THE BEST OF THE VALIDEA HOT LIST – 2009

HIGHLIGHTS OF THE TOP INVESTING COMMENTARY THROUGHOUT THE YEAR

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Five Reasons to Be Bullish in 2009

Excerpted from the January 9th, 2009 Validea Hot List

The past year has been one of the worst in the history of the stock market. Even including dividends, the S&P 500 finished down 37 percent, the Dow Jones Industrial Average down more than 32 percent, and the Nasdaq Composite down more than 40 percent.

But while the same economic factors that sparked thee market meltdown are still dogging the economy, there are many reasons for long-term stock investors to be optimistic as we head into the New Year. That's not to short-change the problems we're now facing; they remain substantial. But good investors must have the ability to look past the near-term and see the forest for the trees. To me, the forest that is the stock market looks quite inviting right now. Here are five major reasons why:

Valuations: Yes, many investors were tricked before the recent crash by "low" P/E ratios that were the result of extreme leverage propping up earnings. But now, we've had almost a full year of recessionary earnings, and P/E ratios and just about every other valuation measure out there indicate stocks are no longer overvalued. And forward-looking P/Es, which reflect the pessimism in the market, are also very low by historical standards. Standard & Poor's is expecting operating earnings of $81.80 per share for the S&P 500 in 2009, which would put the index's forward P/E at about 11.0. More conservative earnings estimates -- like those that 12 strategists recently gave Barron's, which averaged about $60 a share -- still put the forward P/E at a reasonable 15.

Stocks are also now cheap based on their book values (the value of their tangible assets minus their debts and liabilities), even after the huge writedowns and profit cuts we've witnessed. James O'Shaughnessy, one of the gurus I follow, recently noted that three years ago, only nine of the 500 firms in the S&P 500 were trading at prices below their book values; today, 153 of them are. Coming off a period in which many companies' growing profits were propped up by high leverage, this is a bullish sign.

Even the most conservative of the more commonly used valuation tools, the 10-year P/E ratio (which averages earnings over a 10-year period), has recently indicated that stocks are cheaper than they've been in two decades. All of this has led even some notorious bears like Jeremy Grantham to say that the market is finally cheap.

The Post-Bear Market Guru Track Record: The gurus upon whom I base my strategies all have tremendous long-term track records. But they tend to really excel following down periods like the one we're going through. One big reason: their reliance on facts and numbers -- not hype. While many investors are leery of stocks after periods of bad news, the gurus and our models focus solely on the numbers -- earnings, sales, debt, and other fundamentals. While others allow emotion to get the best of them and avoid the great bargains available after fear-provoking downturns, the gurus -- and our models -- snatch up those good stocks selling on the cheap.

Want proof? Consider the bear of 1973-74, which ended in October of 1974. In 1975, when the S&P bounced back 37.2 percent, John Neff's Windsor Fund returned 54.5 percent, and James O'Shaughnessy produced back-tested returns of 47.9 percent. Neff's fund and O'Shaughnessy's back-tested results again handily beat the market in 1976, as did the back-tested book/market method Joseph Piotroski used (1976 was the first year his research covered). Warren Buffett was the only one of our gurus to underperform in one of those two years -- and he followed his 5 percent loss in 1975 with a whopping 134.2 percent gain in 1976.

After the bear market that ended in August of 1982, the gurus also outperformed. While the S&P gained 22.4 percent in 1983, the gurus' returns for the year were as follows: Neff -- 30.1 percent; Buffett -- 69 percent; Peter Lynch -- 82.8 percent; O'Shaughnessy -- 35.6 percent; Piotroski -- 32.4 percent. Only

Martin Zweig lagged the S&P, producing returns of 17.4 percent.

Coming off the most recent bear market and recession, we had a similar experience with our Guru Strategies. The eight individual models we began tracking in July 2003 (shortly after the market began its post-bear market turnaround) each gained between 20 percent and 52 percent for the remainder of that year, while the S&P rose 11.1 percent. In 2004, seven of those eight models more than doubled the S&P's return.

Pessimism: Right now, Americans are at or near all-time lows in terms of confidence in the economy and stock market, and for good reason. The markets have plummeted, the leaders of our financial system have allowed greed and short-sightedness to make a train wreck out of economy, and the Madoff scandal has left investors wondering just who they can trust. Back in July, 55 percent of Americans said they expected stocks to fall in the following 12 months -- an all-time high. And that was *before* the stock market meltdown and financial sector bailout and Madoff scandal.

But pessimism isn't a bad thing. As the great Sir John Templeton once said, "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell."

