THE BEST OF THE VALIDEA HOT LIST – 2007

HIGHLIGHTS OF THE TOP INVESTING COMMENTARY THROUGHOUT THE YEAR

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Selling: Art or Science?

Excerpted from the February 9th, 2007 Validea Hot List

Whether it is spam in our Microsoft Outlook mailbox, a tip from our brother-in-law or neighbor, or an article we read in the newspaper or blog, we are surrounded by recommendations about stocks to buy. The next hot stock seems to be known by an uncommon number of people, and they are very willing to tell us. Yet, when was the last time you read or were told what stock to sell?

Selling: it's the Rodney Dangerfield of stock market investing. So much energy goes into picking stocks to buy, but selling doesn't get nearly the same respect or effort. That's too bad, because an argument can be made that knowing what and when to sell is every bit as important as knowing what and when to buy. Keep in mind that you haven't made a cent of profit until you sell. Everything that goes on before the sale -- price run-ups, great earnings reports, stock splits -- is all window dressing. Your bank account gets no fatter until you've sold a stock and pocketed your gains.

I would guess that most investors have more trouble selling than buying. What is it about selling that makes it so hard? For one thing, the media is focused almost exclusively on buying. You can't sell before you've bought (unless you are a short seller), and the media doesn't know what you've bought and have in your portfolio. That makes it much more useful for the media to focus on stocks to buy. If you saw an article about stocks you should sell and you owned none of them, then you wouldn't be interested in the article. This focus on what to buy is therefore understandable.

But the difficulty concerning selling is more than just about media coverage. There is a whole psychological aspect to selling not found with buying. If we sell a stock after it goes down, we are admitting we made a mistake. Not wanting to admit an error is human nature, even though to err is human. We've all bought an article of clothing or food or even a car or house that we eventually realized was a mistake. Likewise, there's no reason to think all the stocks we buy will prove to be the right ones. If we make a mistake buying a sweater or a type of cheese, why should we think we won't also make a mistake buying a stock?

And if we make a mistake buying a stock, we really have not suffered a loss until we sell (just as we haven't really made a profit until we sell). Who wants to take a loss? We therefore resist selling, and say things to ourselves like, "I'll wait until the stock goes back up to where I bought it and then I'll sell. I want to be made whole before I dump this junky stock." That's a dumb strategy. If the stock's a dog, waiting will probably not result in its turning into Cinderella. Rather, waiting will probably just give the stock more time to tank and increase our losses.

Let's face it, the market's legendary drivers -- fear and greed -- also come into play when selling. The price drops, and we fear we will lose money and lose self-esteem (because we were wrong), so we hold on. Or, the stock rockets up, and we think we can make more and more, and we hold on too long.

The psychology that affects selling is, it seems to me, more complex than that pertaining to buying, and likely inhibits investors from acting with the logic, dispassion and dispatch they should. All of this bodes poorly for our selling strategies.

Given how important selling is and how difficult it is for many of us, it comes as no surprise that a host of simple, mechanical strategies have been proposed. Stop-losses are probably the most widely used. With a stop-loss, a stock is sold as soon as it hits a certain price. We say we'll live with as much as a 15 percent

loss, for example. With a stop-loss, as soon as the stock falls south of 15 percent, we automatically sell. Same with the upside, where we implement a strategy that sells when a stock doubles in price or whatever upside maximum we target. The stop-loss strategy is not bad, but it has its weaknesses. A stock may fall because the market goes down, not because of any fundamental problems with the company, and selling in such a situation could result in our missing the profitable turnaround that occurs when the market -- and the stock -- go back up.

Another strategy is to say that if a stock goes up some percentage, say 50 percent, we'll sell half our holdings to capture a chunk of profit, and then keep the rest with the expectation it will go higher. Of course, when you do this, if the stock goes up -- which is what you are betting on -- you miss out on half the profits because you've sold half your holdings.

You are probably now seeing where I'm going with all this, namely a better selling strategy. Selling is hard, complex, and often runs head-on into psychological forces that tend to have us do exactly what we should not. When we were setting up Validea, we recognized from the beginning that, while we had a great strategy for finding stocks to buy -- use the strategies of those (the gurus) who have years and years of success investing in stocks -- we also needed a strategy for getting our readers, and ourselves I might add, out of the stocks we recommended. We did a considerable amount of research that evolved into the strategy we implemented when we launched this website. The strategy is simple, elegant, easy to implement and very effective.

The strategy: Every 28 days, we rebalance the portfolio. Most notably, we rebalance the Validea Hot List, but we also rebalance the 10 best stocks of each guru strategy.

Deciding to rebalance every 28 days came from a considerable amount of research. We looked at various rebalancing periods, from monthly to annual, and we found that rebalancing about every month produced the best returns. Though rebalancing this frequently means that our gains will almost always be taxed at the ordinary income rate and not the lower capital gains rate, the gains of rebalancing with this frequency, our research shows, more than offset the added tax burden.

