THE BEST OF THE VALIDEA HOT LIST – 2011

HIGHLIGHTS OF THE TOP INVESTING COMMENTARY THROUGHOUT THE YEAR

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The Myth of "Normal" Times

Excerpted from the March 18th, 2011 Validea Hot List

It's been quite a month or two. So far in 2011, we've seen the downfall of multiple Middle East governments, including Tunisia and Egypt; mass uprisings in several other countries in the region, most notably Libya, where Muammar Gaddafi's forces are engaged in a violent conflict with anti-government forces; and now a horrific earthquake and tsunami that have devastated Japan, the world's third-largest economy.

The events have certainly come as a shock to most. As often happens when crises hit, these global shockwaves have sent investors running for the door. And, as often happens in turbulent times, they've led pundits and members of the media saying that we're in a completely new era, one in which all the old rules go out the window. These are more examples of how these aren't the easy, happy-go-lucky times of the past, they say; we're now dealing with big problems and crises that very well may doom us.

Consider one article that appeared this week on Yahoo! Finance, via CNBC. It was entitled, "Black Swans Now a Regular Part of Market Landscape", a reference to Nassim Taleb's book *The Black Swan*. "For global financial markets, once-in-a-lifetime events are happening with such regularity that black swans may as well be white swans," the article stated. "Such supposedly rare occurrences have dominated the markets for more than a decade. They include the Internet explosion in the late 1990s, the ensuing dotcom bubble burst and stock market selloff a few years later, the 2001 terrorist attacks, the collapse of the real estate market that began five years ago, and now, the events in the Middle East and Japan."

Without getting into the exact definition Taleb used for a "black swan" event (and whether all the events listed above truly fit that definition), let's focus on the broader idea -- which seems to be that things are different now, and that we're experiencing shocks to the economic, political, and investing world on a level we've never before experienced. It's a scary idea, for sure, and one that probably leads many investors to consider ditching stocks and stuffing their money in their mattresses.

The problem is, it's just not true.

Yes, we've experienced some truly unexpected, remarkable events over the past 15 years or so, many of which have been anxiety-provoking, or downright scary. To the list above, you can add Hurricane Katrina, the devastating tsunami in the Indian Ocean in 2004, and the demise of Long-Term Capital Management and the subsequent fallout in the financial world.

But go back another 15 years, from 1981 to 1996. In that timeframe, we went through the Iran hostage crisis, a presidential assassination attempt that left the president wounded; the invasion of Grenada; a nasty double-dip recession and accompanying double-digit inflation; the Chernobyl disaster; the terrorist bombing of Pan Am 103; the stock market crash of 1987; the first Gulf War, the Exxon Valdez oil spill, the eruption of war in the Balkans, the savings and loan scandal, and the first World Trade Center attack. And if you think the turmoil in the Middle East is a game-changer, how about the collapse of the USSR? The world's largest country, and one of its only two superpowers, completely imploded, and soon ceased to exist. "Normal", easy times? Hardly.

Of course, the 15-year period before that was pretty uneventful. Except, that is, for man setting foot for the first time on a celestial body besides Earth; a major escalation of the Vietnam War that resulted in tens of thousands of U.S. casualties; the most widespread displays of civil disobedience that we've seen in our lifetimes in this country; the only resignation of a sitting president in American history; an oil crisis that led to skyrocketing gas prices and shortages; inflation that nearly touched 15%; the Six-Day War, Yom Kippur War, and explosion of the Israel-Palestine conflict; the Afghan-Soviet war; the overthrow of the government in Iran, and the opening up and modernization of communist China.

This is becoming dangerously close to a remake of Billy Joel's "We Didn't Start the Fire", so I'll stop here. You get the picture, though. There always have been -- and always will be -- crises in America and throughout the world. There always have been -- and always will be -- threats to our safety, security, stability, and prosperity. (Quick -- since 1900, what's the longest America has gone without being involved in a war or major, prolonged international conflict? A mere 23 years -- the period between the end of World War I and our entrance into World War II, a "calm" era that featured the worst stock market crash in history and the only depression in our nation's history.) The grass of times past has a way of looking oh-so-green, but the reality is that it's strewn with just as many weeds and brown spots as it is today.

None of this is to dismiss any of the current crises. The natural disasters, political conflicts, and financial disasters we've witnessed in recent years are all very serious issues, and will require a great deal of hard work and diligence to deal with. What's important to note, however, is that we as a society have a remarkable record of dealing with crises very similar to these, and moving past them. As Warren Buffett wrote in his recent letter to Berkshire Hathaway shareholders:

"Commentators often talk of "Great Uncertainty." But think back, for example, to December 6, 1941, October 18, 1987 and September 10, 2001. No matter how serene today may be, tomorrow is always uncertain. Don't let that reality spook you. Throughout my lifetime, politicians and pundits have constantly moaned about terrifying problems facing America. Yet our citizens now live an astonishing six times better than when I was born. The prophets of doom have overlooked the all-important factor that is certain: Human potential is far from exhausted, and the American system for unleashing that potential - a system that has worked wonders for over two centuries despite frequent interruptions for recessions and even a Civil War - remains alive and effective."

In fact, in some ways, we are more stable than we were 20 or 30 or 50 years ago. Consider the way technology has improved the response time fire, police, and military forces in terms of responding to emergencies or natural disasters. Think of how advances in transportation and communication have led to the continuing globalization of world markets, which, in turn, has made major world powers more mutually dependent -- and, perhaps, less likely to enter into major wars. Even the stability of our leadership has been greater in recent years than the past; since 1840, the longest the U.S. has gone without a president dying (either of natural causes or assassination) or being wounded while in office is 30 years -- these past 30 years.

Staying Disciplined Amid Crises

What does all this mean for investors? Well, when crises hit, I often keep in mind the work of David Dreman, one of the gurus upon whose writings I base my strategies. In his *Contrarian Investment Strategies*, Dreman wrote a lot about "crisis investing". He explained what tends to happen in a crisis: "In each case, the crisis is the major news of the day. Legions of experts are interviewed, most making dour forecasts of structural damage to the nation. A common theme is 'things will never be the same again.' Because the nation, if not the world, is focused on the crisis, the media is in its glory. A crisis sells newspapers, builds ratings, and peddles advertising."

