



THE BEST OF THE VALIDEA HOT LIST - 2010

HIGHLIGHTS OF THE TOP
INVESTING COMMENTARY
THROUGHOUT THE YEAR

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Thinking Outside the Style Box

Excerpted from the June 11th, 2010 Validea Hot List

As investors regroup amid the current correction, there's a lot of talk about which area of the market will lead the next leg up. Some say that large stocks are poised for a good run, given their underperformance compared to smaller stocks over the past decade or so. Others say high-dividend value plays are the place to be. It's a discussion that you can find in just about any market -- investment publications and pundits are always pitting value stocks against growth stocks, and large-caps against small-caps.

There is value (pardon the pun) to style-box categories. Institutions that need to have a particular percentage of their investments in certain size or style stocks surely make good use of them, for example. And style-box categories that have been out of favor for long periods of time may present investors with buying opportunities.

But in the dozen or so years I've spent studying history's most successful investment strategies, I've found that paying too much attention to such style-box distinctions can be harmful to your returns. And, when it comes to growth vs. value, I've found that an "either/or" approach often misses the boat.

I was recently reminded of this while reading through one of Warren Buffett's past letters to Berkshire Hathaway shareholders. In his 2000 letter, Buffett wrote that "market commentators and investment managers who glibly refer to 'growth' and 'value' styles as contrasting approaches to investment are displaying their ignorance, not their sophistication. Growth is simply a component -- usually a plus, sometimes a minus -- in the value equation."

"Indeed," Buffett said, "growth can destroy value if it requires cash inputs in the early years of a project or enterprise that exceed the discounted value of the cash that those assets will generate in later years."

To Buffett, growth and value aren't polar opposites; instead, the rate at which a company is growing is just one factor involved in determining the true value of a stock. A company can be growing like gangbusters, but if its shares are overpriced, or it is using large amounts of leverage to produce that growth, it's likely not worth your attention.

Buffett isn't the only guru who thinks along those lines. In fact, most of the investors upon whom I base my Guru Strategies used a mixture of growth-related variables and valuation-related variables. Growth-focused Martin Zweig, for example, also used the price/earnings ratio in his analysis of stocks -- he was willing to pay a premium for growth, but not too much. John Neff was a self-described "low-P/E investor", but he also wanted companies to be growing earnings at a nice, sustainable pace (my Neff-based model looks for growth between 7% and 20% per year). Peter Lynch actually incorporated growth and value into one innovative variable -- the P/E/Growth ratio, which divides a stock's P/E by its historical growth rate. The rationale: The faster the rate at which a company is growing earnings, the more you should be willing to pay for every dollar of those earnings.

Other gurus upon whom I base my models -- Kenneth Fisher, David Dreman, James O'Shaughnessy, and even the "Father of Value Investing", Benjamin Graham -- used both growth and value tests in their approaches. That's evident right now in looking at the Hot List, which uses these gurus' strategies to pick its holdings.

For example, consider AstraZeneca, the healthcare/pharmaceutical company. On the surface, AstraZeneca

appears to be a clear value stock -- it sells for just 7.6 times trailing 12-month earnings, and it's yielding about 8%. But the company also has an impressive growth story. It has increased earnings per share in 8 of the past 10 years, and in the financial-crisis-marred years of 2008 and 2009 it grew EPS by 12% and 24%, respectively.

Another Hot List holding that has characteristics traditionally associated with both growth and value stocks is HealthSpring, a niche healthcare firm that specializes in Medicare Advantage offerings. HealthSpring has growing earnings quite rapidly -- it has upped EPS in each of the past four years and seven of the past eight, and over the long term is growing earnings at a 46% clip. But it's also a bargain, as investors leery of the healthcare bill's Medicare cutbacks have been avoiding this proven performer. It sells for just 6.3 times trailing 12-month earnings, 0.34 times sales, and 0.99 times book value.

