. Since 2003, the portfolio has only underperformed the market in two years (2012 and 2014), and when it does outperform, the excess return over the market tends to be substantial.

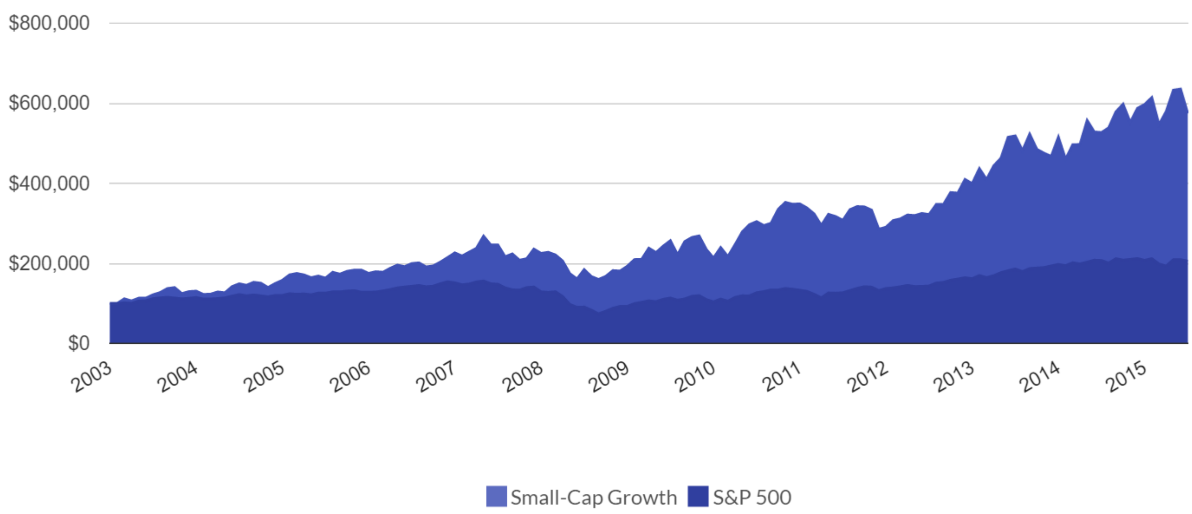
The Fool strategy is based on the approach that Fool co-creators Tom and David Gardner laid out in the *Motley Fool Investment Guide: How the Fools Beat Wall Street's Wise Men and How You Can Too*. The Fool-based approach centers on finding the stocks of small, fast-growing companies that have solid 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 combination of growth criteria and a momentum component helped the model avoid some of the problem areas of the market in 2015 (i.e. energy, non-US companies), while at the same time capitalizing on opportunities.

A number of holdings that were added in 2014 and sold in 2015 added nicely to the portfolio return for the year. Two of those stocks were Vasco Data Security and Universal Insurance Holdings, with each up over 40% and held for less than 12 months. The portfolio held Abiomed, a medical device maker, for a month and banked a 26.8% return, and a position in Natural Health Trends proved to be a big winner, too, with that stock rising 59.4% between August and the end of October.

On the downside, positions in Noah Holdings, a non-US play, and Heritage Insurance were drags on performance, with those stocks declining 33.4% and 19.8%, respectively. The model also lost on WisdomTree Investments (down 36.7%) and Marcus & Millichap (down 25.7%). Strategies that outperform can still have big losing positions, as the data here shows.

The portfolio produced an accuracy of 45% for 2015, meaning 45% of its positions were winners, which is slightly below the model's long-term historical average of close to 51%. Still, in a year like 2015, when many models and active managers underperformed, it was impressive to see the Fool strategy demonstrate the ability to find winning stocks in a difficult stock-picking environment. The Fool-based portfolio does tend to exhibit more volatility than the market, and over the long term the beta of the portfolio is 1.14 based on daily price returns. However, investors have been rewarded for the extra risk by the extra return the portfolio has produced over time.