Sound familiar? Well, with investors being bombarded with negative news, many inevitably head for the door. Such climates "let loose overreaction at its wildest," Dreman wrote. "People no longer examine what a stock is worth; instead, they are fixated by prices cascading ever lower." And, he notes, people always seem to think*this* crisis is *different*: "The event triggering the crisis is always considered to be something entirely new; nothing in our experience shows us how to cope with the current catastrophe," he writes. "'Sell, sell, sell,' the savants chorus."

The reality, however, is that we have a history of recovering from crises. And because of investors' short memories, times of crisis often actually make for good investment opportunities. In his book, Dreman looked at 11 major postwar crises, which included the Berlin blockade, Korean War, Kennedy assassination, Gulf of Tonkin crisis, 1979-1980 oil crisis, and 1990 Persian Gulf War. He showed how, one year after all but one (the Berlin Blockade, when the market dropped), the market was up between 22.9 percent and 43.6 percent, except for a 7.2 percent rise after the Gulf of Tonkin crisis. The average gain was 25.8 percent. Two years after the crisis, the average gain was 37.5 percent. It's worth noting that following the September 11 terrorist attacks, which occurred after Dreman wrote *Contrarian Investment Strategies*, it took just one month for the S&P 500 to climb back to pre-September 11 levels; a year after the attacks, however, the index had fallen below pre-September 11 levels, the dot-com meltdown no doubt being a factor.

Dreman's analysis isn't completely comprehensive, but he provides enough data to support his broader point: Bad news often gives the market the jitters, only to have it recover when the bad news turns out not to be as devastating as first feared, and the savvy investor can take advantage of that knowledge.

Does that mean you should run out and buy up every stock you can when a crisis hits? No. But, to me, it means that you should *not* cash in all your chips and head for the hills -- too often, that leads to selling low and buying high. If you have a disciplined, proven investing system, you should stick to it. That's what we'll continue to do with the Hot List, focusing on proven, solid firms with good fundamentals and financials, whose shares are selling at attractive prices. And over time, I believe that will continue to leave us far ahead of those who bail on stocks every time trouble hits

Stocks: Cheap, or Pricey?

Excerpted from the April 15th, 2011 Validea Hot List

If you're a regular Hot List reader, you know that the Guru Strategies that drive the Hot List portfolio tend to have a distinct value bias. Whether it's deep value strategies like my Benjamin Graham- and Warren Buffett-inspired models, or growth-oriented strategies that include key value components (like my Peter Lynch- or James O'Shaughnessy-based approaches), these methods put a major emphasis on the price you're paying for a stock.

The issue of value is one that's gotten quite a bit of attention lately, particularly when it comes to the broader market's overall valuation. As an asset class, are stocks cheap, or are they pricey? That's the question on many investors' minds, and, depending on whom you ask, you'll get some wildly divergent opinions.

Those on the "pricey" side of the debate include top value strategist Jeremy Grantham and Yale economist and noted bubble-spotter Robert Shiller. In January, with the S&P 500 trading fairly close to its current level, Grantham said that the index was about 40% overvalued.

While I don't believe Grantham has divulged the exact details of his fair-market calculation, one valuation metric he relies heavily on, according to a 2010 article in Advisor Perspectives, is one that has been popularized by Shiller (though it was actually pioneered by the late, great Benjamin Graham, one of the gurus upon whom I base my models). The variable goes by a number of different names -- the Shiller P/E, the 10-year P/E, the CAPE (Cyclically Adjusted P/E) -- but essentially it compares the S&P's price to its average earnings over the past ten years, with some adjustments for inflation. The theory: Comparing price to earnings for the past ten years smoothes out anomalous one-year earnings results that pop up in any given year. Shiller's latest calculations (which are available on his Yale web page) show that, as of the beginning of April, the 10-year P/E for the S&P was 23.47 -- some 45% or so above the long-term average of 16.

Others point to different numbers that paint a strikingly different picture. Wharton professor and author Jeremy Siegel, for example, said not long ago that stocks were still historically cheap. Based on 2011 earnings projections, he said, the S&P 500 was trading about 13% below where it would be with a modest 15 P/E multiple, according to Reuters. What's more, Siegel said that one must take interest rates into account when determining the market's value. During lower-interest-rate periods (when stocks have less competition from fixed-income assets), investors are willing to pay more for stocks -- he said that historically, if you exclude periods in which rates were above 8%, the average P/E for stocks is 19. That would mean the market was about 43% below average valuation.

Siegel and others say that, while looking at one year of earnings can be misleading, looking at 10 years' worth of earnings can also be misleading. In a recent New York Times article that looked at the Shiller P/E, Siegel said that keeping earnings from the financial crisis -- a "once-in-a-75-year event" -- in the assessment of the market's 10-year P/E "doesn't seem to be realistic."

So, two of the market's top minds offer staggeringly different views that stocks are either 45% overvalued, or 43% undervalued -- and we're only talking about earnings-related valuation metrics. There are, of course, other metrics, like the price/sales and price/book ratios, that can provide other takes on the market's valuation. Right now, according to Morningstar, the S&P 500's components on average are trading for 1.3 times sales, for example, not bad at all. That's actually below the 1.5 upper limit my James

O'Shaughnessy-based model uses when examining individual stocks, and in the "good value" range my Kenneth Fisher-based model uses.

The S&P also appears reasonably valued if you use a metric that Peter Lynch used to analyze individual stocks: the P/E/Growth ratio. Using 2010 earnings, the S&P is currently trading for 15.7 times operating earnings, and 17.0 times as-reported earnings. Based on an average of the 3, 4 and 5 year EPS growth rates, the index's earnings grew at a 22% pace. For both operating and as-reported earnings, those figures make for a P/E/G below 1.0, which would be considered attractive by my Lynch-based model.

If we use the S&P 500's projected 2011 earnings, the P/E/Gs are also attractive. Using Standard & Poor's operating earnings projection of $96.99 for 2011, we get a P/E/G of 0.86; using S&P's as-reported earnings projection of $97.26, we get a P/E/G of 0.53. Both those figures would come in under the Lynch model's 1.0 target.

Of course, you could look at S&P earnings or sales from a variety of other periods to determine a P/E/G or a price/sales ratio -- three-year average earnings or sales, five-year average earnings or sales, etc. And, often, you'll find divergent stories of what the market's valuation is. To me, the bottom line is thus this: When it comes to analyzing the stock market's valuation, there's no one metric that you should always rely on, no silver bullet that will tell you just how cheap or expensive stocks are.