AstraZeneca and HealthSpring are both examples of very well-rounded stocks that are solid across a number fundamental levels, which are the types of stocks that tend to do well over the long haul. By using both growth and value metrics, you can identify these type of plays. If you constrain yourself to looking at only growth variables or only valuation metrics, however, you run the risk of getting saddled with two types of stocks that can cause big damage to your portfolio: hot, overpriced growth stocks that have unrealistic expectations priced into their shares (think back to the tech bubble); and so-called "value traps" -- stocks that appear to be cheap, but which are really dogs (think about some of the weaker financial firms whose shares appeared cheap during the '08 collapse -- and then went to zero as the firms crumbled under the weight of their debt).

Just as it's important not to constrain yourself by growth/value characterizations, we also believe it's important not to limit yourself by size, industry, or sector. We allow the Hot List to roam the entire market to find where the best buys are. At any given time, those great buys could come primarily from small-caps, large-caps, or mid-caps; the bulk of them could also come from a couple -- or even just one -- particularly attractive industry or sector.

Because a strategy that has free range can become concentrated in a particular area of the market that it finds to be value-rich, discipline is key. By rebalancing its holdings every month, the Hot List has the ability to capitalize when certain areas of the market become particularly undervalued, while ensuring that it doesn't get locked into those areas if at some point they become overvalued or their fundamentals deteriorate. And as other areas become more attractive, it has the freedom to pursue them at the next rebalancing. I think that combination of a "free-range" approach to picking stocks and a disciplined rebalancing period is a big reason why the Hot List has had so much success over the long term. And I think it's a combination that will continue to serve the portfolio well in the months and years to come.

Get Your Head Out of the Game

Excerpted from the June 25th, 2010 Validea Hot List

The last couple months have had investors on a bit of an emotional roller-coaster. From the European debt woes to the massive oil spill in the Gulf of Mexico to the U.S.'s soaring budget deficit, investors have found plenty to worry about -- and that has meant some volatile times for the market.

Volatile times can, of course, mean emotional times for investors. And, if you're a regular Hot List reader, you know that I believe emotion is perhaps the greatest enemy of the investor.

It's not our fault, really -- in fact, the fields of behavioral finance and neuroeconomics show that as emotional creatures, we humans are, for the most part, born bad investors. Our emotions make us prone to numerous behavioral biases that, while in many cases are good for our survival, are dangerous for our portfolios.

One intriguing new study in this area highlights one of those biases -- the so-called "herd mentality" -- and offers a look at why many investors succumb to it. The study (recently highlighted by *The Wall Street Journal's* Jason Zweig) was performed by researchers at University College London and Denmark's Aarhus University and published in the journal *Current Biology*. Entitled "How the Opinion of Others Affects Our Valuation of Objects", it actually focuses on music, not stocks. Participants whose brainwaves were being monitored were asked to list songs that they most wanted to buy online. Then, they were given ratings of those songs by two professional music "experts". After reading the reviews, they were then asked if they wanted to revise their lists.

The results showed that the experts' opinions did indeed have an impact on the participants. And it's more than just a safety-in-numbers issue. "The brain scans showed that as soon as people learned they had chosen the same song as the experts, cells in the ventral striatum -- a reward center wired with dopamine neurons that respond to pleasures like sugar and sex -- fired intensely," Zweig explains. In other words, the study shows that it feels good to have someone agree with you.

And, Zweig says, the scans showed something else: that finding out experts agreed with each other (regardless of whether they agreed with the participants) triggered activity in the participant's insula, a part of the brain associated with pain and heightened body awareness. "This suggests that the agreement of others may have a special ability to grab our mental attention," Zweig says. "No wonder a consensus opinion is almost impossible for investors to ignore."