The data shows that Templeton was right. Citing data from The New York Times, The Motley Fool's Jim Mueller recently showed that every time the stock market pessimism rate has exceeded 35 percent, the market has gone on to gain ground in the next 12 months. Those instances, and the following 12-month returns of the S&P 500:

November 1987 --- +19 percent
October 1990 --- +29 percent
December 1991 --- +4 percent
April 1994 --- +14 percent
October 1998 --- +24 percent
March 2003 --- +33 percent
Average --- +20.5 percent

Now, given the steep declines we've seen recently, I'm not saying that the S&P will end 2009 above its July 2008 mid-1,200s level. But the general point that the data makes -- that periods of extreme pessimism don't last forever, and usually give way to strong market gains -- certainly bodes well as we enter the new year.

Uncle Sam: I know -- putting the government on a list of reasons for optimism about anything seems oxymoronic. To be sure, there's been plenty of criticism of the government's handling of the financial crisis -- it's decision to let Lehman Brothers fail, Congress's delay in passing the initial bailout, the switch from plans to buy up bad debt to plans to inject capital directly into firms.

Some of those criticisms may have merit, but the bottom line now is this: As flawed as its methods may or may not have been, the government has taken extraordinary measures to prevent the collapse of the financial system. Many experts have said that the steps the U.S. took in the first couple months after the crisis boiled over were more significant than Japan took over the course of years in trying to stem its real estate-triggered decade-long recession.

While the specifics on what legislators and the Obama Administration have been planning in terms of a second stimulus are somewhat lacking, it is apparent that the government is going to continue to take major steps to try to get the economy back on track and prevent a further meltdown. That's encouraging.

Inflation: While the cost of inaction likely would have been worse, the federal government's pumping of more than a trillion dollars into the market is likely to have at least one major problematic effect: inflation.

And that's a reason for investors to buy stocks.

The research of David Dreman and Jeremy Siegel shows that, throughout history, stocks -- not gold -- are the true inflation-beaters because they can produce increasing earnings streams while fixed income investments cannot. From 1946 (when inflation really became a permanent part of our economy) through 2006, stocks averaged real annual compound returns of 6.9 percent; long-term government bonds, meanwhile, averaged 1.6 percent, short-term government bonds 0.6 percent, and gold brought up the rear at 0.5 percent.

Stocks even beat real estate over the long run. From 1945 to 2007, inflation-adjusted home prices in the U.S. increased at a compound rate of only about 1.3 percent per year -- and that's before the precipitous drop in home prices that we saw in 2008 (figure computed using housing data of Yale Professor Robert Shiller).

A Time of Opportunity

Whether or not 2009 will be a good year for stocks, no one knows. While the data certainly seems to support the notion that equities are undervalued, investors don't always go by data -- they go by emotion, and that means anything can happen in the short term.

But what I believe is that 2009 will go down as having been a great buying opportunity for stock investors. It may take a year, three years, or even five years for the bargain shopping to pay off, but those who buy now while values abound will end up with strong returns in the long run. I'm far from the only one of that opinion. Several of the gurus upon whom I base my strategies -- including Warren Buffett, John Neff, David Dreman, James O'Shaughnessy, and Kenneth Fisher -- have talked about the market being flush with opportunity recently. Those gurus have lengthy track records of being right before, and I believe they'll be right again this time.

The Road Back

Excerpted from the April 17th, 2009 Validea Hot List

The fact that the market continued to push upward these past two weeks and didn't give back the huge gains it made over the previous month was no doubt a good sign. And there are some real indications that this move could stick. As Francois Trahan of the research firm ISI Group recently noted, the current bullish turn is the fifth 10%-plus gain we've seen during this nasty bear -- but the first that has been accompanied by an increase in leading economic indicators. "This is not just an oversold pop like the other ones," he told Consuelo Mack of WealthTrack. "This is one that is about better economic prospects down the road. So I think it's legitimate, essentially is the way to think about it. And I think it's the first inning of something that's going to last quite a while."

That doesn't mean the road to recovery will be an easy ride, and there are certainly other strategists who don't share Trahan's view. With more earnings reports to come -- not to mention the first round of bank stress tests in the coming weeks -- a lot could change in the short term. Nothing guarantees that the economy will keep gaining traction, or that the market will keep gaining ground (doomsday-sayers like Nouriel Roubini and Peter Schiff won't let us forget that). Investors should continue to keep in mind that the depth of breadth of the crisis (i.e., the depth and breadth of the deleveraging and unwinding of bad debt) are great.