Oh, one more thing, just to further muddy the waters: Just because the broader market appears expensive doesn't mean it won't rise. For example, back in the early 1990s, the 10-year P/E climbed above 16 (its current historical average) just four months into a bull market that ended up lasting nearly a full decade. When it crossed that level, the S&P was priced around 372; if you'd sold out of stocks then, and waited to buy back in until the next time the 10-year P/E was below 16, you'd have had to wait until November 2008, when the index was at about 883. That's an annualized gain of about 5% per year that you'd have missed out on by shunning stocks (and certainly more than that if you'd picked good stocks) -- not great, but hardly the disastrous returns you might expect for a period when stocks were usually trading for between 20 and 45 times trailing 10-year earnings.

When it comes to individual stocks, there's also no silver valuation bullet. I believe that's part of what makes the Hot List so successful -- by using a dozen different proven strategies, it looks at a myriad of valuation measures, from P/E ratios to price/sales ratios to dividend yield to price/book ratios and beyond. In doing so, it offers a more comprehensive look at a stock's valuation.

Beware the 'Summer Blockbuster'

Excerpted from the May 27th, 2011 Validea Hot List

With the weather finally starting to warm, it's summer blockbuster time for the movie industry, the time of year when throngs of people line up to see the latest big-budget, big-hype films. Even if you're not a movie-goer, it's hard to escape the Hollywood blitz, what with the onslaught of television commercials touting the "most action-packed"/"funniest"/"can't-miss" hits of 2011.

If you're like me, you've probably had the experience of going to one of these types of overhyped movies and walking away less than thrilled. The movie might not have been bad -- in fact, it might have been quite good. But once the buzz surrounding a film reaches a certain level, it's just hard to live up to the hype.

Similarly, you may have been to a movie that didn't get much hype, or even one that critics had bashed. And a lot of the time you may walk away from such a movie being pleasantly surprised. The movie may not have been a great film, but it was better than you thought it would be, and that leaves you in a pretty good mood.

If you've ever had similar movie-going experiences, you know something about what it's like to be a value investor. That's because, just as they play a huge role in a movie you see or a restaurant you visit or a vacation you take, expectations play a huge role in how and why value investing works.

That's what Joel Greenblatt -- the hedge fund guru upon whose writings I base one of my best-performing strategies -- recently discussed in an interview with *Barron's*. "The way we make money as a group," Greenblatt explained, "is that we don't pay a lot for anything, and most of the stocks we buy have low expectations. So if the future is a little better or a lot better than the low expectations -- it doesn't have to be great -- you have the chance for asymmetric returns on the upside. And, hopefully, you don't lose much on the ones that don't do better than the low expectations, because you didn't pay much for them in the first place."

While Greenblatt has used this mindset to great success, he's not the first to embrace it. Benjamin Graham, the man known as the "Father of Value Investing" (and another of the gurus upon whom I base one of my best-performing strategies) recognized more than half a century ago that expectations were a big factor in stock returns. The "margin of safety" concept that guided his investment philosophy was based on the idea that stocks with high valuations (i.e., high expectations) would be hit much harder if something went wrong than would stocks with low valuations (i.e., low expectations).

The Wall Street Journal's Jason Zweig, who provided commentary in Graham's revised version of *The Intelligent Investor*, had this to say in discussing expectations and margin of safety: "Great expectations lead to great disappointment if they are not met; a failure to meet moderate expectations leads to a much milder reaction. Thus, one of the biggest risks in owning growth stocks is not that their growth will stop, but merely that it will slow down. And in the long run, that is not merely a risk, but a virtual certainty."

History does indeed show that value stocks -- which usually have low expectations -- as a group have outperformed growth stocks -- which usually have higher expectations -- over the long haul. From 1927 through 2009, U.S. large-cap growth stocks averaged a 9.08% annual compound return, according to the data of Dartmouth College Professor and noted stock researcher Kenneth French. Small-cap growth stocks, meanwhile, averaged 9.23%. On the value side, large-cap value plays averaged 11.21%, and well ahead of the pack were small-cap value stocks, which returned an average of 14.17% per year. (For the breakpoint between small and large stocks, French and colleague Eugene Fama use the mean market equity of New York Stock Exchange stocks. Growth stocks are defined as those in the bottom 30% of the market based on book/market ratios; value stocks are those in the top 30%.)

Contrarian Mindset

Perhaps more than any of the gurus I follow, David Dreman put great emphasis on investor expectations, and their impact on investment strategy. Dreman believed that investors' penchant for overreaction often makes popular stocks overpriced and unpopular stocks underpriced. Because of that, popular stocks have a long way to fall if they don't meet expectations, and little room to climb in the event they meet or exceed expectations. Because unpopular stocks are often already undervalued, however, they have a lot of room to climb if the company meets or exceeds expectations, and not much room to fall if the company disappoints.

"Negative surprises are like water off a duck's back for [stocks with the lowest valuations]," Dreman wrote in *Contrarian Investment Strategies*. "Investors have low expectations for what they consider lackluster or bad stocks, and when they do disappoint, few eyebrows are raised. Consider the 'best' companies, however. Investors expect only glowing prospects for these stocks. After all, they confidently -- overconfidently -- believe that they can divine the future of a 'good' stock with precision. These stocks are not supposed to disappoint; people pay top dollar for them for exactly this reason. So when the negative surprise arrives, the results are devastating."

Dreman believed, moreover, that surprises occurred a lot in the stock market, in part because analysts so often miss the mark with their earnings estimates. "There is only a 1 in 130 change that the analysts' consensus forecast will be within 5 percent for any four consecutive quarters," he wrote. "To put this in perspective, your odds are ten times greater of being the big winner of the New York State Lottery than of pinpointing earnings five years ahead. "Because of the frequent surprises in the market, focusing on unloved stocks could net you big rewards over the long run", his extensive research on historical stock returns found.

Having the conviction to buy stocks when expectations are low is how Dreman and other value-focused gurus I follow fared so well coming out of bear markets. The bear of 1973-74 ended in October of 1974. In 1975, when the S&P bounced back 37.2%, John Neff's Windsor Fund returned 54.5%, and James O'Shaughnessy produced back-tested returns of 47.9%. Neff and O'Shaughnessy again handily beat the market in 1976, as did the back-tested book/market method Joseph Piotroski used (1976 was the first year his study covered). Warren Buffett was the only one of our gurus to underperform in one of those two years -- and he followed his 5% loss in 1975 with a whopping 134.2% gain in 1976.