If you want a good example of investors succumbing to the herd mentality, look at the Internet bubble of the late 1990s. At that time, technology stocks were all the rage; if you didn't get in on the tech stock bonanza, others made you feel bad about it -- you were called old, stodgy, and out of touch with the times. Investors piled into these high-flying stocks not because they'd analyzed them and found real value -- indeed, many of the companies behind these stocks had no value at all; instead, they piled in because they let other people's opinions affect them. And they paid dearly for doing so when the bubble burst and they were left holding onto worthless stocks.

The tendency to follow the herd is far from the only behavioral bias that can impact investors. Another big one: hindsight bias -- the tendency to think, after the fact, that we could have easily avoided mistakes. The result is a false sense that you can avoid trouble in the future now that you've "learned your lesson". For those who try to jump in and out of the market without any sort of system, this is particularly dangerous --

so many factors go into stock movements in the short term that almost no one can be successful in such endeavors, and those who think they've "figured it out" are usually wrong. (The proof is in the pudding: According to data from DALBAR, Inc., the average equity fund investor has gained just 3.17% per year over the past two decades -- a period in which the S&P 500 has gained 8.2% annually.)

The truth is that the future is never as obvious as it seems in hindsight, and the 2008 financial crisis is a great example. Today, there no doubt are many investors who believe they've "learned their lesson" from the market crash, and will now be able to avoid the next market plunge -- just think about all of the stories you've seen in the past year or so that claim to identified "the next bubble". But the reason that the crash was so severe and shocking was precisely because so few strategists rang the warning bell ahead of time. If it had been more obvious, the real estate and credit bubbles and corresponding stock market rise never would have lasted as long as they did.

Nevertheless, you can bet that many investors will try to outsmart the market to avoid future downturns. And in doing so, you can also bet that many will key on false warning signals, and in the process jump in and out of the market at inopportune times.

Many behavioral biases really rear their heads when it comes to deciding when to sell stocks. One of the big ones: "myopic loss aversion". Coined by behavioral finance pioneers Richard Thaler and Shlomo Benartzi, myopic loss aversion is the notion that investors hold on to losing stocks too long, not wanting to lock in losses. And there's biology behind it -- studies show that losses cause roughly twice as much emotional pain as gains create emotional pleasure. Investors will thus delay that pain by refusing to lock in losses, even if the stock has little in the way of future prospects.

"Anchoring" is another bias that can lead investors to hold on to a stock too long. It is when one bases one's expectations on facts that are no longer relevant. For example, you'll often hear strategists touting a particular stock (or the market in general) saying that the stock is still well off its highs. And, on the surface, the fact that a stock is selling for, say, \$40 when it used to trade at \$60 makes it sound like a bargain. But that previous high may not be relevant anymore. If something has changed within a company's fundamentals, then it may not be realistic to expect its stock to climb back to its previous high. But many investors will "anchor" on that \$60 figure, and assume that the stock has room to run.

Another big foe for investors: "recency bias" -- the penchant for people to extrapolate the recent past into the future. For example, one argument against investing in stocks over the past year or two has been the poor performance of equities over the past decade. Why invest in stocks if the broader market has been in the red for the last ten years?

What that argument leaves out, however, is the fact that over the longer haul, stocks have performed very well compared to other asset classes -- and they've done particularly well following poor periods. That doesn't mean that the coming decade will be a great one for stocks -- but it means you shouldn't just assume that stocks will fare poorly going forward just because they've fared poorly in recent years.

There are still more cognitive biases that derail investors -- contra-positive investing occurs when one buys a stock because he or she has had a good experience with it previously, expectation bias makes us prone to focusing on data that supports our point of view -- but these should give you an idea of what investors are up against. The big question, then, is how do we keep these natural tendencies from destroying our portfolios?

The answer, I believe, is that you stay disciplined and stick to the numbers -- that is, the numbers on a company's balance sheet and in its stock's fundamentals. By basing buying and selling decisions on what

those numbers say -- rather than on what your gut, or your neighbor, or a pundit on TV tells you -- you keep many of those pesky biases I discussed (the tendency to follow the herd, for example) at bay. In addition, by using a disciplined rebalancing system that forces you to buy and sell stocks at regular intervals based on their fundamentals, you can avoid other pitfalls to which investors fall prey (such as myopic loss aversion or anchoring).

