THE BEST OF THE VALIDEA HOT LIST – 2012

HIGHLIGHTS OF THE TOP INVESTING COMMENTARY THROUGHOUT THE YEAR

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The Contrarian Case

Excerpted from the January 20th, 2012 Validea Hot List

Over the past decade-and-a-half, some very powerful emotions have been at work in the stock market. In the late 1990s, the rise of the Internet sent stocks -- particularly tech stocks -- soaring, and many investors were swept up in the euphoria. But the bursting of that bubble in 2000 turned visions of endless profits into the reality of devastated portfolios. Then the real estate bubble began to inflate, and buyers across the country were consumed with visions of homeownership, and/or quick, easy profits. But, of course, those dreams turned to nightmares when the housing bubble burst. Panic set in in the fall of 2008, with unemployment spiking, lending seizing up, and the "D"-word -- Depression -- swirling.

Those scars still haunt many investors today, more than three years later. As the European debt crisis and America's own inability to deal with its deficit flared up in the second half of last year, markets swung wildly; every negative story, it seemed, confirmed that we were headed for another crisis, while every positive story seemed to generate huge sighs of relief. Some companies saw their market values rise or fall 10% or 15% from day to day during the height of the volatility -- without having announced any changes to earnings or revenues or debt.

How can emotions shift so suddenly, and what can investors do in the face of such swings? Those are among several of the key questions that noted contrarian investor David Dreman tackles in his new book, *Contrarian Investment Strategies: The Psychological Edge*. As you probably know, Dreman's work forms the basis of one of my better-performing Guru Strategies. He's been a pioneer in the field of behavioral finance, and in the past I've touched on many of his key points and findings. His new work includes a number of very interesting, and very relevant, pieces of data and research, many of which I'm sure I'll be sharing with you in the coming weeks in one form or another. For this newsletter, I'd like to focus on two key issues Dreman addresses: the notion of "Affect" and its impact on investors, and the performance of contrarian strategies over the past tumultuous decade.

Let's start with "Affect". Dreman writes that psychologists have begun to recognize and understand the critical role Affect plays in people's decision-making, whether in the financial world or otherwise. It essentially is the way that our minds tag representations of objects or events with positive or negative feelings. "A rabid sports fan, for example, will have positive representations for a favored sports team and negative ones for an archrival team," Dreman writes.

That may seem obvious. But what's important is how Affect works within the "dual-process" dynamic our minds use to make decisions. One part of that process is the "rational-analytic system", which is deliberative and analytical and evidence-based, Dreman notes. The other part of the process is where Affect comes into play -- the "experiential system", which draws on "information derived from experience and emotional recall and encodes reality into images, metaphors, and narratives to which affective feelings have been attached," Dreman writes.

And here's a crucial point: The emotion-based experiential system functions much faster than the rational-analytic system -- though it often is a far worse investment decision-maker than its rational counterpart. "Although analysis is critical to many decision-making circumstances, reliance on Affect and emotions is a quicker, easier, and more efficient way to navigate in a complex, uncertain, and sometimes dangerous world," says Dreman. "In periods of great anxiety and uncertainty, it is quite natural for the experiential system, often dominated by Affect, to take over." That's just what happened in late 2008, and it's what happened last summer when the debt ceiling debacle and European debt crisis dominated the headlines.

During such times, fundamentals and facts fall by the wayside; emotions take over. Often, Affect leads investors to abandon their strategies and simply follow the herd, which can have disastrous results. Dreman says it's critical not to let emotion and Affect overtake your investment decisions in those periods. "Do not abandon the prices projected by careful security analysis," he writes, "even if they are temporarily far removed from market prices. Over time the market prices will regress to levels similar to those originally projected."

Before you can combat the impact Affect has on your decision-making processes, of course, you first have to be able to recognize it. It comes in four key forms, Dreman says. They are:

Insensitivity to probability: Dreman cites several studies showing that once people attach a positive Affect to something, they don't care how expensive it is -- they become convinced it will only continue to gain in value. One study, for example, "demonstrated that if the potential outcome of a gamble is emotionally powerful, its attractiveness (or unattractiveness) is relatively insensitive to changes in probability as great as from .99 to .01, or 100 fold," he says, adding that the way tech stocks became overvalued during the Internet bubble is a perfect example.

Judgments of risk and benefit are negatively correlated: Studies also show that people tend to let their personal feelings about the nature of an activity or technology color their judgments of the risk and benefits involved. When we view something as "good", i.e., with positive Affect, we tend to think it entails less risk. When we view something as "bad", i.e., with negative Affect, we tend to think it involves more risk -- regardless of the facts and data. So, for example, when the tech stock bubble formed, the positive emotional response people had when they thought of tech stocks actually caused their brain to underestimate the amount of risk associated with those stocks, which was of course quite substantial.