Below is a chart simulating a $100,000 investment in the 10-stock Motley Fool model and the same investment in the S&P 500 since the portfolio's 2003 inception.



The Momentum Investor Strategy

Our second-best performer in 2015 was the Momentum approach, which gained 2.4% (3.1% excess return over the market). The portfolio was accurate on just about half of its picks (49%) throughout the year, proving once again that you don't need to be right anywhere close to all the time to notch market-beating gains. There are common characteristics between the Fool and the Momentum model. Both focus on growth-like stocks and both have a price momentum component in their selection criteria. In 2015, the market rewarded growth over value, and it's no surprise that this approach came in second in performance for the year.

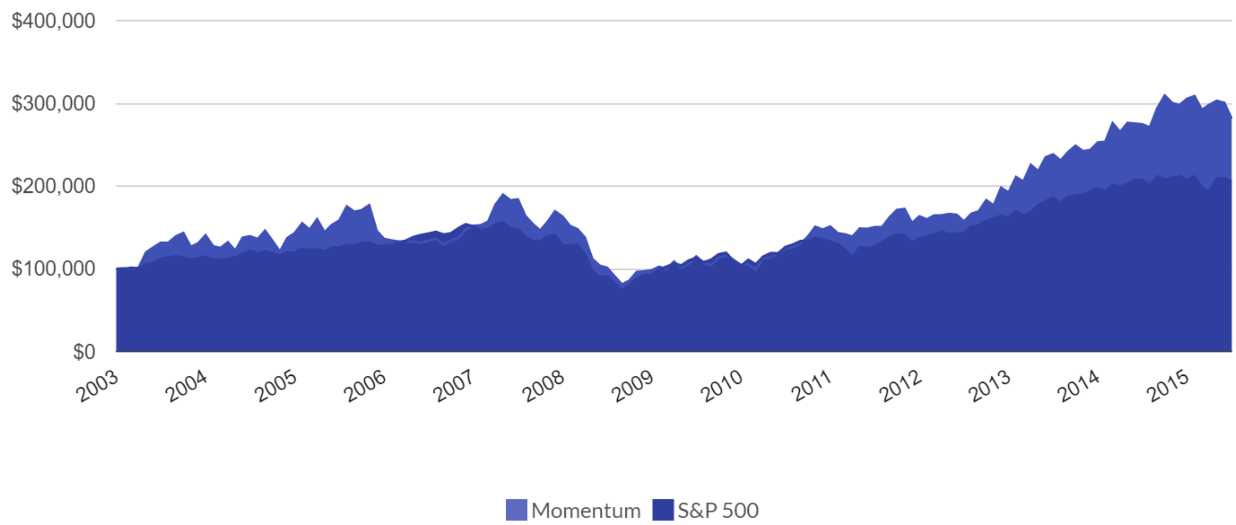
The Momentum model looks for firms with strong short- and long-term earnings growth and high relative strengths (i.e. price momentum), as well as high returns on equity and low or declining debt/equity ratios. The strategy found some nice winners in 2015. Among them: Credit Acceptance (up 27.9%), Eagle Bancorp (up 18.9%), and IPG Photonics (up 12.9%).

The Momentum portfolio also had some losers, like Universal Insurance, down 33.9% from September-November and BOFI Holdings, down 16.9% over a two-month period.

One of the more interesting holdings during the year was Apple, which was added to the portfolio twice, once in the late Spring and once in the late Fall. Apple's stock had a difficult year, but at times the shares performed well, which is why the Momentum model added them, but in both instances the strategy was quick to sell as momentum receded. Overall, the position in the technology giant was a net drag on performance.

Since its mid-2003 inception, the Momentum Investor portfolio is up 181.2% vs. 104.2% for the S&P 500. That's an 8.6% annualized gain vs. 5.9% for the index, even though it has been accurate on less than half of its picks (46.7%). Its ability to find and ride big winners has helped it notch those nice long-term gains.