In the end, staying disciplined and focusing on the numbers won't lead you to winners on every pick you make -- nothing can do that. But over the long haul, a disciplined, numbers-focused approach should put the odds in your favor. It's no coincidence that most, if not all, of the highly successful gurus on whom I base my strategies used an array of quantitative tests in picking stocks -- and it's also no coincidence that just about every one of them talked extensively about the need to stay disciplined. Their ability to do those things is a big part of what made them so successful, and it's a key reason for the Hot List's long-term success. In volatile times like these, that's particularly important to keep in mind.

The Corrections

Excerpted from the September 3rd, 2010 Validea Hot List

In the past couple newsletters, I've taken a look at how past economic recoveries have proceeded, examining how key indicators like GDP, unemployment, and manufacturing activity fared during some previous turnarounds. The main trend in those analyses was that recoveries don't occur in a straight line; there are ups and downs and plateaus along the way, so a slowdown in a recovery -- which we've seen over the past couple months -- is by no means a sure sign that a new downturn is imminent, or even likely.

This week, I thought we'd look in a similar way at how past bull markets have developed, to see what has happened historically after a bull run first hits trouble (as it has recently). To do so, I examined four bull markets (using the S&P 500) that cross a wide span: those that started in 1957, 1974, 1982, and 2002.

Let's take the earliest first. The 1957 bull began in October, running for nearly two years before hitting a rough patch. From August 1959 to late October of 1960 -- a span of more than 14 months -- it went into correction mode, losing 14.0% in a series of stops and starts. Then, however, the bull resumed, with the market gaining close to 40% over the next 13-and-a-half months before the bull ended in late 1961.

The bull market that followed the steep 1973-74 bear was much more eventful. It started in October 1974, and featured five corrections during its six-year run (and that's not including another big dip that wasn't quite a correction). Here's how it went:

1974-80 Bull Market

(Start: Oct. 3, 1974)

First Leg: +20.8% (13 months)

Correction: -13.6% (1 month)

Second Leg: +47.1% (7 months)

Correction: -14.1% (2 months)

Third Leg: +31.4% (12 months)

Correction -19.4% (5.5 months)

Fourth Leg: +28.0% (19 months)

Correction: -10.2% (1 month)

Fifth Leg: +18.6% (3 months)

Correction: -17.1% (1.5 months)

Sixth Leg: +43.1% (8 months)

Bull market ends, Nov. 28, 1980

A six-correction bull market certainly isn't the norm, but the '74-'80 bull shows just how topsy-turvy a bull can be. Many other bulls, however, are closer to the 1957-61 version, with just one correction (and several other 5%-10% dips). One example is the bull that followed the 1980-82 bear. It started in mid-August of '82, and ran for nearly 70% and 14 months before correcting. It then lost 14.4% over a nine-and-a-half-month span, before the second leg of the bull took hold. It took the market up another 127.8% over more

than three years until the bull finally died.

Another one-correction bull is the most recent bull, which ran from 2002-2007. It started in October of 2002, with the S&P gaining 20.9% over its first month-and-a-half. The market then ran into a correction, falling 14.7% in a three-and-a-half-month span. Then came Leg #2 of the bull, which featured several minor dips but ended up taking the S&P up more than 95% over the next four-and-a-half years.

This is a lot of data, but it all boils down to this: Bull markets aren't smooth and easy. In fact, every bull market of the past 50 years has had at least one correction of at least 10%. And as you can see, some have multiple corrections, and sometimes the corrections can be long -- even over a year. In that context, the recent correction -- which, using the July 2 low, was a 16.0% decline in a little over two months -- certainly isn't unusual. In fact, Kenneth Fisher -- one of the gurus upon whom I base one of my best-performing strategies -- recently said this correction has been "textbook", and the numbers indicate he may well be right.