The gurus also performed exceptionally after the bear market that ended in August of 1982. While the S&P gained 22.4% in 1983, the gurus' returns for the year were as follows: Neff, 30.1%; Buffett, 69%; Peter Lynch, 82.8%; O'Shaughnessy, 35.6%; Piotroski, 32.4%. Only Martin Zweig lagged the S&P, producing returns of 17.4%.

The Guru Strategies I base on the writings of these investment greats also performed exceptionally well coming off the last two recessions and bear markets. The eight individual ten-stock portfolios we began tracking in July 2003 (shortly after the market began its post-bear market turnaround) each gained between 20% and 52% for the remainder of that year, while the S&P rose 11.1%. In 2004, seven of those eight portfolios more than doubled the S&P's return. In 2009, meanwhile, 11 of my 14 10-stock portfolios beat the market, and they did so handily, by between 6.7 and 39.6 percentage points.

These gurus and portfolios beat the market by so much because they did what few investors can do: buy solid stocks when expectations are very low, which they always are as bear markets wear on. Similarly, those investors who jump onto hot stocks with high expectations -- or who jump into the market when broader expectations for stocks are high, as they were in early 2000 and 2007 -- usually end up getting hit hard.

That's why I actually find the copious amount of negative news stories swirling around the stock market to be a good sign. Yesterday afternoon, for example, the top stories on CNBC.com included one about banking giant UBS "falling apart"; one on the FDIC chief saying a U.S. debt default would be "calamitous"; and one on how foreclosures are becoming a bigger part of the U.S. housing market. That's not to mention the lingering EuroZone debt crisis, the continued fallout from the Japan earthquake and tsunami, and fears about what will happen when the Federal Reserve's latest round of quantitative easing ends.

To be sure, all of those issues are legitimate and must be dealt with. But while these problems may inspire fear, they also lower expectations -- and investors' tendency to be myopic often leads those expectations to become unrealistically low. And, for disciplined investors, that signals opportunity.

Don't Forget Quality

Of course, low expectations -- whether it's for the market or individual stocks -- aren't inherently a bullish sign. Sometimes, for example, expectations are low for a stock for good reason -- the company is a dog, and everyone knows it. That's why my models look not only for attractively valued shares, but also for companies that meet a variety of quality tests. My Buffett-based model, for example, looks back ten years into a firm's historical returns on equity and total capital. Several of my models look at how much free cash a firm is generating per share. And the most popular variable my models examine -- more than earnings growth, more than price/earnings ratios -- is the level of a company's debt.

Right now, I see a lot of quality in the U.S. market. And despite the market's two-year bull run, I also see a lot of lingering fears and low expectations, which are holding down the valuations of some quality investments. Through Wednesday, the ten holdings in the Hot List were trading for an average of 9.8 times trailing 12-month earnings, and yielding almost 4%. The nine non-financials also had average debt/equity ratios of just 12.7%. Those are the types of shares the Hot List will continue to focus on as we move deeper into 2011.

Giving Debt Its Due

Excerpted from the August 5th, 2011 Validea Hot List

With all of the talk of deficits and fiscal responsibility lately, I thought it might be a good time to take a look at debt -- though not the governmental type, but the corporate sort. Of all the dozens of variables that my Guru Strategies examine, debt -- not earnings, or sales, or price/earnings ratios -- is the one that most frequently pops up.

And for good reason. What the gurus knew was that, while debt can be a benefit if used wisely, too much debt leads to big problems for a company. It bogs down future earnings because of interest payments; it ties up revenues that could be going to expansion, capital upgrades, or dividends and share buybacks; and it can leave a company without much flexibility if it hits a rough patch (or, as we saw in 2008, if the economy hits a rough patch).

Most of the gurus shun debt, regardless of their specific investing style. In his 2010 letter to shareholders, for example, Warren Buffett -- a conservative, deep value investor -- said that debt can be "lethal" to businesses. Discussing the concept of debt generally, he wrote, "unquestionably, some people have become very rich through the use of borrowed money. However, that's also been a way to get very poor. When leverage works, it magnifies your gains. Your spouse thinks you're clever, and your neighbors get envious. But leverage is addictive. Once having profited from its wonders, very few people retreat to more conservative practices. And as we all learned in third grade -- and some relearned in 2008 -- any series of positive numbers, however impressive the numbers may be, evaporates when multiplied by a single zero. History tells us that leverage all too often produces zeroes, even when it is employed by very smart people."

But top growth investors like Martin Zweig also are leery of debt. In his book Winning on Wall Street, Zweig wrote, "If a company has a tremendously high level of debt, the earnings or earnings growth rate would be worthless because of the potential risk. Companies with high amounts of debt have high interest expense, and interest expense is a fixed cost. If business turns down moderately, the high fixed cost can have a very negative effect on earnings. *So be careful not to overpay for companies with high debt. Indeed, you may want to avoid them entirely."* (his emphasis added)

All in all, 10 of the 12 individual guru-inspired models that go into the Hot List assess a company's debt level. The specifics of how the gurus examined debt differ slightly, however. Here's a look at some of the criteria they employed. (Note: Depending on the model, certain types of companies, like financials or utilities, are exempt from these criteria because of the nature of their businesses.)

Debt/Equity Ratio: This is the most commonly used metric among the gurus I follow, though the standards used vary. My Peter Lynch-based model uses an upper limit of 80%; my Kenneth Fisher-based approach uses a stricter standard of 40%; my David Dreman-based model is stricter still, using a 20% limit. The strictest though, is my Motley Fool-based model, which permits long-term debt/equity ratios up to only 5%.

Debt/Equity Ratio vs. Industry: The Zweig approach puts a twist on the use of the debt/equity ratio. Zweig found that companies in different industries tended to carry different levels of debt, so he compared a firm's debt/equity ratio to that of its industry average.

Decreasing Debt/Equity Ratio: You might not think momentum investors would be concerned with debt, but our Momentum Investor model is. If a company has a high level of debt, it can pass this model's debt criterion if it has consistently cut its debt/equity ratio over the past three years. (If it has a debt/equity ratio less than 200%, it also passes.)

Long-Term Debt vs. Net Current Assets: This criterion was employed by Benjamin Graham, the man known as the "Father of Value Investing". Graham wanted long-term debt to be no greater than net current assets (that is, current assets minus current liabilities). Essentially, this means that if you liquidated a company and paid off all its debts, you would still at least break even.