But while it will take time, I continue to believe that the economy will recover, and recover fully, and that we are not headed into some sort of financial apocalypse that will decimate stocks for the long term. Some great data on this topic comes from Ben Inker of GMO (the investment firm of Jeremy Grantham, whose name I've referenced in other Hot Lists).

In a recent report, Inker writes that the he believes the current economic conditions are, in fact, temporary -- not permanent. In justifying his view, he highlighted the long-term productivity of the economy, and the long-term dividend stream that stocks have provided investors throughout history. Both, he says, have proved quite stable over the long run, and have shown a clear tendency to revert to a mean, even after terrible crises.

To understand why such mean reversion occurs, one needs to understand just what the economy is, and how it works. Writes Inker, "The productive capacity of the economy comes from the skills and size of the workforce and the country's accumulated intellectual and physical capital. If GDP were to fall by 5%, it would not be because our ability to produce goods and services had fallen by 5%, but because aggregate demand for those goods and services had fallen. When the demand returns, the economy will be able to ramp up production quite quickly."

As proof, Inker points to the Great Depression. GDP dropped 25% from 1929 to 1933, he says, a staggering decline. "But that fall, as extraordinary as it was, was a fall in demand relative to potential GDP, not a fall in the economy's productive capacity, and so the economy eventually got back onto its previous growth trend as if the Depression had never happened."

There are more extreme examples of economic production reverting to a mean in other countries. World War II, for example, caused incredible devastation in Germany and Japan. But, Inker says, that devastation eventually left the German and Japanese economies "without a noticeable trace", as GDP recovered and settled back into the long-term trend it had been on before the war.

Inker's conclusion, with regard to American economic production: "If the Great Depression and two world wars failed to materially change the long run path of GDP or dividends," he says, "then it seems that the safest assumption is that the credit crisis will not, either."

I agree. As I've noted in past newsletters, David Dreman and Jeremy Siegel have both presented similar evidence on the resiliency of both the U.S. economy and stock market. Dreman, you'll recall, found stocks showed a remarkable ability to bounce back following traumatic events, including wars and presidential assassinations. Siegel's data showed that, over more than two centuries, the stock market has continued to revert to after-inflation returns of 7%. That covers a period in which huge changes -- the Industrial Revolution, the introduction of the automobile, airplane, television, and Internet, the rise and fall of many different nations -- occurred throughout the globe. I think Inker's data and observations build on Siegel's and Dreman's findings about the resiliency of the economy and stock market.

If you believe, as I do, that we'll make it through this crisis without some sort of irreparable harm, the question for the long-term investor thus centers on one thing: value. And I continue to see quite a bit of it in the market. Could valuations get cheaper? Of course. While stocks are cheap based on measures like the 10-year P/E ratio, stock market value/GNP ratio, and Tobin's Q, they are not as inexpensive as they've been at the bottom of past downturns, such as 1932 or 1982. Many are waiting for stocks to turn back down and reach, or come close to reaching, those all-time low levels. Will they? It's a close-to-impossible question to answer, particularly in light of the fact that this downturn involves an unprecedented multi-trillion-dollar government stimulus plan, the full impact of which is yet to be seen.

The bottom line is that when stocks are cheap compared to historical standards, it's a good time to buy. And, while they might not be at all-time lows in terms of valuations, stocks are cheap -- and may actually be cheaper than you think. That's what Siegel said in one of his recent columns, in which he contended that Standard & Poor's inaccurately calculates the earnings of the S&P 500. Siegel has taken some hits in the media lately as buy-and-hold strategies have been criticized, but I continue to respect his opinions, both because of his long-term, data-driven approach and his sharp intellect. And in regard to the earnings issue, he raises an intriguing point.

Siegel notes that S&P calculates the price of the S&P 500 index by a market-cap-weighted formula. The greater the company's market value, the more impact its price movements have on the index. In calculating earnings, however, S&P weights all earnings equally, simply adding up each of the 500 companies per-share figures. "as a result," he writes, "the billions of dollars of losses racked up by, say, AIG, whose market value is extremely low, is added dollar for dollar to the earnings of the profitable firms, such as Exxon Mobil, whose market value is more than 20 times larger." S&P's methodology [gives] far too much influence to firms with big losses and low market values, and thereby gave a distorted valuation to the S&P 500 Index."

S&P says reported earnings for the index for 2008 were just $14.97 per share, Siegel notes, which means the S&P 500 index was selling at 53.3 times earnings as of March 31, when it was valued at 798. Using Siegel's market-weighted earnings method, the index's reported per-share earnings would be $71.50, making for a P/E of just over 11.