Many investors, however, continue to focus on more recent history, staying away from stocks in part because of the broader market's poor performance over the past decade. They see the correction as the start of another big, lengthy move downward. But in succumbing to this "recency bias", they are ignoring the fact that many of the market conditions that led to the poor decade of returns for stocks -- including bloated valuations and easy, bubble-forming credit for just about anyone -- aren't present right now.

What are present, however, are a number of strong, streamlined firms whose shares are trading at reasonable -- or cheap -- prices. And the Hot List is pouncing on some of them.

Consider the balance sheets of the companies in the portfolio right now. One of the tests that the late, great Benjamin Graham used while looking for good investments was the ratio of a firm's long-term debt to its net current assets (current assets minus current liabilities). Essentially, this tells you whether a company could pay off all its liabilities if it were liquidated today. It's a tough standard to meet, but currently, seven of the eight non-financial stocks in the Hot List do just that -- in fact, seven of the eight have more than double as much in net current assets as they do in long-term debt. (The lone stock not to pass this test is newcomer GameStop, which falls just short; it has \$431 million in net current assets and \$448 million in long-term debt.)

Financial firms, of course, tend to carry high debt levels because of the nature of their businesses. So for the two financial firms in the portfolio, let's look at two measures that the great Peter Lynch used on financials: the equity/assets ratio, which measures financial health, and the return on assets rate, which measures profitability. The model I base on Lynch's writings requires E/A ratios of at least 5% and ROAs of at least 1%. HealthSpring and Cash America both have E/As over 50% and ROAs of at least 8%, passing those tests with flying colors.

The firms in the portfolio have also been producing strong growth in earnings and sales, averaging long-term EPS growth rates of about 30% and long-term revenue growth rates close to 20% -- and only one trades for more than 15 times trailing 12-month earnings, despite their strong growth. (That's Dollar Tree, which trades for about 17.5 times TTM earnings, but still has a solid P/E/Growth ratio of 0.83.)

Whatever happens to the economy and the market in the short term, strategies that focus on stocks and businesses like these are a good bet to do well over the long haul. That's how the gurus achieved such outstanding success, and it's how the Hot List continues to stay far ahead of the market over the long run

Discipline Amid Turmoil

Excerpted from the September 17th, 2010 Validea Hot List

It's been a good couple weeks for stocks, with the past fortnight continuing the bumpy trend we've seen in recent months -- that is, two or three good weeks being followed by two or three bad weeks.

Investors' emotions appear to have been pushed and pulled amid the volatility, which is evident by looking at the American Association of Individual Investors' weekly sentiment survey. In the week ending July 8, only 20.9% of survey respondents said they were bullish on the market over the next six months; 57.1% said they were bearish. Those figures were well out of line with the long-term bullish/bearish averages of 39%/30%.

By the end of the month, however, the bulls were back on top. The survey for the week ending July 29 showed 40.0% of respondents to be bullish, with 33.3% bearish.

Over the next four weeks, however, sentiment tumbled; in the week ending Aug. 26, only 20.7% of respondents were bullish, while nearly 50% were bearish.

Over the last three weeks, however, the pendulum has swung back -- strongly -- to the bullish side. For the most recent week (ending Sept. 15), 50.9% of respondents were bullish; just 24.3% were bearish. That's the highest bullish reading in more than a year, and only the third week since May 2008 that the figure has been 50% or higher.

The swings we're seeing in sentiment aren't surprising, given the unusually wide range of possible fates many investors are seeing for the market. As Wells Capital Management's James Paulsen recently put it, "At this point in the cycle -- one year into recovery or so -- in the past, we'd be debating whether this recovery's going to grow at 3% or 1.5%. And there's a little bit of that debate going on today. But I think the bigger debate in investors' minds is, are we going to grow at 3%, or are we going to have a depression?"