Change in Long-Term Debt/Assets Ratio: This was the criterion Joseph Piotroski used. He just wanted to make sure there was no deterioration here -- as long as the company's long-term debt/assets ratio wasn't higher in the most recent year than it was the previous year, it passed the test.

Debt vs. Annual Earnings: The Warren Buffett-based model uses this criterion. It targets companies that have enough annual earnings that they could, if need be, use those earnings to pay off all debt within five years (and preferably within two years).

Earnings Yield: This might not seem like a debt-related criterion. But it is the way Joel Greenblatt uses it, which is the same way my Greenblatt-inspired model calculates it. Greenblatt found that using a simple earnings/price ratio to determine earnings yield could be misleading, because earnings can be skewed by the amount of debt a firm uses. So instead of share price, this strategy uses enterprise value, which includes both share price and the amount of debt a company has.

As the success of all of these gurus shows, there's no one "right" way to examine debt; debt can be assessed through a myriad of different lenses. The main idea is that you should use *some way* to assess whether a company is using high enough leverage that it poses a danger to its future profits. I think that with the Hot List, part of the reason for the portfolio's success has been its use of numerous different debt-related criteria (i.e., all of the criteria used by my individual Guru Strategies).

Government debts are important, too. When a country is bogged down with debt, the impact trickles down to citizens and companies in ways that can be very complex. Countries have an advantage over businesses and individuals, however: They can print money, which reduces the value of its debt in real terms. (This, of course, can also have wide-ranging consequences.)

For investors, the more important point, I believe, is that many companies can -- and have been able to -- increase profits and sales during periods when national debts are high or rising. So while huge national debts and deficits have negative implications, they are not so overwhelming that they will have a terrible, universal impact on all companies or all stocks. Regardless of the country's debt situation, smart investors will be able to find good, well-financed companies whose shares are trading on the cheap. (In fact, thanks to the fears surrounding the country's debt issues, there may be more of these types of companies selling on the cheap than usual.) And over the long haul, they should be rewarded.

Tune Out The Noise

Excerpted from the September 16th, 2011 Validea Hot List

Lately -- for the past few years, in fact -- it seems like macroeconomic factors have had a far greater impact on the market than have individual stock fundamentals. Some have termed it the "risk-on, risk-off" trade: Negative news about the global economy sends equity investors rushing herd-style for the door, fearing another 2008-like crisis and market crash; when economic news is good (or "less bad"), they breathe a sigh of relief and pile back into equities. Often, this occurs indiscriminately. It doesn't matter much what the individual stock or company does -- if the broader economic news is bad, sell it; if the news is okay, buy it.

Correlation levels bear out this trend. The Chicago Board of Options Exchange runs a "correlation index" that measures how closely the movements of the S&P 500 components track each other. The index had been in the 40 to 50 range in the months leading up to the Lehman Brothers collapse; after, it rose sharply, topping 100 in November 2008. It fell quite a bit, but hasn't gotten back to pre-Lehman levels, staying well above 50 for most of the nearly three years since. It's been rising since late July as the Europe fears have heated up, and for the past couple days has been in the low-80s.

This can be maddening for a value investor. After all, value investors depend on certain stocks becoming overvalued and others becoming undervalued. When everything moves more or less together, a wrench is thrown into that whole process. Stocks move less on their earnings power and share prices, and more on vague premonitions and hunches. One day, a resignation by a top European Central Bank official sends the market plunging downward, as investors fear it's a sign that Europe won't be able to pull together to fix its problems. Another day, the German Chancellor makes some positive comments about Greece, and the market jumps -- all is well again.

Some say this has brought in a new age of investing, one in which you have to play the risk-on, risk-off game, and somehow do it better than the masses. To those who try, I say good luck. Because, most likely, luck is the only thing that will work if that's the game you're playing. Think you can predict what top European officials will do or say from day to day? Or that you can jump in early -- ahead of the high-frequency traders -- when the market starts to assert an upward or downward trend on a given day? I certainly can't do either of those things. And frankly, I don't know anyone who can. I think even great investors like Warren Buffett, Benjamin Graham, Joel Greenblatt, and Peter Lynch would readily admit that they can't either.

What to do then? Well, in a recent *Wall Street Journal* article, Jason Zweig offered some insights. One big thing you can do is keep perspective, he says, and I couldn't agree more. The first step in doing that is realizing that, while it may *seem* like today's market is more at risk from macro factors than markets of the past were, it's really not. Back in a March newsletter I noted that the notion of "normal" times is a misguided one. While today macro events like the European banking crisis, U.S. debt, and terrorist threats play on investors minds', a myriad of other macro events -- many with far wider-reaching impacts -- played on investors' minds in the past. World War II threatened to end our country as we know it. The opening of China to the outside world created tremendous opportunity, and uncertainty, in the global economy. So too did the fall of the Soviet Union -- which, at the time, was the largest nation in the world.

In his article, Zweig interviews investment advisor William Bernstein, who, in addressing the issue of terrorism and the supposed "unprecedented" impact it has on the economy, put things in crystal-clear perspective: "Two generations ago, the U.S. endured a global conflict that cost 50 million lives," Bernstein said. "The next generation faced down the Soviet Union and its 20,000 nuclear warheads. If you had told Americans then that the U.S. should someday be even more afraid of a handful of jihadis from countries that couldn't even make their own bicycles, they'd have keeled over laughing."

I don't mean to make light of the problems facing us today. They are very serious indeed, and there is no guarantee they will be fixed efficiently or in totality. But I believe we've lost some perspective. And a big reason, as Zweig astutely notes, is the tremendous advances in information-sharing. "The average person lives today in a virtually mediated reality," Sheldon Solomon, a psychology professor at Skidmore College, told Zweig. "Thanks to the unfiltered spread of news over services like Facebook and Twitter, we all get a wide variety of instantaneous images that are likely to have more-inflammatory effects."

You also have instantaneous access to your portfolio. Every time the market drops, you see it right there on the screen, and it can hit you right in the gut. That's led many investors to shorten their time horizons, Zweig notes, when they should in fact be lengthening them.