Using operating earnings, S&P said earnings per share for the index were $49.49 in 2008, resulting in a 16 P/E ratio as of March 31, Siegel says. Using his method, operating earnings were $79.40 per share, making for a P/E of 10.

One interesting point in all of this: "Back in 2002 the aggregate earnings of the S&P 500 Index also plummeted when a few firms, such as AOL and JDS Uniphase, took huge writedowns on some of their

Internet investments," Siegel writes. "Reported P/E ratios soared into the 60s in the second quarter of 2002, yet rather than being overvalued, the market was just approaching its bear market low."

Could we have just come through a similar scenario? Let's hope so. But I think there's a broader point here, that being how the debate between Siegel and S&P (which has tried to refute his argument) highlights just how hard it is to pinpoint an exact valuation for stocks, and for the market as a whole. Can you get a general idea of the market's valuation? Sure, by examining historical data and using any number of valuation metrics, like the 10-year P/E. But there's a margin of error in any valuation assessment. (In fact, in the GMO report I referenced earlier, Inker estimates that about half of the market's "intrinsic value" comes from cash flows that will occur*more than 25 years out into the future*.) That's something to keep in mind if you're waiting for those "all-time low" valuations to appear before jumping into stocks.

I won't be. Stocks are cheap by a number of historical standards, and history shows that investors who buy at times like these far more often than not end up with excellent long-term returns. Could that mean some short-term losses if the market does, in fact, turn around and head lower? Yes. But to me, the alternative -- missing out on a big chunk of a bull market surge -- is a far more dangerous proposition.

Why Not to Listen to the "Why Not to Invest" Crowd

Excerpted from the May 1st, 2009 Validea Hot List

The market's continued strength over the past two weeks is very encouraging. For stocks to continue to climb after such a surprisingly weak GDP announcement and during the quasi-hysteria caused by the swine flu news indicates that expectations had gotten so low in the earlier part of this year that stocks did indeed become quite undervalued. Now, any flickers of hope seem to be slowly pulling money back into the market -- and there's a lot of it out there to pull back. According to Forbes, investors have $9.5 trillion in money with zero maturity -- cash sitting in Treasuries or money market accounts. Charles Schwab's Chief Investment Strategist Liz Ann Sonders says that is more than the value of all publicly traded U.S. firms, and represents the most money sitting on the sidelines in history.

Still, even with all that cash laying in wait, many are saying that now is no time to put money into stocks. I disagree, and I thought it would be a good time to counter several of the bearish arguments I've seen recently. Here they are -- with the other side of the story.

"We're Due for a Pullback": Yes, the dramatic turnaround we've seen since March 9 has been a bit dizzying, and makes one wonder whether it was too much too soon. But a closer look shows that it may, in fact, have been just the right amount. According to Kenneth Fisher, one of the gurus upon whose writings I base my strategies, the nature of bottoms has historically been "V-shaped", meaning that the steeper the decline at the end of a bear market, the steeper the incline at the start of a bull run.

When we look at the current turnaround, the "V-shapedness" is pretty striking. Back on Jan. 12, the S&P 500 sat at 870.26. Over the next eight weeks exactly, it tumbled to that 676.53 March 9 low. As of yesterday's close (which was two days shy of exactly eight weeks since the March 9 low) the index was back up to 872.81 -- less than one-third of one percentage point from that Jan. 12 starting point.

Could there be a "post-V" pullback, though? Maybe. But history shows it's no sure thing. Back in 1982, after bottoming following a nasty bear, the market surged 22% in about 40 days. It then had only a minor pullback of a couple percent before surging almost 20% in the next 40 or so days. The bottom line: Trying to avoid a 10% or 15% pullback that might never occur is, for me, too risky a proposition -- especially given that equity prices are still fairly low. Avoid stocks at these valuations, and the odds are you'll be sorry.

"The Great Depression Recovery Took 25 Years": This, frankly, sounds terrifying on the surface. And, in literal terms, it's true that the Dow Jones Industrial Average took about 25 years after its Great Depression bottom to reach its pre-Depression high. Does that mean that it could be 2027 before we get back what we've lost in the recent market crash?

According to Mark Hulbert, founder of Hulbert Financial Digest, that's pretty unlikely. Hulbert said in a recent New York Times column that the 25-year Depression recovery figure is misleading for three big reasons. First, major deflation --- by 1936, the Consumer Price Index was 18% lower than it was when the market crashed in 1929 -- made the dollar worth much more than it had been. So, the amount of purchasing power investors gained in the recovery when the market turned up by, say, a dollar, was greater than the amount of purchasing power they lost for each dollar of declines in the preceding bear market.