The Durability Bias: Investors overestimate how long a positive or negative event will impact a company, its stock, its industry, or the market itself, Dreman says. "To take one example, oil exploration and development companies plummeted sharply in the spring of 2010, after the BP rig blew up and a major oil spill ensued in the Gulf of Mexico," he notes. Many assumed these firms would struggle for a lengthy period. But deepwater drilling resumed again within a year and many offshore drilling companies' stocks rebounded strongly.

Temporal Construal: Studies also show that when people look at a company's short-term prospects, they are more detail- and fact-oriented. But when the look at the longer term, they let vague feelings drive their decisions. This, for example, pertains to the plight of Yahoo investors during the tech bubble, Dreman says. They somewhat ignored weak short-term earnings results, instead focusing on the broader idea that the company had incredible, if not unlimited, potential to grow over the longer term. By continuing to focus on these vague beliefs rather than short-term facts and data, many investors continued to pour money into the stock even after there were plenty of signs that it was far overvalued.

Portfolio Applications

The notion of Affect and the latest research into the concept supports something that Dreman has said for years: that investors allow emotions to make them overvalue stocks that are considered "good" -- those flashy stocks with exciting growth stories behind them -- and undervalue stocks that are considered bad -- those that are getting bad press because of short-term problems, industry concerns, or some other factor. Because of that, buying unloved stocks -- those trading at low prices compared to their book value, earnings, cash flow, or dividend payout -- has been a very profitable strategy over many decades. Investors overreact in the short term, pushing the prices of these stocks down too low; then, once rationality returns to the market, those stocks tend to bounce back strongly.

I've noted in many other newsletters how Dreman's research has shown that investing in these low price-to-book, price-to-cash flow, price-to-earnings, and price-to-dividend stocks has generated exceptional returns going back several decades. But that research was published in 1998, before the bursting of the tech bubble, the succeeding bull market, and the financial crisis and recovery of the past few years.

So, how have those strategies fared more recently? Dreman's new work examines that question. And while emotions have ruled several short-term periods in the past decade or so, the data shows that investors who stuck with a disciplined, value-based approach fared far better than most. From 2000 through 2010, here's how the cheapest quintile of stocks based on those four valuation metrics fared in terms of annualized returns:

Low P/E stocks: 11.7%
Low price/dividend stocks: 11.5%
Low price/cash flow stocks: 9.8%
Low price/book value stocks: 8.7%
Market Average: 5.6%

And here's how the most expensive quintile of stocks based on those metrics fared:

Market Average: 5.6%
High price/dividend stocks: 2.4%
High price/earnings stocks: 0.0%
High price/cash flow stocks: -2.9%
High price/book value stocks: -3.0%

Even in a turbulent period marked by the bursting of two major asset bubbles, investing in contrarian stocks produced solid returns while the broader market struggled. My Dreman-inspired 10-stock portfolio has also done much better than the broader market. Since its mid-2003 inception, the portfolio has averaged annualized returns of 7.2%, more than doubling the 3.2% annualized returns of the S&P 500.

The success of contrarian-type stocks, both over the past decade or so and over the longer term, shows that it's essential to keep emotions at bay, and focus on the facts and figures. That's a concept that is at the core of Dreman's research, and I believe it's at the core of any good investment strategy.

An Investing Mission Statement

Excerpted from the February 17th, 2012 Validea Hot List

On any given day, we investors are bombarded with a seemingly never-ending stream of earnings reports, P/E ratios, gross domestic product figures, unemployment rates, national debt ratios, and much, much more. Given the omnipresence of the Internet and 24-hour cable news networks, it can be easy to get too caught up in the latest news of the day. It can also be dangerous -- if you allow that latest bit of news to obscure your investing principles and long-term goals.

That's something I was reminded of recently while reading a great column from the*Wall Street Journal's* Jason Zweig. Writing on WSJ's Total Return blog, Zweig considered the following question, and posed it to a number of top financial minds: Could you sum up your investing beliefs in 10 words or less?

At first skeptical that he could distill his own approach down into that short of a mantra, Zweig found that he could, in fact, do just that: "Anything is possible, and the unexpected is inevitable. Proceed accordingly," he wrote. Other top strategists he interviewed were also able to do so. Among the responses:

"Determine value. Then buy low, sell high. ;-)"
-- David Herro, manager of Oakmark International Fund (and a Morningstar Fund Manager of the Decade)

"Own competently managed, competitively advantaged businesses at discounted prices."
-- O. Mason Hawkins, Southeastern Asset Management

"Fallible, emotional people determine price; cold, hard cash determines value."
-- Christopher C. Davis, Davis Advisors and Davis New York Venture Fund

Zweig's piece got me thinking about how some of the gurus who inspired my investing approach (and I myself) might respond. He offers a suggestion for one of them, the late, great Benjamin Graham, who once wrote, "Confronted with a challenge to distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY."