I agree. If you think you can time all of the macro news and move in and out of the market in short intervals, you're most likely fooling yourself. Equity investors have over the past 20 years (through 2010) averaged annualized returns of 3.83%, according to the research firm Dalbar, Inc. In the same period, the S&P 500 has gained 9.14%. By jumping in and out of the market at the wrong times, investors have cost themselves more than 5 percentage points per year. From 2008-2010 -- as this brave new "macro" world took hold -- investors fared slightly better, but still lagged the S&P by about 1.4 percentage points per year. Their hunch-playing, on average, still detracted from their returns.

Instead of trying to time the market's day-to-day or week-to-week swings, I'd rather stay the course and stick to a good strategy for the long term. Let the traders take each others' money -- and then give it right back -- as they try to outguess the market in the short term. Focus on the fact that plenty of good values exist right now in the market -- eight of the ten stocks in the Hot List have price/earnings ratios (using trailing 12-month earnings) of 12 or lower, even though they have been growing earnings at rates of 13% to 50% over the long term. Of the nine non-financials, five have no long-term debt, one has a debt/equity ratio of less than 1%, and three have debt/equity ratios between 18% and 39%. And there are plenty of other stocks out there that are nearly as attractive.

History has shown that when fears are high, those who buy equities with a long-term perspective make out well. They buy low -- maybe not at the absolute low, but low enough -- and good things happen when you buy low. Remember, when Lehman Brothers collapsed exactly three years ago yesterday, on September 15, 2008, many said those who kept buying stocks -- particularly U.S. stocks -- were headed for ruin. Well, it's three years later, and the S&P 500 is actually in the black, and the Nasdaq Composite is up about 20%. And those are indices. Many good stock-picking strategies have fared far better. Since Sept.1, 2008 (we track monthly data but not day-to-day data, thus the slightly different start date), my Motley Fool-inspired portfolio, for example, is up 47.7%. My Joel Greenblatt-based portfolio has gained about 15%. The Hot List is right around even, not a bad place to be given that we're not even fully healed from the 2008 crisis and Great Recession.

Just as importantly, the portfolio is well positioned to take advantage of the current fears and resulting bargains in the market going forward. Others can crowd into overpriced bonds, speculate on gold, or sit in cash that is yielding virtually nothing -- we'll stick with stocks, block out the day-to-day noise, and focus on long-term value.

Back to the Basics

Excerpted from the November 11th, 2011 Validea Hot List

As the European debt crisis has heated up over these past couple months, long-term strategy seems to have gone out the window for a good many investors. Fundamentals have given way to brief, alternating periods of fear and relief. Investors have fled stocks when the headlines coming out of Europe indicate the debt crisis may be about to spill over, and they rush back into stocks when hopeful signs emerge.

Different forms of this "risk-on, risk-off trade" seem to have been going on since the U.S. financial crisis hit in 2008. Pundits have warned that we are in a "New Normal", and that to make money in stocks, you need to focus on macroeconomics -- stocks are now, and will remain, highly correlated, so stock-picking is dead, they say.

Well, in a recent MarketWatch article, columnist and investment newsletter-tracker Mark Hulbert said that notion is bunk, and offered some intriguing facts to support his contention. "The trading environment has not changed," Hulbert wrote. "Superior stock picking remains as possible -- and as valuable -- as ever. Those concluding that it isn't are guilty of a fundamental misunderstanding of the ways in which stocks are now -- and have always been -- correlated with each other."

According to Hulbert, a statistical phenomenon actually makes correlations seem higher when the market is more volatile. "It turns out that increased market volatility more or less automatically leads to heightened estimates of stocks' correlation -- even when nothing has really changed," he says, noting that this has been known for more than a decade in academic circles. One of the M.I.T. researchers who detected this bias, Kristin Forbes, told Hulbert that this "statistical artifact" is playing a major role in leading analysts to falsely opine that correlations have increased.

Hulbert also notes that correlations "almost always are greater during market declines than in rallies". So, with the market having featured a lot of volatility, particularly to the downside, in the past few years, it seems that the notion that the market has fundamentally changed is highly questionable. "We're in a highly interdependent world all the time," Forbes said. "We are just more aware of it during volatile periods and down markets."

The idea that the market hasn't undergone a fundamental change doesn't surprise me. As I've said many times in past newsletters, America has been though a myriad of crises in its two-century-plus history, many of which have shaken it to its core. A civil war, world wars, presidential assassinations, energy crises, terrorist attacks -- the U.S. has dealt with all of these and more. And through it all, the fundamental principles of good investing have endured.

With that in mind, I think now is thus a very good time to go back and review the principles that sit at the core of the investing strategy we use in handling the Hot List. These are the six principles of "Guru Investing" that I laid out in my most recent book,*The Guru Investor*, back in 2009. And, while the economy and the market have been through quite a bit since then, nothing has changed my belief in their validity.

Principle 1: Combining Strategies to Minimize Risk and Maximize Returns

There are numerous different strategies that have proven track records of beating the market over the long haul -- just look at the wide variety of approaches used by the gurus upon whom I base my models. But by using multiple proven strategies within the same portfolio, you can increase returns and limit risk. The Hot List chooses the stocks that get the most combined interest from my individual models, with the strategies with the best long-term track records given greater weight. This allows the portfolio to focus on stocks that are fundamentally and financially sound on a number of different levels, and such stocks tend to produce very strong returns over the long haul. You can also combine strategies by choosing a fixed number of stocks from each of several strategies, which is what our Top Five Gurus portfolio does. Both approaches really put a stock and company through the wringer to try to bring any serious flaws to light.

Principle 2: Stick to the Numbers -- or the Market Will Stick It to You

Just about everyone has a part of them that thinks they're clever enough or experienced enough to outsmart the market. But several studies show that as forecasters, most humans flat-out stink -- even those supposed experts. Studies also show that statistical or actuarial models are much better at predicting the future than we humans are. The reason? Our emotions get in the way, leading many investors to buy high and sell low. But by sticking to the cold, hard numbers -- i.e., using proven quantitative approaches that measure a stock's financials and fundamentals -- you remove emotion from the equation and put the odds in your favor.

Principle 3: Stay Disciplined Over the Long Haul

There simply is no strategy that will succeed every month or even every year. Anyone telling you that their strategy does so is almost certainly up to no good -- Bernie Madoff's investors found that out the hard way. In fact, every guru I've followed -- from Warren Buffett to Peter Lynch to Benjamin Graham -- has gone through rough years. But one similarity these diverse strategists shared was that they stuck with their approaches through thick and thin. When others bailed, they were thus there to pick up great bargains. That's a big part of why they fared so well coming out of downturns, and over the long haul.