Second, the Dow took 25 years to recapture its pre-Depression price high, but that doesn't include dividends. And when the market bottomed in 1932, the dividend yield of the overall market was almost

14%, according to Yale Professor Robert Shiller's data. Those payouts were no doubt a big boost to investor's portfolios.

Third, Hulbert notes that the Dow can diverge significantly from "the market". And back in the late 1930s, IBM was removed from the index. It went on to be one of the best-performing stocks of the '40s, Hulbert says, and the popular stock was likely in many investors portfolios even though its gains didn't help the Dow.

So, when you take all of those factors into account, when did investors really regain the purchasing power they had, pre-Depression? About four-and-a-half years after the 1932 market bottom, Hulbert says. That's just four-and-a-half years to regain the losses suffered when the Dow declined 80%.

"Bonds: The Best Long-Term Investment": A couple of big names -- Rob Arnott of Research Affiliates and Forbes' Gary Shilling -- have made headlines with articles along these lines recently. Shilling and Arnott are both very smart men and are extremely knowledgeable about the financial world, but I -- and many others -- believe their data is somewhat misleading.

Shilling, for example, contends that stocks underperform bonds, even in very bullish periods. In fact, he says, 25-year Treasury bonds generated 11 times the return of the S&P 500 from the early 1980s through March of this year. That may be true, but the problem with Shilling's argument is that the early 1980s was perhaps the greatest period to buy Treasury bonds in history. With inflation rates around 13% or so, T-bonds were offering yields in the 15% range. Today, the rates are in the 3% to 4% range. In addition, to make the stocks/bonds comparison through March of this year means you're valuing stocks just a few weeks after a low that represented the second-largest bear market decline ever. Doesn't seem like a good time to get a "big picture" view of what to expect from stocks in the future.

Arnott's study also has similar biases. One of the major periods he looks at, for example, is 1979 through 2008. (For a more in-depth look at the stocks/bonds issue, see Brett Arends recent piece for The Wall Street Journal athttp://online.wsj.com/article/SB124096744859166453.html.)

"Haven't You Heard? Stocks are *More* Risky in the Long Run" A recent study by two notable professors -- Lubos Pastor of the University of Chicago and the National Bureau of Economic Research and Robert Stambaugh of the University of Pennsylvania's Wharton School -- found that stocks actually become riskier over longer periods of time, contrary to what conventional market wisdom states. The reason lies in the fact that the future gets harder to predict the farther out you go. For example, we have a decent idea of what global warming's impact will be in the next year. But 20 years from now, the picture gets much murkier.

Given all that we've been through in the past year or two, the study injected another level of fear into the stock debate: If stocks just lost more than half their value in a matter of a year-and-a-half, why would anyone want to invest for longer -- and riskier -- periods?

Well, in an interview with one of Wharton's web sites this week, Stambaugh indicated that things weren't that bleak for stocks, and urged readers not to misinterpret what the study meant. The study's findings about volatility increasing over longer periods doesn't mean that volatility in the future will be greater than the high volatility levels we've been experiencing in the past several months, he said: "We expect that sort of short-run volatility to moderate. Our paper is more about what a more typical environment -- or more average environment -- for volatility would offer an investor in terms of short-run versus long-run. We'd all be very surprised if [this historically high short-term volatility] were to continue for long periods".

In addition, Stambaugh said the study only looked at stocks. Other asset classes could get riskier over time as well, he said. "It's quite possible that this same kind of [long-term] uncertainty in nominal bonds could well make them less attractive," he said, adding that he and the study's other authors hope to due follow up research on that issue.

Speculation Doesn't Just Hurt Bulls

Now, to be clear, all of this is not to say that the market's current run is going to continue, uninterrupted, for months and months. What it does mean, however, is that much of the anti-stock rhetoric that is lingering in the post-crash environment seems somewhat overblown, or based on mere speculation about potential disastrous consequences -- and allowing speculation to keep you out of the market can be as dangerous as allowing speculation to pull you into the market. I'd rather continue to look at the facts and the long-term data, and right now I think both are indicating that this is no time for long-term investors to bail on stocks.

Emotion, Discipline, and the Gurus

Excerpted from the July 24th, 2009 Validea Hot List

With the economy still far from stellar, there remains intense debate over whether or not the "green shoots" we're seeing in the economy are real, and whether the market's rally over the past few months will continue. Some say this is just the start of a long bull run, other says it's a false rebound that will fade.

This debate has been going on for some time now, and the one thing that seems clear is this: Those who have been waiting on the sidelines for the economy to show major signs of recovery continue to miss out on some huge gains. Since March 9, the S&P 500 is up about 45%, while the Nasdaq Composite has been even better, jumping 56%. In the past three months alone -- after the "Is it real?" debate was already well underway -- nine of my models are up more than 20%.