I wouldn't want to put words in any of their mouths, so I looked for wise words that some of the other gurus I follow have already imparted, and which seem to capture the essence of their approach in no more than ten words. Warren Buffett -- Graham's protege -- has advised, for example, to "be fearful when others are greedy; greedy when others fearful" (I've edited out a couple extraneous words there). Hedge fund guru and author Joel Greenblatt, meanwhile, has offered this simple yet powerful advice that too many investors forget: "Buying good companies at bargain prices makes sense." And James O'Shaughnessy, whose research into investment strategy may be the most substantial ever done, has offered, "Disciplined implementation of active strategies is the key to performance."

Distilling investment advice down into ten words or less is of course somewhat of an incomplete endeavor. You probably shouldn't offer a novice investor ten words and then give him or her $100,000 to invest; things are of course more complicated than that. But when you examine the ten-word advice of some very successful strategists, like the gurus I follow and those that Zweig quoted, some important themes emerge -- themes that average investors all too often lose sight of. Among them:

Focus on facts and figures: Most good stock-pickers have key fundamental and financial characteristics

they look for in their buys (and key criteria for selling stocks, too). Greenblatt looks at earnings yield and return on capital; one of Herro's favorite metrics is free cash flow yield; Graham looked at price/earnings and price/book ratios, as well as the current ratio and the ratio of a company's long-term debt to net current assets. There's no one "right" strategy, but the important thing is that the best investors tend to use metrics that identify financially sound companies whose shares are selling on the cheap.

It's also important that you focus on facts and figures *plural*. As I noted earlier, you don't want to hyperfocus on just one piece of data. In my dozen-plus years of researching history's best investment strategies, I've found that any good strategy uses multiple variables, and most use four, five, six, or more.

Beware Emotion: It's easy to get swept up in an exciting story surrounding a stock and buy it, or get swept up in a negative story and sell it. But doing so without actually crunching the numbers often leads to buying high and selling low. The best investors don't let hype alter their decisions. Consider what Peter Buffett once told PBS television about the key to his father's success: "I think it's because he's removed emotion from his decision-making. He is not colored by anything he thinks somebody else is doing, somebody else might want, some feeling he has about something that might not be rational. Ultimately, it's because he is clear and unemotional, dispassionate about his relationship to those numbers on the page and the information he's taking in."

Stay Disciplined Over The Long Term: No strategy will beat the market every month, or even every year. If that's your goal, you'll probably end up jumping from strategy to strategy and chasing hot stocks, which is a recipe for buying high and selling low. Sometimes, it just takes time for the market to recognize bargain stocks. If you think long-term -- as in, a time horizon of at least five years -- you'll be able to better deal with short-term underperformance, and reap the full rewards of the bargains that a good strategy identifies.

So, with all of that in mind, what would my own 10-words-or-less investing mantra be? I think it would boil down to something like this:

Follow proven strategies, stay disciplined, trust facts, and beware emotions.

Successful investing takes more than a 10-word "mission statement". But don't underestimate the importance of such an exercise. The stock market -- and our own emotions -- continually throw tricks and traps our way that eat away at our returns. If you don't have a clear understanding of why, and how, you are investing -- or if you lose sight of that plan -- you can easily get swept up in some very dangerous tides.

So one of these days, I'd encourage you to sit down and try coming up with your own 10-words-or-less mission statement or mantra. And when the market tides of fear and greed roll in -- and if there is anything you can count on in the market, it is that they will roll in -- make sure you have that mission statement close at hand. Those 10 words just might end up offering you the sort of clarity and perspective that can prevent some portfolio-pummeling mistakes.

Assets and Inflation

Excerpted from the March 16th, 2012 Validea Hot List

With the economy showing solid improvement and gas and food prices continuing to rise, concerns about inflation have again come to the forefront of many investors' minds. Actually, they've been at or near the top of the list of concerns for many investors ever since the Federal Reserve and U.S. government unleashed their efforts to combat the financial crisis of 2008-09. Since the last week of August 2008, the Fed's balance sheet has more than tripled, with the total factors supplying reserve funds surging from about $939 billion to more than $2.9 trillion. The Fed's purchasing of Treasury bonds as part of its quantitative easing plans has been a big factor in the increase, with the amount of its Treasury holdings nearly doubling.

But an even bigger factor has been the amount of money banks are parking at the Fed -- that figure has soared from $9.75 billion in late August 2008 to nearly $1.6*trillion* today. A few factors seem to be behind the huge increase. For one thing, the Fed is paying a quarter of a percent in interest on funds parked with it, which doesn't seem like much but is actually not bad considering how low it is keeping interest rates overall. Some have also posited that a lack of loan demand has led banks to keep their funds with the Fed. And some banks that were burned badly in the commercial real estate market seem unwilling or unable to lend.