Indeed, for every strategists and pundit who says a double-dip recession -- or depression -- is coming and will slam stocks, there seems to be another saying that stocks, or at least certain areas of the market, are trading at historically cheap valuations and are a screaming buy. The crisis of 2008 still fresh in their minds, average investors seem to be caught in the middle, hanging even more intently than usual on the next big economic report. Positive reports are seen as a big sigh of relief that the economy isn't going to head back down into a double-dip recession or a depression; negative reports, on the other hand, play into the double-dip/depression fears.

The numbers seem to bear out this landscape of sentiment extremes. Historically, the average percentage of AAI survey respondents who've said they are "neutral" on stocks over the next six months has been 31%. In the past 25 weeks, however, the percentage of investors reporting they were neutral has been below that average 21 times, and above it just 4 times.

Given all of the issues the economy is working through -- and given that the '08 crisis and Great Recession are still so fresh in people's minds, I wouldn't be surprised to see sentiment, and the market, continue to swing back and forth in the short term. And in my opinion, the best thing to do in times like these is not to try to time the shifts in sentiment and market swings; the market and investors are too fickle in the short term to try to predict their moves -- and a good deal of data from companies like Dalbar, Inc. and

Morningstar shows just how poorly individual investors fare when they try to jump in and out of stocks.

Instead, I think the emotional climate makes it particularly important to stay disciplined, and stick to a long-term strategy. Allowing yourself to get caught up in the big sentiment shifts can be very dangerous, and more often than not will lead you to buy high and sell low.

Staying disciplined through difficult and volatile times is, in fact, something that the majority of the gurus who inspired my strategies talked about extensively. Given all of the emotions swirling around the market right now, I thought it would be a good time to review what some of these highly successful investors had to say about discipline. Here's a sampling:

Warren Buffett: "Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

"To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding the framework." -- *The Intelligent Investor (Fourth Edition, Preface)*

Peter Lynch: "The real key to making money in stocks is not to get scared out of them." - *Money magazine*

"If you're in the market, you have to know there's going to be declines. [Big declines are] gonna happen. When they're gonna start, no one knows. If you're not ready for that, you shouldn't be in the stock market. I mean stomach is the key organ here. It's not the brain. Do you have the stomach for these kind of declines? Time is on your side in the stock market. It's on your side. And when stocks go down, if you've got the money, you don't worry about it and you're putting more in, you shouldn't worry about it. You should worry what are stocks going to be 10 years from now, 20 years from now, 30 years from now." -- PBS Television

James O'Shaughnessy: "We are a bundle of inconsistencies, and while that may make us interesting, it plays havoc with our ability to invest our money successfully. Disciplined implementation of active strategies is the key to performance." -- *What Works of Wall Street*

"[Making money in stocks] requires the ability to consistently, patiently, and slavishly stick with a strategy, even when it's performing poorly relative to other methods." -- *What Works on Wall Street*

"What always works on Wall Street is strict adherence to underlying strategies that have proven themselves under a variety of market environments -- Reuters (2007)

Benjamin Graham: On speculating, or trying to time the market. "The people who persist in trying it are either (a) unintelligent, or (b) willing to lose money for the fun of the game, or (c) gifted with some uncommon and incommunicable talent. In any case, they are not investors." -- *The Intelligent Investor*

"Successful investment may become substantially a matter of techniques and criteria that are learnable, rather than the product of unique and incommunicable mental powers. The intelligence here presupposed is a trait more of the character than of the brain." -- *The Intelligent Investor*

John Neff: "My investment style can give investors a lucrative edge over the long haul. But if you can't roll with the hits, or you're in too big a hurry, you might as well keep your money in a mattress." -- *John Neff on*

Investing

Joel Greenblatt: "The magic formula works -- long-term annual returns of double, or in some cases almost triple, the returns of the market averages -- only those good returns can get pretty lumpy. Over shorter periods, it may work or it may not. When it comes to the magic formula, 'shorter' periods can often mean years, not days or months." -- *The Little Book that Beats the Market*