So, while many have been poring over economic reports, investors who have stayed disciplined and didn't let emotion knock them out of the market this past fall or winter have benefited greatly. By sticking to their strategies, they've regained much of the losses incurred in late '08 and early '09. Two of my individual guru-based models -- those I base on the writings of Joel Greenblatt and Benjamin Graham -- have already regained all of their 2008 losses, and continue to pick up stocks selling at low valuations.

Some would argue that you could have simply avoided the losses of last year by getting out of the market at the start of 2008, and then getting back in recently. And that's true -- true, but incredibly unlikely. History has shown that the vast majority of investors have bad timing -- a perfect example is the fact that on March 5, the day before the S&P 500 hit its 666 intraday low, a mere 18.92% of respondents said they were bullish on the American Association of Individual Investors' weekly sentiment survey. And that's how many *said* they were bullish; I'd be willing to bet that fewer than that had the fortitude to actually put their money where their mouths were.

The reality of investing is that most people jump in and out of stocks at the wrong times. Want proof? Consider the research of DALBAR, Inc. In one of its studies of investor behavior, DALBAR found that over a 20-year period, equity investors earned well less than half the returns that the S&P 500 made. The reason? As markets rise, the data shows that investors pour cash into mutual funds, and when a decline starts, a "selling frenzy" begins. In other words, the research shows that investors tend to do the opposite of the old stock market adage, "Buy low, sell high."

Morningstar has found the same trend. The investment research firm actually measures fund performance in two ways -- the return an investor would have had by putting money in the fund on a certain date and then keeping it there, and, perhaps more importantly, the return an average investor in the fund actually got. The latter figure, which Morningstar calls the "Investor Return", is very often lower than the former figure, showing that investors more often than not jump in and out of funds at the wrong times.

That didn't change in the market madness of 2008. DALBAR's 2008 Quantitative Analysis of Investor Behavior found that equity fund investors lost 41.6% last year, compared with 37.7% for the S&P 500. DALBAR President Lou Harvey had this to say about investors' continued failure to time the market correctly: "For 15 years, [DALBAR] has shown that investor returns lag what performance reports and prospectuses would lead one to believe is achievable. While those returns are, in fact, theoretically achievable, the reality is that investors are not rational, and make buy and sell decisions at the worst possible moments."

Our Biased Minds

Statistics like those from DALBAR and Morningstar make it pretty clear that investors have bad timing. The question, however, is, "Why?"

We don't have to look far for a big part of the answer -- it's in our brains. In recent years, more and more attention has been put on neuroeconomics and behavioral finance, which study how and why investors act the way they act. In my newest book,*The Guru Investor*, I examine a number of ways in which our brains are wired lead us astray when it comes to investing, causing us to chase after hot, flashy stocks and avoid good, solid, cheap stocks so that we buy high and sell low. Here are some examples of the behavioral biases I mention in the book, as well as some other examples that have popped up in the news recently:

Hindsight Bias: This is when we tell ourselves, "Man, it was so obvious what I*should* have done last time; now that I've learned my lesson, I'll be able to time things right next time" -- even though it wasn't obvious what we should have last time, and it won't be obvious when it comes to future market-timing decisions.

Fear of Regret: When we make an error in judgment, we feel badly; often, we'll beat ourselves up with "woulda-coulda-shoulda" thinking, which is never pleasant. Because of the unpleasantness of those feelings, one theory on why people sell at the wrong time is that they avoid selling stocks that have lost value, instinctively wanting to postpone those feelings of pain and regret -- even if those stocks now have little prospect of rebounding.

Myopic Loss Aversion: This goes hand-in-hand with fear of regret. According to one study, investors weigh losses more heavily than they do gains, because losses hurt roughly twice as much as gains feel good. Investors will avoid that pain by failing to lock in losses, even if there's little hope that the stock will recover.

Anchoring: This, Forbes' David Serchuk notes, is the tendency to hold on to previously established ideas or opinions -- such as the target price for selling a stock -- even if they're not relevant anymore.

Contra-positive investing: This is when investors allowing previous experience with a stock to influence reinvestment, rather than sticking to the facts and data.

Expectation bias: The Sydney Morning Herald's Marcus Padley notes that this is the tendency to believe in things that you expect. You look for evidence that supports your hopes or expectations, and ignore that which contradicts them.