By rebalancing based on the computer's calculations of the guru strategies, we eliminate fear, greed, guesswork and all sorts of negative psychological factors. The guru strategies do all the work, and when they say a stock is no longer one of the 10 top, it is time to sell. Period.

What is rebalancing? It is taking a fresh look at the portfolio and choosing the 10 best stocks at that time. Every 28 days we start anew and find the 10 best stocks. A stock may stay on, say, the Validea Hot List, for 28 days, only to fall off the list at the next rebalancing because the guru strategies have found a stock which, at that time, is a better investment. Others may stay on for months, if they remain among the 10 best picks. You can see how long a stock has been part of the Hot List in the table below.

One more aspect of our sell strategy is worth mentioning. About two years ago we had a couple of heavy losers on the Validea Hot List. Yes, even we are not perfect. The Validea Hot List did well overall (because the winners more than made up for the losers), but the fact that we had, for example, a stock drop more than 30 percent during a rebalancing period got us thinking about how we could prevent such losses and improve our returns even more. We spent a considerable amount of time and effort studying the issue, and implemented a stop-trigger strategy. This is similar to a stop-loss strategy, only it goes further.

A stop-loss strategy, as I just mentioned, sets a specific level -- often 15 or 20 percent -- and then automatically institutes a sale the moment the stock drops below that level. We tested stop losses, only to find they hurt our returns overall because many stocks that hit the stop losses subsequently rebounded.

As we analyzed our historical data, it became clear there was a clear difference between stocks that hit our stop losses and later rebounded and those that did not. The difference is what we call a "triggering event."

A triggering event is something that triggers a drop in the stock's price. Examples of triggering events: an earnings warning, an SEC investigation, an announcement of accounting irregularities, or an earnings restatement that significantly affects the future of a company but is not yet reported in the publicly available financials we use to analyze each security.

The strategy we implemented was this: when a stock drops 15 percent and has a corresponding triggering event, we remove the stock from our portfolio and not allow it back in for four months. By that time, the negative event has had time to be reflected in the stock price. We immediately replace it with a stock that scores highly in that portfolio. By replacing a stock with a negative triggering event with a stock that has not experienced such an event, we boost our returns. We tend to have more high scoring stocks than we can fit into a 10-stock portfolio so finding replacements is easy. We are very cold-hearted about this. There is no fear, greed, second guessing or ego involved. If we make a mistake, we act immediately to correct it and move on. A triggering event and a 15 percent price drop results in a sale. It's not open for discussion.

Using the guru strategies, rebalancing every 28 days, and protecting ourselves with the stop-trigger strategy produces a sell strategy that is, I believe, as effective as any available. Knowing when to sell is too important to be left to fear, greed or your brother-in-law's hot tip.

Choosing and Using the Guru Strategies

Excerpted from the April 6th, 2007 Validea Hot List

At Validea.com, we constantly talk about "gurus" and "guru strategies." The website itself revolves around the 11 guru strategies I've chosen to use as a means to pick investments. Full subscribers to the Validea.com website have access to the Validea Hot List and all individual strategies, while those who subscribe to the newsletter only have access to the Validea Hot List, which is derived by combining several of the individual strategies. What many subscribers do not know is how the gurus were originally chosen, what kind of work we've done with these strategies since they were included on Validea.com and how to use the strategies. These are points I'd like to discuss now.

I chose which gurus to follow based on three criteria:

1. The guru needed an impressive track record. I never put an exact number to this (such as a guru needing to have an annual rate of return of at least such-and-such). Rather, I looked for those gurus who had public track records (typically because they had written books and managed mutual funds) that were impressive enough to be widely acknowledged and respected. Others I included because they had published academic papers that were impressive and ground breaking, such as Joseph Piotroski.

2. They must have written a book or other document that outlined in detail their stock picking methodology. Obviously, if they had not publicly revealed their strategy, there was no way I could have access to it. At first, Warren Buffett was not going to be included because he never wrote about his strategy. True, he includes descriptions of his strategy in his letters in Berkshire Hathaway's annual reports, but these are just bits and pieces, and not a comprehensive overview of his strategy. He still has not written a book about his investment approach, but shortly before I created Validea.com, his former daughter-in-law, Mary Buffett, published her book, *Buffettology*. She had worked with Buffett and, when I read this book, I believed it accurately mirrored Buffett's investment strategy so I included it.

3. The investment strategy had to include multiple quantitative elements. I needed quantitative elements because this is what I could program into the computer. Qualitative criteria, such as, "I look for good management," I could not use. That said, I should note that some gurus translate qualitative elements, like good management, into quantitative ones, such as the return on equity that management has produced, or actions that benefit shareholders, such as buybacks of company shares. By the way, when looking for a book about Buffett, I did not use Robert Hagstrom's *The Warren Buffett Way*, because it is highly qualitative and not very quantitative. In fact, the majority of investment books which I have read over the years that pick stocks are heavily weighted towards qualitative guidance rather than quantitative.