Whatever the reasons, the bottom line is that the government has created large sums of money in response to the financial crisis, and hordes of that cash are sitting at the Fed. If and when they start to trickle into the real economy, some significant inflation should come.

That raises the question of how investors should guard against inflation, a topic I've touched on several times before given the explosion of the Fed's balance sheet in recent years. I thought it would be a good time to re-examine the issue given a couple of things that caught my eye recently. One was a new study recently highlighted by MarketWatch columnist Howard Gold. The study was performed by Elroy Dimson, Paul Marsh, and Mike Staunton of the London Business School, who over the years have performed some of the most in-depth research ever on asset prices. Their latest effort looks at 19 different markets since 1900, examining how different assets performed during periods of "marked" inflation. They found that bonds -- not surprisingly -- get crushed in such periods, averaging a real return of -23.2%. Stocks, however, also struggle, they found, losing an average of 12% in real terms.

That sounds troubling, especially given how stocks are generally considered to be good inflation fighters. But if you look at Dimson, Marsh, and Staunton's analysis (which is part of a Credit Suisse report), there's a lot more to the story. For one thing, in their study, "marked" inflation signified inflation of at least 18% annually -- a very steep figure that the U.S. didn't even reach during the sky-high inflation of the late '70s/early '80s.

So how have stocks fared when inflation has been high, but not at that 18% mark? Well, according to the professors, when inflation has been between 8% and 18%, stocks haven't fared great, but they've remained ahead of inflation, with 1.8% average annual real returns. Bonds, on the other hand, have averaged real annual losses of 4.6% in those periods. And, when inflation has run between 4.5% and 8%, stocks have produced annual real returns of 5.2%, while bonds have barely eked out a positive return.

Gold, meanwhile, has been a good hedge in those periods when inflation has been at least 18%, with real returns that were just in positive territory. In the 8% to 18% inflation range, gold has also outperformed

stocks, with real returns of 4.4%. In that 4.5% to 8% inflation range, however, gold has produced real returns of just 2.8%.

So when inflation has gotten *very* high, gold has certainly been a better option than stocks; when inflation has been high but below that 18% mark, the results are mixed. But Dimson, Marsh, and Staunton warn against using inflation data as a timing signal, particularly since investors don't know what the inflation rate is for a particular period until the period is over, and asset prices have already moved. "This is not a market timing tool," they write. "High inflation may look like a sell signal, but our model is derived with hindsight and could not be known in advance; there is clustering of observations, so many of the signals may occur at some past date (e.g. the 1920s); and it is not clear where sales proceeds should be parked. In particular, real interest rates tend to be lower in inflationary times, the expected real return on Treasury bills will be smaller after an inflation hit, and other safe-haven assets like inflation-linked bonds are likely to provide a reduced expected return in real terms."

I'd add a couple other points, one being that in general, trying to time your participation in any asset class is dangerous. It's now been more than three years since the Fed's balance sheet started to balloon -- a sign that inflation *should* be coming -- and we've yet to see the sort of inflation that many (including myself) thought was on the horizon. Yes, had you bought up gold when the Fed's balance sheet began to balloon in the fall of 2008, you'd have made some excellent profits to-date -- but not because gold protected you against inflation. Inflation has been quite moderate, and at times tepid, since then. Instead, the profits you'd have made were because of *fears* of inflation -- speculation, in other words. And gold investing is often rife with speculation, thanks to the fact that gold has no true underlying value -- it produces no earnings, as the company behind a stock does, and it comes with no guaranteed coupon rate, like a bond does.

In addition, the data above on stocks and bonds and inflation looks at the stock market as a whole. But during inflationary times, certain types of firms -- commodity producers and those that have enough of a durable competitive advantage that they can pass costs on to consumers -- should perform much better than others. That will show up in their fundamentals, and a fundamental-focused system like ours should pick up fairly quickly on that and be able to profit from buying such stocks.

To me, basing your investment decisions on short-term inflationary changes is a dangerous endeavor. I think the more important issue is assessing how inflation impacts your portfolio over the long term. I've often cited David Dreman's exceptional work on that topic, and now, because Dreman recently revised his *Contrarian Investment Strategies*, we have new updated data on the subject.

In his revised book, Dreman says that the introduction of permanent inflation to the U.S. economy following World War II was something of a game-changer. "By far the most dangerous new risk over the past sixty years has been inflation, which can attack our savings in many ways," he writes. "Nothing is safe from this virulent virus, although its major victims are the supposedly safest investments we own: savings accounts, T-bills, Treasuries, corporate bonds, and other types of fixed-income securities."