Below is a chart simulating a $100,000 investment in the 10-stock Momentum model and the same investment in the S&P 500 since the portfolio's 2003 inception.



NOTABLE 2015 VALUE STRATEGIES

The Warren Buffett-Based Strategy

The Buffett-based approach was the best performing value strategy for 2015, coming in just slightly behind the S&P 500. The portfolio lost 3.0% for the year, which was just a hair behind the S&P 500's 0.7% loss. Since the model's 2003 inception date, the 10-stock monthly rebalanced portfolio has returned 130.7% compared to the S&P 500's return of 92.6% and has delivered a 56% accuracy rating (meaning that 5.6 out of every 10 holdings in the portfolio historically have appreciated from the buy price). As of the end of 2015, the Buffett 10-stock portfolio is the 5th-best performing value-focused strategy Validea tracks – ahead of the Buffett model are the model portfolios inspired by the approaches of Ken Fisher, Ben Graham, James O'Shaughnessy and Peter Lynch. We should note that both the O'Shaughnessy and Lynch inspired models incorporate both value and growth metrics. The Buffett portfolio carries a beta of 1.05 and tends to be less volatile than many of the other model portfolios tracked on Validea.com.

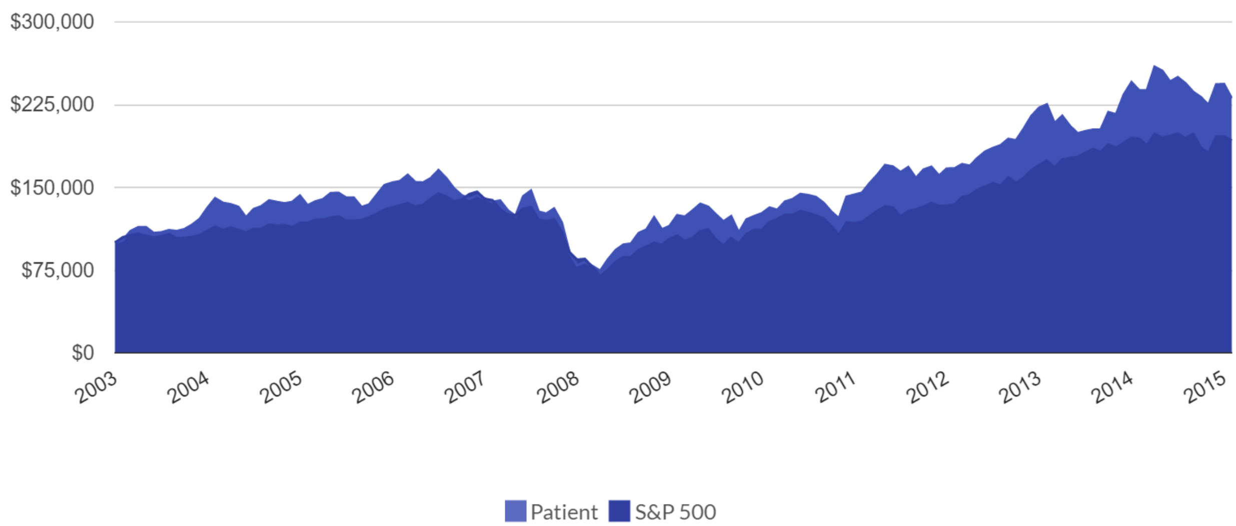
The Buffett-based model, due to its selection criteria, tends to choose stocks of many well-known, larger companies. For example, in 2015 the model selected a number of widely followed issues, including Apple, Kellogg, TJX Companies and Monster Beverage. A few of the portfolio's top-performing positions during the year were in holdings such as Ross Stores (up 76.6% and still a current holding in the portfolio as of 12/31) and Monster Beverage (up 99% from May 2014 to July 2015). On the downside, Apple detracted from the model's returns and losing positions like Polaris Industries (down 35.1%), FMC Technologies (down 22.6%) and World Acceptance Corp. (down 29.6%) also hurt the full-year results.