Looking to Add Strategies

I started tracking strategies on Validea.com in July 2003 with nine strategies. Since then, I've publicly added two more, those of John Neff and Joseph Piotroski. In addition, I track others privately. These are test situations to see how well the strategies perform in the real world. Also, on an ongoing basis we read new investment books, and consider adding their strategies as well.

Adding strategies at this point is somewhat difficult. That's because we have such diversity now that it is tough for new strategies to add much value. Many so-called "new" strategies are really rehashes of existing ones. And some authors who have previously written books publish new tomes as a way to sell more books, rather than providing substantive new thinking. We won't add a strategy that is similar to

those we already have as there are no major benefits to doing so. We now have a good crop of strategies, with plenty of diversity for subscribers to pick and choose.

Instead, we are looking for new strategies that use criteria we generally are not using now, have requirements not found with our existing strategies, have outstanding track records or are otherwise substantially different than any strategy now in our portfolio.

We've never dropped a strategy, but we have considered doing so. Motley Fool is one we have toyed with eliminating. That's because the authors, brothers David and Tom Gardner, have come up with so many strategies over the years that they are no longer very closely associated with the strategy we use. And the strategy is fairly volatile. Plus, the Gardners do not have much credibility with the Wall Street professional community, though that may in part be a function of the in-your-face, tweak-your-nose attitude of the Fool website. But so far, we've decided to retain the strategy because it uses some criteria, such as accounts receivable relative to sales and daily dollar trading volume, that other strategies do not use. Also, it goes into more depth identifying small cap stocks than other strategies and uses some fairly stringent, discriminating criteria. What I like about the strategy is its very tight screening criteria, and what I don't like is its high volatility.

The Individual Strategies

Let me briefly comment on each of the individual strategies. I've just discussed the Motley Fool strategy. The Buffett strategy is, I believe, our site's most popular with subscribers. Buffett's performance has been public for over 30 years, and is widely admired. Also widely admired is that of Benjamin Graham, who is considered the father of value investing, was Buffett's teacher at Columbia University, and is author of the classic investment guide, *The Intelligent Investor*.

I started my search for gurus with Peter Lynch and his book, *One Up on Wall Street*. I find his book clearly written, and he had a great track record running the Fidelity Magellan fund. I respect his stock picking abilities. David Dreman added a contrarian view to our basket of strategies, and I think this is a valuable addition. He is also a respected *Forbes* columnist. Martin Zweig's newsletter was the highest performing of all newsletters, on a risk-adjusted, long term basis, according to *Hulbert Financial Digest*.

Kenneth Fisher adds the price-to-sales ratio to our analysis, a ratio he is considered the father of. And he, like Dreman, is a respected *Forbes* columnist. William O'Neil is widely watched because he is the publisher of*Investor's Business Daily*. I also liked the fact that he took a contrarian approach -- buy high, sell higher -- and his strategy includes a lot of sharp, observant rules. His approach is also quite complex and not easily calculated by hand.

James P. O'Shaughnessy wrote in *What Works on Wall Street* about his great work back testing the stock market over 45 years. It was impressive research and his strategy is impressive. John Neff ran the Windsor Fund, which beat the market 22 out of 31 years, and his strategy focuses on value stocks. He is someone with a substantial, impressive, real-world track record.

Joseph Piotroski, an accounting professor at the University of Chicago, conducted a breakthrough study. Before Piotroski, it was known that high book-to-market stocks would outperform the market. But many companies with high book-to-market ratios are having problems. He posed the question: Are there some rules among companies with high book-to-market ratios that can separate the troubled companies from the good ones? He was able to define such rules and created a strategy that provided extraordinary returns using high book-to-market stocks.

Using the Strategies

Why pay attention to any but top strategies? First, as you can see from their track records which we list on Validea.com, all the strategies, with the exception of O'Neil's (the O'Neil strategy's return is 37.2 percent versus the S&P 500's 43.7 percent), have handily beaten the S&P 500 during the time we've followed them. This isn't back dating, but real world. Because none are losers (including O'Neil's), you can hardly go wrong using one or another. I consider the O'Neil strategy a winner because, while it is currently not performing as well as the market, there are times when it outperforms the market; it is a volatile strategy that over the long term I believe will outperform the market.

Additionally, there is no guarantee the top strategies for the current quarter or current year will continue at the top of the food chain. Diversification gives you protection if one or a few of the strategies fall behind at any given time. You would not (or at least should not) put all your money into one or a few stocks. Likewise with strategies.

With a diversified basket of strategies, you should do well in many kinds of markets and be less tempted to stop using a strategy when you think it is underperforming for too long. This is similar to timing the market, and is extremely difficult to do well. Some people abandon a strategy that underperforms for three months, even a year, but there is research that shows the best strategies can underperform for even three years and yet still whip the market over the long term. We provide you with a broad breadth of strategies because we believe diversity in strategies provides real value. I strongly urge you to pick your favorite strategies when choosing stocks to buy, and stick with them through the ups and downs of the market, rather than continually second guessing yourself and jumping on another strategy because it has recently done substantially better.