Essentially, inflation eats away at the value of everything. And because the Federal Reserve has said that it sees one of its mandates as promoting an inflationary environment of 2% or so per year, inflation is essentially hardwired into our system, though it can vary widely from year to year. Over the long haul, that means that everything -- stocks, bonds, bills, gold, real estate -- has 2 or 3 percentage points chopped from its nominal returns. For stocks, it's bad news, but far from terrible. Because equities have averaged returns in the 9% to 10% range over the long haul, after-inflation annualized compound returns still have come in at a very respectable 6.5% in the 1946-2010 period, according to Dreman's research.

But for Treasury bonds and bills, which have averaged much lower nominal returns, the few percentage points that inflation eats away is a death knell. In that same 1946-2010 period, bonds averaged annual compound returns of just 1.6% after inflation; for T-Bills, it was even worse, at just 0.4%. Over time, the difference is staggering: In the average 10-year post-WWII period, stocks have produced compound after-inflation returns of 87.9%. Bonds have returned just 17.2%, and T-bills a mere 4.5%. The longer your holding period, the more dramatic the differences become.

Of course, stocks can fluctuate greatly from year to year, and are thus considered "riskier" than bonds or bills. But Dreman provides some interesting data on how that "risk" plays out if you're a long-term investor. For example, in the post-WWII era, stocks have beaten bonds in 74% of five-year periods, 84% of ten-year periods, 94% of 15-year periods, and 98% of 20-year periods. Compared to bills, stocks have won in 75% of five-year periods, 82% of ten-year periods, 88% of 15-year periods, and 100% of 20-year periods. In other words, if you ride out the short-term volatility of stocks, the odds become overwhelmingly in your favor. The real risk for investors isn't volatility, it's inflation's impact on your portfolio over the long term. (Dreman also includes data on how taxes eat away at even more of your portfolio's nominal returns, which only further bolsters the case for stocks over the long haul.)

Dreman doesn't include gold price data, which is less extensive given that the U.S. only let the free market begin to drive gold prices in the mid-1970s. But according to data from The London Bullion Market Association, gold has increased in price from about $185 per ounce at the start of 1975 to about $1575 at the end of 2011. That makes for an annual compound nominal return of about 6.1%. Inflation averaged about 4% over that period, according to the Labor Department, which means gold has averaged just over 2% in real terms. (Stocks have averaged 8.4% nominal and 4.4% real over the same period.)

Bonds and gold can certainly be good investments. Bonds should be a part of your portfolio, especially as you get closer to retirement. And gold offers benefits that can make it a good choice for a piece of your portfolio, too. But for me, the bottom line is this: Stocks are the best long-term investment vehicle, and timing asset allocation based on short-term inflation expectations is a risk -- a big risk. Even if you think we'll get the sort of runaway inflation in which gold has historically been a much better hedge than stocks, consider this: Investors have bid up the price of gold by 100% or so over the past three-plus years in anticipation of major inflation; if we eventually do get major inflation, isn't it quite possible that the lag time has led a good chunk of gold's inflation-fighting ability to already be baked into its price?

Rather than taking on the risk associated with trying to use inflation to time asset allocation, I think investors are better off focusing on managing the greater risk of inflation's long-term impact on their portfolios. History has shown that risk to be great, and often overlooked. And over the long haul, stocks have proved the best way to counter that risk -- the best antibody for that return-eating "virus", as Dreman so vividly put it. As such, they should be a major component of your portfolio in just about any inflationary and economic climate.

Why Fund Managers Fail -- And How To Succeed

Excerpted from the September 28th, 2012 Validea Hot List

We are now nearly three-quarters of the way through the year, and, despite all the concerns about the U.S. fiscal cliff, European debt, and China's slowdown, 2012 has thus far been a pretty strong year for the stock market. Unless things have turned around markedly in the third quarter, however, it has not been a good year for many mutual fund managers. According to a Bank of America Merrill Lynch report, about 70% of large-cap active fund managers underperformed the Russell 1000 benchmark during the first half of the year.

Unfortunately, that's not that unusual. While I often highlight some top-performing mutual fund managers in this newsletter, whether it be gurus upon whom I base my strategies or top current managers like Donald Yacktman and Bruce Berkowitz, the reality is that most fund managers fail to meet their benchmarks. Consider this: In 2011, 81.3% of active large-cap funds failed to beat the S&P 500, according to Standard & Poor's. Mid-cap managers fared better, but the results were still dismal -- 67.4% of them failed to beat the S&P MidCap 400 benchmark. And small-cap managers fared worst of all: 85.8% of them failed to beat the S&P SmallCap 600 benchmark.