Principle 4: Diversify, but You Can't Beat the Market by Owning It

Everyone knows that diversification is generally a good thing. You can invest in a company that has the strongest fundamentals and balance sheet imaginable, and tomorrow something unpredictable -- an earthquake swallows its headquarters, it's revealed that its CEO has embezzled billions and fled the country -- could happen that leaves you with nothing. At the same time, however, over-diversification presents its own problems. Mutual funds that own 500 stocks are inevitably going to come pretty close to mirroring the broader market's returns. To beat the market, you need to own enough stocks to diversify away systematic risk, but few enough that you're not simply going to track the broader market. One study I examine in my book found that diversification benefits are limited once you own 50 or so stocks, and I've found that you can beat the market over the long haul with focused, fundamental-driven portfolios of 10 or 20 stocks.

Principle 5: Size- and Style-Focused Systems Only Limit Investment Possibilities

"Style-box" investing has become quite popular over the years, and many funds focus specifically on one segment of the market -- small-cap growth, mid-cap value, etc. That's great for big institutions that are required to hold so much of each category. But for individual investors, it simply limits your returns. Every category goes out of style for periods of time; if your strategy is finding that the best opportunities are in mid-cap growth at a particular point in time, why limit how many of those stocks you can buy? A good value is a good value, regardless of what category it comes from.

Principle 6: You Don't Have to Hold Stocks for the Long Term to be a Long-Term Investor

A lot of people think long-term, buy-and-hold investing means that you buy a stock and hold on to it for years and years and years, if not forever. But that can lead to trouble. For example, say your strategy calls for you to buy stocks with long-term earnings growth of 20%, less debt than annual earnings, and a return on equity of 30%. If you buy a stock that meets those criteria, and then it takes on tons of debt, its earnings growth drops, and its ROE declines, should you keep holding it? I sure don't think so. You buy stocks because they have qualities that make them good candidates to rise; if those qualities disappear, so too does that potential for the stock to rise, so why would you hold onto it? Using a disciplined rebalancing system like the Hot List does can help remove emotion from the selling process, and let you cut ties with stocks whose attractiveness declines and replace them with stocks that now have better prospects. Being a long-term stock investor thus can mean you stick to your *strategy* for the long term, even if the specific stocks you hold turn over every month, quarter, or year.

I didn't come upon these principles easily, and I don't take them lightly. I believe in them because they incorporate parts of the approaches of some of history's greatest investors -- from Benjamin Graham more than half a century ago to modern-day greats like Warren Buffet and Joel Greenblatt. And just as these tenets helped the gurus succeed, so too have they helped the Hot List produce exceptional returns over a period in which the broader market has struggled mightily. The portfolio has had some short-term problems this year, but I expect them to remain just that -- short term. That's because as great of an impact as the European debt crisis (and America's own deficit woes) are having on the financial world, I believe these concepts remain as relevant as they've ever been, and will continue to be just as relevant for decades to come.

New Research from a Market Guru

Excerpted from the November 25th, 2011 Validea Hot List

As Hot List readers know, our investment process is driven by data -- particularly long-term historical data. We don't invest based on short-term trends, the latest big macroeconomic headlines, or gut feelings on a particular day. History has shown that such emotional, short-term thinking is a recipe for failure. The gurus whose approaches inspired the Hot List, meanwhile, have proven that a rational, long-term, stick-to-the-numbers approach often leads to success in the market.

One of the gurus who has compiled the most data on long-term investment strategy is James O'Shaughnessy, whose book *What Works on Wall Street* forms the basis of two of my strategies. O'Shaughnessy recently released an updated version of that excellent book, and this one includes a plethora of new data on long-term stock returns and strategies. I'd like to share some of the more intriguing observations with you now.

For O'Shaughnessy, one of the biggest problems investors face is the tendency to focus on recent events. In the introduction to his book, he discusses how some began calling the "abysmal" returns of the past decade the "new normal", even though it wasn't that long ago that commentators were declaring that the Internet had ushered in a "new era" of perpetually rising stock returns -- a declaration that proved to be horribly wrong. "It seems that the one thing that *doesn't change* is people's reaction to short-term conditions and their axiomatic ability to perpetuate them far into the future," O'Shaughnessy writes.

But while many investors are assuming that the poor performance of stocks during the 2000s is the start of a new era of poor returns, O'Shaughnessy says history shows something entirely different. He looks at the worst rolling ten-year returns for equities since 1900; the period ending in February 2009 was the second-worst over that span, with 10 other 10-year spans ending in 2008, 2009, or 2010 cracking the top 50 (his data goes through 2010).

What did he find? Well, he found that equity returns following those awful 10-year periods tended to be outstanding. In the year following the 50 worst 10-year periods, stocks averaged a real return of 20.47%. The average three-year real compound return following the bad decades was 14.53%; the average five-year compound return was 15.78%, and the average ten-year compound return was 14.55%.

Since stocks bottomed in early 2009, we've seen that pattern play out, to an even greater degree. The S&P 500 gained 68.57% in the first year after its March 9, 2009 bottom; it averaged 39.68% gains in the first two years. (These S&P figures are before inflation is factored in, but the main idea should hold true.)

"Historically, we have always seen reversion to the mean," O'Shaughnessy explains. "After stocks have had an unusually great 10 or 20 years, they typically turn in subpar results over the next 10 or 20, and after bad 10- to 20-year stretches, the next 10 to 20 tend to be above average." Why is that? O'Shaughnessy astutely notes that it's largely about valuation -- stocks get overvalued after good decades, and undervalued after bad decades.

Undervaluation is certainly what appears to have happened after the 2008-09 market crash. And nearly three years later, even after stocks have risen significantly, valuations remain attractive. Sentiment, however, remains low, which is not surprising after having had two big market crashes in a decade. With all of the negative headlines, it's hard to stay focused on the valuations, but O'Shaughnessy's research shows that that's what good investors have to do.

A New Valuation Equation

That brings us to another very interesting new piece of O'Shaughnessy's research. In past editions of What Works on Wall Street, he found that, when it comes to valuation, the price/sales ratio (PSR) was the best predictor of future performance. That's why the growth model I base on his writings requires that a stock have a PSR below 1.5.