Of course, all of these biases don't mean that no one is a good market-timer, or that you can't sometimes make what seem to be prescient market calls. But these successes -- which research shows are rare compared to the failures -- can compound the problem, because they give the investor the illusion that he or she can continue to successfully time the market. That encourages him or her to "go on instinct" in future situations -- situations in which they'll most likely be wrong.

How the Gurus Overcome Emotions

While we have a lot going against us as human investors, there are ways to keep your brain from wreaking havoc with your returns. In fact, most of the gurus I follow were cognizant of the biases I mentioned -- sometimes years before such behaviors had names -- and they found ways to limit the impact of those biases and post incredible returns.

For most of the gurus, the solution involved having a systematic approach, one that forced them to buy stocks when they were cheap -- no matter how much fear was involved -- and forced them to buy based on the numbers and fundamentals, not gut reactions or instinct. In a recent interview with Fortune, for example, Warren Buffett said that "investing is simple but it's not easy. The reason it's not easy is because emotions get in people's ways. They get all excited about stocks when they've gone up recently and they get depressed when they've gone down and all of that." Buffett's advice: "You have to sit back and have a [long-term] philosophy."

Buffett says that for him, that philosophy still comes from *The Intelligent Investor*, a book written 60 years ago by Buffett's friend and mention, Benjamin Graham, who is another of the gurus I follow. In his classic book, Graham said that investors too often followed the crowd and chased "hot" stocks and sold "cold" ones. To succeed, he said that investors needed to distinguish themselves in kind -- not in a fancied superior degree from the pack. They needed to focus not on emotion-causing short-term price fluctuations, but instead on balance sheets and fundamentals.

Other gurus on whom I base my strategies have expressed similar views. James O'Shaughnessy, for example, has said, "Finding exploitable investment opportunities requires the ability to consistently, patiently, and slavishly stick with a strategy, even when it's performing poorly relative to other methods. Disciplined implementation of active strategies is the key to performance." Joel Greenblatt says that discipline is absolutely critical to his approach, because it forces you to buy good stocks on the cheap -- even when others are afraid of them. Peter Lynch has said that "the real key to making money in stocks is not to get scared out of them" by ditching a good strategy when things get rough. And, as you'll see below in this week's Guru Spotlight, David Dreman has made a fortune by sticking to the numbers when other let fear overwhelm them.

Buy Cheap -- Even if It Hurts

Sticking to your strategy when times get tough is painful, to be sure, but it allows you to do a seemingly simple task that is crucial to investment success: buy shares on the cheap. And there's evidence that buying cheap shares, even cheap shares that keep going down in the short term, can lead to much more long-term success than buying more expensive shares that are still rising. A recent T. Rowe Price study looked at four different investors, who started investing in stocks in 1929, 1950, 1970, and 1979. Each invested $500 a month in a fund indexed to the S&P 500 for 30 years, reinvesting all dividends in the fund.

The two investors who started right before major bull runs produced great returns over the first decade. "However," Price's Christine Fahlund noted, "they were accumulating fewer shares at a higher average cost during these robust decades. Moreover, their average returns over the next 20 years were much lower than the returns earned over the subsequent 20 years by the other two investors [who started investing right before big bear markets]. Thus, despite their strong starts, their ending balances after 30 years were remarkably less than half that of the two investors who began investing at the start of bear markets."

The recent downturn, while one of the most painful in history, presented an opportunity to buy shares of good firms on the cheap. And that's what the Hot List did, as it is designed to do. The portfolio remains fully invested in stocks through the market's ups and downs because history has shown pretty clearly that the vast majority of investors don't have the discipline or stomach to stick with their strategy and buy shares when they're cheap. By using a fully invested system that relies purely on quantitative measures, we eliminate the possibility that emotion-driven decision-making will prevent us from buying good shares on the cheap.

Does that make for trying moments or periods? It sure does. But we live through those periods because we know that trying to avoid them will likely lead to even more pain, and because we know that over the long term, a portfolio of stocks with good fundamentals bought at good prices will most likely produce strong returns. By sticking to that approach, we've already recaptured a big chunk of the losses we sustained in one of the worst bear markets ever, and we've positioned ourselves to gain a lot more ground moving forward.

Don't Fight the Fed

Excerpted from the October 16th, 2009 Validea Hot List

As the market has kept rising in recent weeks, strategists have continued to debate whether stocks can keep climbing, or whether the rally is running out of steam. On the whole, the strategists I keep my eyes on have leaned toward the bullish side. Among them are some managers with excellent long-term track records, including Steven Leuthold, Liz Ann Sonders, Bob Doll, Jeremy Siegel, James O'Shaughnessy, Kenneth Fisher, and Anthony Bolton.