The 20-stock Buffet-based portfolio fared just slightly better than the 10-stock portfolio, losing 1.9% for the year.

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 our 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.

Below is a chart simulating a $100,000 investment in the 10-stock Buffett model and the same investment in the S&P 500 since the portfolio’s 2003 inception.



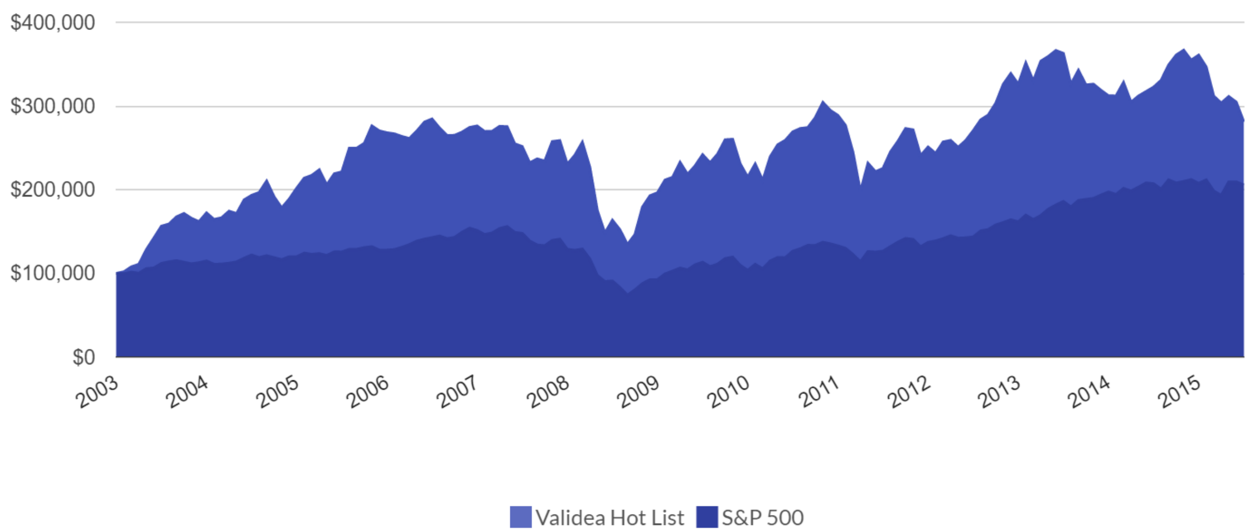
2015 CONSENSUS STRATEGIES

The Validea Hot List

The Validea Hot List portfolio had a difficult year, as its value, small-cap, energy and international exposure all proved to be problematic. For the year, the portfolio lost 12.9% compared to the S&P 500’s loss of 0.7%. Despite the last two years of relative underperformance, the portfolio still maintains a lead over the S&P 500 since its inception in 2003. Over the last 12+ years, the portfolio has generated a return of 181.8% compared to 104.3% for the S&P 500. That's an 8.7% annualized return compared to 5.9% for the index.

The Hot List portfolio looks for stocks that get the best consensus scores from all of our guru-inspired models, with the models with the best risk-adjusted long-term performance being weighted more heavily. It did find some nice winners in 2015. For example, WisdomTree Investments, a big loser in the Fool portfolio earlier in the year, rebounded in the Hot List and gained 24.6% from September-November. Other notable winners included Heritage Insurance, up 16.9% from September-November, and Credit Acceptance, up 18.5% from March-June. On the flip side, a number of larger losing positions, particularly after the mid-point of the year, hurt the Hot List's returns. Among those that declined in price were Chart Industries (down 41.8% from March-November), Universal Insurance (down 23.3% from August-November), and Lumber Liquidators (down 30.1% from June-August).