In the book's updated version, however, O'Shaughnessy taps into expanded historical data that leads him to a different conclusion. Using return data from 1964 through 2009, he looks at how stocks that were in the top decile based on a number of valuation metrics have fared historically. Here are the average annual compound returns for some of the more popular measures:

Top Decile Based On
Enterprise Value/EBITDA -- 16.58%
Price/earnings -- 16.25%
Price/operating cash flow -- 16.25%
Buyback Yield -- 15.81%
Shareholder Yield -- 15.56%
Price/book value -- 14.53%
PSR -- 14.49%
Dividend Yield -- 13.30%

(A few definitions may be necessary here: *Enterprise value* is equal to common equity at market value, plus debt, minority interest, and preferred equity at market value, and minus associate company at market value and all cash and cash equivalents; *EBITDA* is earnings before interest, taxes, depreciation, and amortization; *buyback yield* is the change, percentage-wise, between the amount of shares outstanding now and a year ago; *shareholder yield* is buyback yield plus dividend yield.)

Of course, raw returns aren't everything; risk is also a big factor to consider, so O'Shaughnessy looks at factors like standard deviation of returns, biggest annual declines, percentage of years in which returns were positive, and consistency of returns. One measure that takes into account both risk and return is the Sortino ratio. Here's a look at how the various valuation metrics stacked up on that basis.

Top Decile Based On
Enterprise Value/EBITDA --0.50
Shareholder Yield -- 0.47
Price/earnings -- 0.46
Price/operating cash flow -- 0.45
Buyback Yield -- 0.44
Dividend Yield -- 0.31
Price/book value -- 0.30
PSR -- 0.29

So, which valuation does O'Shaughnessy recommend? None, in a manner of speaking. As the data above shows, the higher-returning strategies aren't always the best when you factor in risk. On top of that, different approaches fare better in different environments. So O'Shaughnessy decided to find out how stocks that had the best *composite valuation* based on a number of metrics fared.

He found that combining value metrics could produce even better results. An approach that incorporated the price/book, price/earnings, price/sales, EBITDA/EV, and price/cash flow ratios as well as buyback yield was a top performer, for example. To do this, he ranked all stocks by percentile in each of those categories, with those with the worst of a particular ratio (say, the PSR) getting 1, and those with the best getting 100. Then he simply added up the six scores, and split the results into deciles. He found that stocks in the top decile based on those six factors historically averaged a compound annual return of 17.30%, with a Sortino ratio of 57 -- much better than any of the individual metrics.

O'Shaughnessy's finding about multiple valuation metrics being used in concert is significant, but it doesn't surprise me. In a sense, it's the same general approach we use with the Hot List. Because a number of different strategies go into the Hot List's stock-selection method, so too do a number of different valuation metrics. Current Hot List holding Forest Laboratories, for example, gets approval from my Joel Greenblatt-based approach in part because of its strong earnings yield (which is essentially the inverse of the Enterprise value/EBITDA ratio), strong interest from my Benjamin Graham-based model in part because of its strong P/E and price/book ratios, and strong interest from my Peter Lynch-based model in part because of its strong yield-adjusted P/E-to-growth ratio. As I've noted before, stocks that are strong across a variety of different valuation metrics and fundamentals tend to perform well over time, and O'Shaughnessy's exceptional research is more proof of that.

Core Tenets

Finally, I'd like to leave you with a brief summary of some of the keys to investing success that O'Shaughnessy references in the final chapter of his book. Some of these should look very familiar, as they are right in line with the tenets we use to manage the Hot List.

Always Use Strategies: "You'll get nowhere buying stocks just because they have a great story," O'Shaughnessy writes. These stocks usually come with huge price tags, and usually go down in flames. "You *must* avoid them," he says. "Always think in terms of overall strategies and not individual stocks."

Ignore the Short Term: "When you look only at how your investment portfolio has performed for the last quarter, year, and three- and five-year period, you are looking at a tiny snapshot of time," he writes, saying that that snapshot can be very misleading. He recommends focusing on rolling returns vs. a benchmark over time.

Use Only Strategies Proven Over The Long Term: O'Shaughnessy says to make sure you use an approach that has proven its worth over several different market environments. Short-term performance, or even the fact that a strategy might make intuitive sense, are no match for a long-term track record. "Stocks change. Industries change," he says. "But the underlying reasons certain stocks are good investments remain the same. Only the fullness of time reveals which are the most sound."

Invest Consistently: "If you use even a mediocre strategy *consistently*, you'll beat almost all investors who jump in and out of the market, change tactics in midstream, and forever second-guess their decisions," O'Shaughnessy writes.

Always Bet With The Base Rate: "Base rates are essentially the odds of beating the market over the time period you plan to invest," O'Shaughnessy says. "If you pay attention to the odds, *you can put them on your side*."

Never Use The Riskiest Strategies: O'Shaughnessy says to always focus on strategies with the highest risk-adjusted returns.

Always Use More Than One Strategy: O'Shaughnessy says that combining strategies that focus on different types of stocks (i.e., growth, value, large-cap, small-cap, geographic regions) can allow you to do much better than the broader market while not taking on more risk.

Use Multifactor Models: "You should always make a stock pass several hurdles before investing in it," O'Shaughnessy says. I couldn't agree more -- all of my models use multiple variables, and most use at least four or five.

To paraphrase Warren Buffett, investing is simple, but it's not easy. It's simple because we know what we need to do -- buy stock in good companies selling at good prices. And gurus like O'Shaughnessy have shown us strategies that identify good companies, and attractively priced shares. The hard part -- and O'Shaughnessy stresses this in his book -- is sticking to your strategy when times get tough. A bad quarter or half-year or year can wreak havoc on investors' psyches, particularly in today's world of 24-hour financial news, when we are continually reminded of every potential danger or negative in the market and economy.

But history has shown that sticking with fundamental-focused strategies with good track records -- even when it seems the whole world is running away from stocks -- is a recipe for success. And making emotional decisions based on today's headlines or your gut feelings is a recipe for failure. That's why we'll continue to stick with the Hot List, even during a rough year like this one has been. Over the long haul, the strategies that underlie the portfolio have been exceptionally successful -- both for us and for the gurus who developed them. Even if it ends up lagging the S&P 500 this year, the Hot List will still have beaten the index 67% of the years since its inception, and it's done so by a huge margin -- the portfolio's gains are more than six-fold the S&P's gains since inception. I'm confident that by continuing to focus on fundamentals and staying disciplined, the portfolio will bounce back strong.