These top market minds have presented some strong arguments for why they remain high on stocks, and this week I'd like to focus on one of those points. It's one that's close to the heart of one of the gurus upon whom I base my Guru Strategies.

The argument involves interest rates. Currently, interest rates are at or near historic lows -- part of the Federal Reserves "quantitative easing" strategy for stabilizing the economy and keeping credit markets liquid. Now that the economy has shown signs of stabilizing, and improving, many have begun to wonder when the Fed will begin to tighten up its monetary policy.

This week, Australia became the first major nation to raise interest rates, leading to speculation that others -- perhaps even the U.S. -- will soon follow. But it appears we're still a ways away from that. Yesterday, the latest inflation figures from the Labor Department showed that the consumer price index rose just 0.2% in September, and it remains 1.3% lower than year-ago levels. So despite all of the money the government has pumped into the economy, inflation is far from a problem right now. In addition, the difference between 10-year Treasury note rates and Treasury Inflation-Protected Securities -- a gauge of future inflation expectations -- remains in line with what the spread has been over the past five years, according to Bloomberg News.

What would continued low inflation mean for stock investors? It could mean a lot. As the great Martin Zweig astutely observed, interest rates and the stock market's direction tend to have a lot to do with each other.

In his book *Winning on Wall Street*, Zweig, whose approach is the basis for my Growth Investor model, offers this key maxim: Don't Fight the Fed. "In the stock market, as with horse racing, money makes the mare go," he wrote. "Monetary conditions exert an enormous influence on stock prices."

Zweig found that, generally, high rates or a rising trend in rates was a negative for the market, while low rates or a falling trend in rates was a positive. And right now, rates are low -- very low. For example, the prime rate -- the rate banks charge their best customers -- was at 3.25% in September. Prior to last December, it hadn't been below 4% since 1958. The federal funds rate, meanwhile (the rate at which banks lend money overnight to each other) was at 0.15% in September. Prior to last fall, its monthly reading had been below 1% only once in the previous 50 years. And the September discount rate (which the Fed charges banks looking to borrow from it) was also at all-time low levels, at just 0.5%. (All figures come from the Federal Reserve.)

Why are low rates better for stocks? There are a couple reasons. "First," Zweig said, "falling interest rates reduce the competition on stocks from other investments, especially short-term instruments such as Treasury bills, certificates of deposit, or money market funds." That appears to be what's happening now. As of yesterday, the 10-year Treasury note was yielding under 3.5%. While that's up from last fall, when investors flocked to the safety of T-bills amid the financial crisis, it's still far below historic norms. In fact, from 1959 through 2007, the monthly reading on 10-year T-bills was below 3.5% just once, in June 2003, according to the Federal Reserve.

In other words, if you want to find impressive returns in today's investment climate, stocks -- not bills or bonds -- are probably your best bet.

The other factor is that low or falling rates allow corporations to borrow money for less. "That reduces a major expense, especially for companies that are heavy borrowers such as airlines, public utilities, or savings and loans," Zweig wrote. And that means more profits for companies. "Wall Street loves the idea that future earnings will go up," Zweig says. "So, as interest rates drop, investors tend to bid prices higher, partly on the expectation of better earnings."

Current rates are already so low that it's unlikely we'll see them decrease much more. But it seems likely that they'll stay low for a while. One reason is the low inflation readings I discussed earlier. Another is the sheer size of the government's efforts to stimulate the economy. One would think that, given the depth of the recession and the massive efforts to jumpstart the economy, the Fed will want to err on the side of caution and not jump the gun on rate increases, lest it risk another economic turn for the worse.

One important related factor in all of this involves the slow recovery many strategists and pundits are predicting for the U.S. economy. Many assume that a slow economic recovery would be a negative for stocks. But looked at through the interest rate lens, you can see that the opposite may well be true. If growth is indeed slower, the government will likely keep rates low, which could help boost stocks.

If we do go through a slow-growth environment, investors who can find those companies that are producing strong growth could really benefit. And that's what my models are designed to do -- find companies that are producing strong results, regardless of the economic climate.

Of course, the Fed and interest rates are just part of the investment landscape picture. Zweig's "don't fight the fed" maxim doesn't always work -- during last year's market collapse, rates were also quite low and the market kept falling while they were cut further. But then again, no one variable will always work; Zweig himself looked at a myriad of other factors. But the "don't fight the Fed" advice does have a good track record, and in a broader market context which includes strong valuations, an improving economy, and huge amounts of government aid designed to bolster the economy and markets, it's a key reason to be optimistic that stocks can continue to climb higher.