Below is a chart simulating a $100,000 investment in the 10-stock Validea Hot List multi-guru model and the same investment in the S&P 500 since the portfolio's 2003 inception.



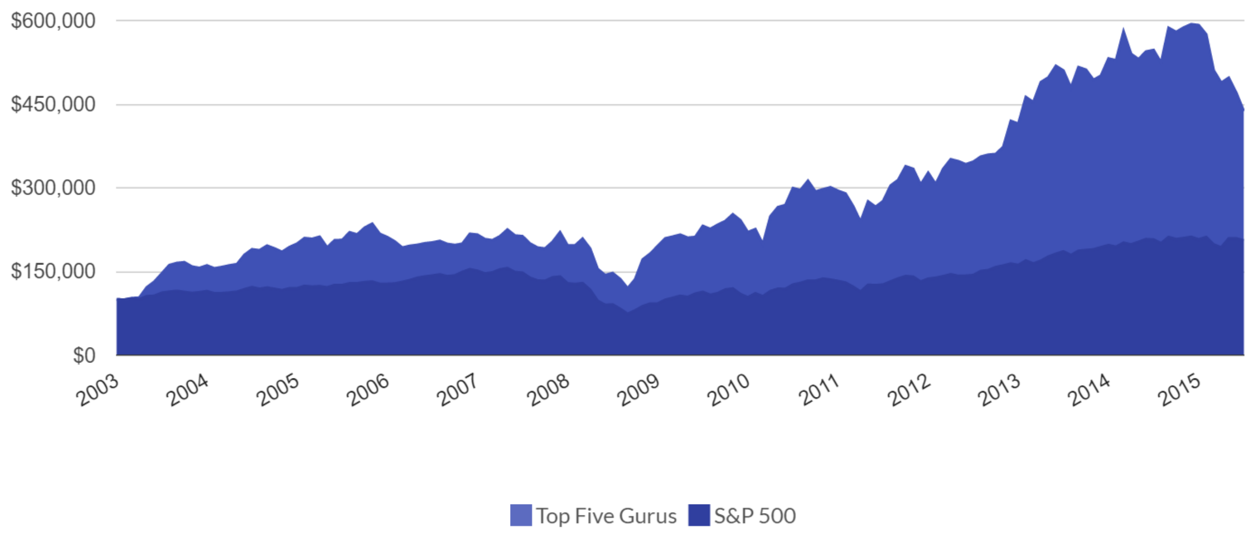
The Top 5 Gurus Strategy

Like the Hot List portfolio, the Top 5 Gurus portfolio has a stellar long-term track record, but underperformed by a wide margin in 2015. For the full year, the portfolio was down 20.0%, compared to a 0.7% loss for the S&P 500. The underperformance in 2015 was the portfolio's worst since its mid-2003 inception. The only other year it struggled as much as it did this year was 2006, when it trailed the market by 16%. However, the recent performance needs to be looked at in a long-term context. The Top 5 Gurus portfolio still maintains an outstanding long-term track record, one of the best –- since mid-2003 the portfolio has returned 12.6% per annum, which is more than double the S&P 500's annual return of 5.9% per year over the same timeframe. That's an overall 337.1% gain vs. 104.3% for the index. This return puts the portfolio in the #2 position overall out of all of our portfolios since their 2003 inception date.

The portfolio (which uses the top two picks from five top-performing strategies) was only accurate on about 42% of its picks throughout the year. This is well below the portfolio's long-term accuracy average of 56%. Despite its disappointing performance during the year, there were some individual standouts in the portfolio. For example, Amtrust Financial was up 18.1% from April-October, King Digital was up 23.7% from July-November, and WSFS Financial, a stock added to the portfolio in September, is currently up 14.6% as of Dec. 31.