Those results were particularly bad. But over the longer term, the track record is still very weak. In the 10-year period ending in 2011, an average of 59.4% of actively managed large-cap funds failed to beat the S&P 500, according to S&P; an average of 63.5% of mid-cap managers failed to beat the S&P MidCap 400; and an average of 63.1% of small-cap managers failed to beat the S&P SmallCap 600. How about international fund managers? Well, over the past five years, according to S&P, about 83% of emerging markets fund managers have failed to beat the S&P/IFCI Composite, and about 78% of international funds have failed to beat the S&P 700. International small-cap fund managers are one of the few bright spots: Only about 26% of them underperformed the S&P World Ex-U.S. Small-Cap benchmark.

In theory, fund managers should have the expertise, experience, and resources to beat the market pretty consistently, right? So, why do so many fail to generate the returns you could get from simply investing in a passive index fund? Part of the reason is that fund managers are human, and, as I've often discussed, we humans are poorly wired for investing -- it's no different if you're an individual investor managing a $10,000 portfolio, or if you're a fund manager overseeing billions of dollars in assets. We're prone to a number of behavioral biases that, if unchecked, can constantly eat away at returns. There's Myopic Loss Aversion, which is when investors, not wanting to feel the pain of locking in losses, hold onto losing stocks well after they're no longer attractive. And Anchoring, which is when one bases one's expectations on facts or figures that are no longer relevant. (When a stock falls from, say, $100 a share to $50 a share, for example, many investors will "anchor" on that initial $100 price and assume the stock must be a bargain, without considering its fundamentals.) Then there's Recency Bias, which is when investors extrapolate the recent past into the future. And don't forget Hindsight Bias, which is more than just realizing how you could have made money (or not lost money) after the fact -- it's when we incorrectly think that what we should have done was obvious or easily predictable, and allow that misconception to color our future decisions.

All of these and other biases that are hardwired into our brains impact not only individual investors, but fund managers as well. But in addition, there are a couple other factors that negatively impact fund managers specifically, perhaps the most significant being "career risk". Jeremy Grantham and his GMO colleagues have written pretty extensively on this topic, and here's how Grantham explains career risk: "The central truth of the investment business is that investment behavior is driven by career risk," he

wrote in his first-quarter letter this year. "In the professional investment business we are all agents, managing other peoples' money. The prime directive, as Keynes knew so well, is first and last to keep your job. To do this, he explained that you must never, ever be wrong on your own. To prevent this calamity, professional investors pay ruthless attention to what other investors in general are doing. The great majority 'go with the flow,' either completely or partially. This creates herding, or momentum ..."

It's understandable, really. In today's world, many investors -- who are continuously barraged by reports from a financial media that has the attention span of a gnat -- have little tolerance for underperformance. They might give a fund manager six months, maybe a year, but quite often it isn't long before they'll jump ship if a fund is significantly underperforming its peers or the broader market. Of course, if you're going to beat the market over the long term, you're going to go through periods of significant underperformance -- every one of the incredibly successful gurus I follow experienced that at some point. But many investors are too shortsighted to realize that, or they've been duped by crafty fund marketers into thinking that it's possible to always beat the market.

However you want to dole out the blame, the resulting situation is one that often isn't good for investors over the long haul. Knowing that they will lose their clients -- and perhaps eventually even their jobs -- if they significantly lag their peers for more than few months, fund managers don't deviate too far from their benchmarks. After all, it's a lot easier to defend your performance -- even if it's a bad performance -- if the broader market and many of your peers are in the same boat then it is if you're alone.

Research shows that leads to a myriad of funds that are overdiversified and look extremely similar to their benchmarks. James Montier, Grantham's colleague at GMO, pointed to one study in a 2010 letter to clients. He said that Jonathan Lewellen of Dartmouth College examined aggregate holdings of U.S. institutional investors over the period 1980 to 2007. "Quite simply," Lewellen found, "institutions overall seem to do little more than hold the market portfolio ... Their aggregate portfolio almost perfectly mimics the value-weighted index ... Institutions overall take essentially no bet on any of the most important stock characteristics known to predict returns."

What's interesting is that there's evidence showing that fund managers actually aren't bad stock-pickers. In one paper, Montier noted, researchers Randy Cohen, Chris Polk, and Bernhard Silli looked at the "best ideas" of U.S. fund managers over the period 1991 to 2005. ("Best ideas", Montier explained, were measured as those stocks with the biggest difference between the managers' holdings and the weights of the benchmark index.) Their findings: The top 25% of best ideas from active managers generated an average return of over 19% annually vs. a market return of 12% annually. "The poor overall performance of mutual fund managers in the past is not due to a lack of stock-picking ability," the authors said, "but rather to institutional factors that encourage them to over-diversify."