"Most investors won't (or can't) stick with a strategy that hasn't worked for several years in a row. [But] for the magic formula to work for you, you must believe that it will work and maintain a long-term investment horizon." *The Little Book that Beats the Market*

Money Where Their Mouths Are

What's important to remember is that these gurus didn't just pay lip service to the notion of staying disciplined in tough or volatile times. Many have actively managed money through some of the most trying periods in U.S. history. Graham, for example, started his own money management firm in 1926 -- just three years before the market crash of 1929. Neff took over the Windsor Fund in 1964, just two years before a decade-and-a-half stretch began in which the broader market was basically flat, and four bear markets occurred. Lynch was just a few years into his career as a fund manager when the double-dip recession and bear market of the early 1980s hit.

Through those rough periods, the gurus appear to have stuck to their guns. Consider some of these figures: In the bear market of 1973-74, Neff's fund was hit hard, losing 25% in '73 and 16.8% in '74. But in 1975, when the S&P 500 bounced back 37.2% Neff's Windsor Fund returned 54.5%; in 1976, the fund returned another 46.4%, almost doubling the S&P's 23.6% return. Buffett was hit even harder; Berkshire Hathaway's stock fell 10.1% in '73, 43.7% in '74, and 5.0% in '75. But it then roared back, gaining 134.2% in '76 and 55.1% in 1977 (a negative year for the S&P).

Lynch, meanwhile, was hit hard by the 1980-82 bear, with his Magellan Fund losing 22.6% -- more than four times the S&P's loss -- in 1981, and also being in the red in 1982. But in 1983, Magellan surged back, gaining 82.8%. Buffett's firm's shares also more than tripled the S&P that year.

When looking at other gurus' post-bear track records, a similar pattern shows up. During downturns, many tend to take their hits; but after the downturns, they tend to produce exceptional outperformance. That would seem to indicate that, when many others are fleeing stocks, the gurus are bargain-hunting, picking up beaten-down shares, many of which take off once things turn around.

Discipline also has paid off for the gurus in times of over-optimism. While many investors ignored fundamentals and jumped on overhyped tech stocks in the late 1990s, Buffett and another guru I base a strategy on, David Dreman, steered clear -- and they took a lot of heat for it in the press as tech stocks surged. But when the tech bubble burst, they were proved right, and ended up far ahead of the market when all was said and done.

Whether in good times or bad, the gurus -- unlike most investors -- tend to stay disciplined, focusing on the facts and numbers -- namely, the figures on a company's balance sheet and income statement and in their fundamentals. They don't get swept up in the crowd mentality, and don't let emotion rule their decision-making. That's a big part of how they've been so successful over the years. Investors would be wise to take a page from their books amid the current market volatility.

It's Not (Just) The Economy, Stupid

Excerpted from the October 15th, 2010 Validea Hot List

In today's world of instant information, it can be easy to get caught up in the reams of economic data that investors are deluged with every day. Unemployment statistics, manufacturing growth, housing market numbers -- investors hang on these and a myriad of other sets of data every day.

But as you wade through the ocean of economic figures, it's important not to lose sight of a key broader point: The stock market is not the economy.

Yes, the economy is, over the long term, the driving engine of the stock market. An economy that cannot overcome challenges, sustain growth, and inspire confidence over the long haul does not make for a healthy environment to invest -- that's why we give an update on the economy in each Hot List. But in the shorter term -- and the shorter term can mean periods of years -- the economy and the market can become quite detached. Strong growth does not guarantee strong stock returns, nor does weak growth guarantee poor stock market performance. In fact, forget "guarantee" -- the reality is that strong growth doesn't even mean that strong stock performance is *likely*, and weak growth doesn't mean weak market performance is likely.