But the Top 5 Gurus portfolio also found a number of significant losers, which largely influenced returns for the year. BOFI Holdings was down 35.4% from August-November, HCI Group was down 17.9% from April-August, and Chesapeake Energy was down 22% from May-early July.

Below is a chart simulating a $100,000 investment in the 10-stock Validea Top 5 Gurus multi-guru model and the same investment in the S&P 500 since the portfolio's 2003 inception.



LONG-TERM OUTLOOK

As we mentioned at the beginning of the report, 2015 was a below-average year for the market and, to a greater degree, the majority of the portfolios on Validea.com. Yes, there were some bright spots, like the growth strategies highlighted above, but several of the portfolios stumbled.

While we are of course disappointed with this performance, we are not alarmed; all strategies, even those used by history's best investors, go through losing periods, and sometimes those periods can last two or even three years. We do think it's important to understand the reasons behind the underperformance, however, and in this case there seem to be a couple main factors, which we touched on in this report's introduction.

First, while history has shown that smaller stocks tend to beat their larger peers by a significant margin over the long haul, we've seen a divergence from that trend over the past couple years. US large-cap stocks were just about flat in 2015, posting average losses of 0.3%, according to Morningstar. US small-cap stocks, meanwhile, were *down* more than 6% for the year. Part of that wide spread may be due to the normal ebb and flow that occurs between different market segments. But we think that a big part of it may be the result of something else: the rise of index funds. Index-tracking funds have become so popular in recent years, and the majority of them are weighted by market capitalization. This creates a cycle in which investors load up on index funds, pushing prices of the market's biggest stocks higher, which in turn makes those stocks comprise an even greater portion of the index, which means investors are buying more of those stocks when they buy index funds, and on and on.

The second major reason for the underperformance of many of our models: the struggles of value stocks. Over many, many decades, value investing has proven to be a winning strategy. That doesn't mean it always works, however, and 2015 was one of those years. US growth stocks gained 4.4% during the year; US value stocks, meanwhile, were *down* 5%, according to Morningstar. When you combine the underperformance of small stocks with the underperformance of value stocks, the results are much worse: US small value stocks were down 11% in 2015. On the opposite end of the spectrum, large US growth stocks were up 6.4%. That gap of more than 17% is completely antithetical to the long-term historical averages; according to the data of noted financial researcher Kenneth French, from 1927 through 2014, small value stocks outperformed large growth stocks by an average of more than 5 percentage points annually.

Many of the models on Validea tend to have a value emphasis and tend to select stocks in the small- and mid-capitalization parts of the market. When small- and mid-caps and value stocks have difficulty, it is not a surprise to see our models struggle as well. Furthermore, the performance of the market indices in 2015 doesn’t fully represent what happened to the average stock during the year. In periods when the market leadership becomes narrow (i.e. a small percentage of stocks are driving the market's returns) and most stocks are declining, strategies such as the ones found on Validea.com can have difficulty. However, history shows that trends reverse and often times when they do, the reversion and snapback can happen swiftly and be rewarding for those investors who have had the patience to stick to a proven long-term strategy. Our expectation is value will once again shine and smaller stocks will reassert themselves. This may not happen in the next few months or even in the next year, but it will happen.

Having faith and steadfastly believing in their fundamental-focused approaches during times when fundamentals were being overlooked was a key to the long-term successes of the gurus we emulate on Validea.com. Peter Lynch, Warren Buffett, Ben Graham, Joel Greenblatt, John Neff and many other great investors all went through periods when their strategies seemed to stop working, but sooner or later, the market would come back to fundamentals and value, and their results would revert to their very successful means.

The hardest part about investing is staying disciplined through periods of underperformance. But, as the gurus we follow have demonstrated, if you can do so, you should reap the rewards down the line. We believe that the rewards are coming, and we will continue to be patient and disciplined so that we do not miss out on them.

To view the 2015 model portfolio results, as well as the full historical record of all of Validea’s strategies, please click here to view our model portfolios.