Other factors can also stack the deck against mutual funds, including size. Managers who have success attract a lot of attention and new clients, which at a certain point limits the types of stocks you can invest in -- if you're running a multi-billion-dollar fund, you're not going to be able to focus on smaller stocks, no matter how much you like them. Success can thus become self-defeating in some cases.

And, of course, fees are a huge issue. A percent or two off your returns might not sound like much, but over the long haul it can really add up.

To be sure, there are some great active fund managers, and I don't mean to malign an entire industry. Lynch, Neff, Berkowitz, and Yacktman are among those who have had great success for lengthy periods of time. While there's no specific formula for achieving that kind of success, I found that, generally, successful fund managers have the emotional fortitude to overcome the obstacles we've just examined. Often, they'll

hold more concentrated portfolios, with holdings that diverge significantly from their benchmark. They also focus on cold, hard facts and figures, and focus on the long-term -- they aren't swayed by popular opinion or short-term hype. Berkowitz, for example, took all sorts of criticism last year when a big investment in financials like much-maligned AIG dragged his fund down, putting it at the very bottom of his category in terms of 2011 returns. But he wasn't swayed, and this year his fund has rebounded sharply, and is ranked in the top 1% of its class, according to Morningstar.

The majority of fund managers and most individual investors don't have that kind of temperament, however. That's why I created Validea. By using a system that is purely quantitative and focuses only on facts and figures, and by using a fixed rebalancing period that allows for buying and selling only at regular intervals, the Hot List and our other portfolios take emotion and behavioral biases out of the equation. That doesn't mean the system will be right on every pick, or that it will beat the market every month, or even every year. But over the long haul, the system has proven that this sort of fundamental-focused, unemotional approach can generate impressive returns. Whatever the specifics of your own investment approach, I would urge you to make sure that you, or those who you trust to manage your money, are willing to follow a similar path -- that is, act unemotionally, make decisions based on hard data and not hype, and always focus on the long-term.

When Should You Sell?

Excerpted from the October 26th, 2012 Validea Hot List

Over the past couple weeks, we've seen a few big sell-off days in the market. Those disappointing earnings and guidance reports I mentioned above were probably the biggest reason behind the declines, as investors feared it was a sign of a weakening global economy. Lingering fears about Europe's and China's economies also played roles.

The sell-offs were thus by and large the result of speculation about macroeconomic factors that triggered emotional responses in investors. We, however -- like the vast majority of the gurus we follow -- don't think investors should ever sell based on emotion, macroeconomic factors, or speculation. History has repeatedly shown that such behavior ends up being harmful to an investor's portfolio over the long haul.

Under what conditions, then, should you sell? It's a question that doesn't get nearly enough consideration. In the financial media, selling usually comes up in the context of recommendations about when to decrease your overall stock allocation (usually due to macroeconomic factors), or case-specific examples of why to sell one particular stock. Rarely do you see long-term, broader strategies for selling stocks discussed.

It's a topic that deserves more airtime. In fact, deciding when to sell can be more difficult than deciding what to buy. Once you own a stock, and it has either risen or fallen, all sorts of emotions start swirling in your mind. It's the finality of selling that makes it so tough -- sell a winner, and you'll wonder if you're selling it too soon and missing out on bigger gains; sell a loser, and you'll fear that it will bounce back strong as soon as you dump it. These kinds of thoughts can lead to emotional decisions that do serious damage to your portfolio.

Selling is such an important -- and overlooked -- part of the investment process that I dedicated an entire chapter to it in my most recent book, *The Guru Investor: How to Beat the Market Using History's Best Investment Strategies*. I think it's important to review the mindset behind the Hot List approach from time to time, so below I've taken excerpts from that chapter that I think best explain our selling approach.

The Missing Piece: Determining When to Sell

While a lot of strategies out there tell you how to buy stocks that will make nice gains, there are few that address the second half of the stock investing equation: when to sell - the proverbial brakes on our car. It's amazing, really, because for many investors, deciding when to sell is a harder decision than deciding what to buy. Cabot Research, a behavioral finance consulting firm, has found that even top-performing mutual fund managers may be missing out on 100 to 200 basis points per year because of poor sell decisions, Institutional Investor's Amy Feldman noted in a June 13, 2008 article entitled "Know When To Fold 'em". Seeing as how amateur investors tend to do much worse than the pros … it's likely that the average, nonprofessional investor suffers even greater losses because of poor sell decisions.

Part of the reason investors struggle with selling is that advice on the topic is somewhat lacking in the investment world. A survey performed by Cabot and the CFA Institute found that more than 70 percent of professional investors used a selling approach that was not highly disciplined or driven by research and objective criteria, Feldman noted in her piece, so it seems most of the pros aren't offering a whole lot of guidance here. But another part of why sell decisions are so hard involves an old, familiar foe: our own brains.