That's what the historical data shows, according to a 2009 paper published by Rajiv Jain and Daniel Kranson of Vontobel Asset Management. It examined stock market return data from 16 developed countries from 1900 to 2002, and the returns' correlation to gross domestic product growth. (The paper used data from Elroy Dimson, Paul Marsh, and Mike Staunton's book *Triumph of the Optimists: 101 Years of Global Investment Returns*), with updated figures for 2001-02 from University of Florida professor Jay Ritter.)

Jain and Kranson's conclusion: "The data clearly shows that, over long periods and when adjusted for inflation, stock market returns and GDP per capital growth are negatively correlated." At best, they added, "there is no relationship between GDP per capita and stock returns over the long term."

Ritter also looked at similar data for 19 developed countries from 1970 to 2002, and from 13 other countries, mostly emerging markets, from 1988 through 2002. The data for the first group showed a negative correlation between per-capita GDP and equity returns, Jain and Kranson say; the data for the second group shows a "marginally positive correlation".

How can that be? Shouldn't economic growth and stock market returns be attached at the hip? Well, a big reason for the lack of (or in some cases, negative) correlation involves expectations. Much like popular growth stocks, countries producing stronger growth are going to attract a lot of investors, which bids up the prices for stocks in those regions. Just look at how investors have been pouring money into emerging markets lately, while shunning the U.S., Europe, and other developed markets that are expected to produce slower growth. Much as with beaten-down value stocks, economies going through shorter-term slowdowns can thus present opportunities to "buy low".

Expectations aren't the only reason stock returns and the economy often don't jive. Jain and Kranson offer several other reasons. Among them:

GDP is analogous to sales; stock returns to corporate profits: GDP takes into account the value of goods and services produced in a country -- regardless of the margins being earned on those goods. If a company

cuts prices and margins to boost sales, it will be adding to GDP, but not doing much for profits, which drive share prices.

Globalization: Many of the largest companies in the world sell their products and services in a number of countries, not just their home markets. So when a U.S. firm has overseas operations that are bringing in lots of sales and profits, it's good for the company -- but not included in U.S. GDP.

Not the "Full" Economy: The performance of private, government-owned, or newly-formed companies often isn't reflected in the stock market, but it does count toward GDP.

There are other reasons to look far beyond GDP growth, too. For instance, in emerging markets, demand may drive excellent sales growth, and, therefore, strong GDP growth. But to make money for shareholders, corporations need to turn those sales into profits. For new, up-and-coming firms, it may take time to work out the kinks and become more efficient to get the most out of their sales.

So, what does all of this mean? Does it mean we should hope for weak economic growth for the U.S.? Of course not. At the end of the day, the stock market is as strong as the companies behind its stocks, and successful companies over the long haul will spur solid economic growth.

What it does mean, however, is that in the end, good investing comes back to finding value in individual companies, wherever they are located -- not making sweeping decisions based on one piece of macroeconomic data. Blindly dumping money into emerging market stocks because those markets are expected to grow GDP more quickly than others is no recipe for success. Similarly, avoiding the U.S. and other developed markets because of fears of prolonged anemic growth is equally narrow-minded. That's the tact that many investors are taking right now, however.

Like a number of the gurus I follow, I believe the fears of prolonged slow U.S. growth are a) overblown, and b) helping create a myriad of buying opportunities in individual stocks. While focusing on slow-growth fears that they don't even know will come to fruition, investors are ignoring factors like valuations (which, for many strong companies' shares, are very cheap); interest rates (which, being incredibly low, mean fixed-income investments offer little competition to stocks); and the high levels of cash on the sidelines and on many companies' balance sheets (which they can put to use through share buybacks, acquisitions, or dividend payouts, all of which benefit shareholders). Even if growth is weak for an extended period -- which I don't think it will be -- those other factors are combining to make for some excellent opportunities right here in the U.S. And those who continue to focus solely on the macro forecasts are likely to regret not taking advantage of them.