Just as our brains tell us to avoid unpopular stocks and jump on hot stocks when we're buying, they also cause havoc when we're trying to figure out when we should sell a stock. If you've ever put money into the market, you've almost surely found this out the hard way.

A few phenomena make selling and sticking to a selling plan a difficult task. For starters, there's the "fear of regret." When we make an error in judgment, we feel badly; often, we'll beat ourselves up with "woulda-coulda-shoulda" thinking, which is never pleasant. And that's certainly true when we take a loss on a stock. Hindsight is always 20/20, and we end up thinking that we could have easily avoided what turned out to be a bad move. Because of the unpleasantness of those feelings, one theory on why people sell at the wrong time is that they avoid selling stocks that have lost value, instinctively wanting to postpone those feelings of pain and regret, even if those stocks now have little prospect of rebounding.

This is similar to the concept of "myopic loss aversion" that we examined in the previous chapter. In his 1999 paper, "The End of Behavioral Finance," Professor Richard H. Thaler of the Chicago University explains that loss aversion refers to the observed tendency for decision makers to weigh losses more heavily than gains; losses hurt roughly twice as much as gains feel good. Locking in losses thus hurts a lot so we'll avoid selling stocks for a loss even after they no longer have good prospects to delay that hurt.

Why are losses so painful? The fact that they are a shot to our egos seems to be part of the reason. Professors Kent Daniel and Sheridan Titman state that people tend to ignore or underweight information that lowers their self-esteem in "Market Efficiency in an Irrational World," which appeared in the 1999 volume of the Financial Analyst Journal. "For example," they write, "investors may be reluctant to sell their losers because it requires that they admit to making a mistake, which could lead to a loss in confidence and have deleterious consequences. For similar reasons, investors may systematically overweight information that tends to support their earlier decisions and to filter out information that suggests the earlier decisions were mistakes." Essentially, we'll twist the facts to avoid admitting mistakes so that we feel better about ourselves, and our stock-picking abilities. That keeps us from feeling badly about ourselves, but it also keeps us from learning from those mistakes.

Another common mistake many investors make is holding on to winners too long. In his 2001 book *Navigate the Noise: Investing in the New Age of Media and Hype*, Richard Bernstein notes that growth fund managers often do just that because they are encouraged to do so by all the good news regarding companies' prospects. A perfect example would seem to be the tech stock boom of the late 1990s. Blinded by the hype, most of those people who had made huge sums of money ignored logic and held on to their stocks too long, only to see them come crashing down.

Selling Smart

So with all of these challenges, how do you stave off emotion and make good, sensible sell decisions? The same way that you keep emotion at bay when deciding what stocks to buy: By using a disciplined system that makes sell decisions based on cold, hard fundamentals, not emotion-driven hunches, or arbitrary price targets. That's what we've done with our model portfolios, as well as with our investment management business, and we think that's a big reason why the results have been so good.

To understand how and why our sell system works, you have to go back to the basic premise behind our buy strategy. And that is that over the long term, investors gravitate toward stocks with strong fundamentals because those are the strongest companies, and that causes those stocks' prices to rise over time. We buy because of the fundamentals not just because the price is high or low or rising or falling. Remember, the only way price comes into the decision to buy is in how it relates to the stock's fundamentals that is, in the form of such variables as the price-sales ratio or price-earnings ratio.

When you're building your portfolio, then, you want to pick the stocks that have the best fundamentals because (sorry to sound like a broken record) over the long run, investors gravitate toward stocks with strong fundamentals because they are the strongest companies.

Okay, great, you're saying, but that's buying stocks; we've already covered that. What does this have to do with selling stocks?

Well, it has everything to do with selling. If you're buying stocks because they have strong fundamentals, and (everyone now), over the long term, stocks with strong fundamentals tend to rise, you should hold on to a stock as long as it continues to meet the fundamental criteria you used to select it. Whether the stock has dropped sharply since you bought it or whether it has skyrocketed is no matter; what matters is where the stock's fundamentals stand right now. Price, just as with buying, matters only in terms of how it relates to the fundamentals (what the stock's P/E or P/S ratios are, for example).

Many investors will sell a stock because its price has fallen and they think they need to cut their losses, or because the price has risen and they think the "smart" thing to do is to take the profits rather than risk the stock coming back down. But those are arbitrary, emotional decisions. Remember, you bought the stock because its strong fundamentals made it a good bet to gain value; if its fundamentals are still strong, why wouldn't it still be a good bet to gain more value?

If the stock's fundamentals have slipped, however, so that it no longer meets the criteria you used to buy it, it's time to sell and replace it with another stock that does meet your criteria (and one that thereby has better prospects of rising in value).

The selling assessment is thus an ongoing reevaluation of where a stock stands right now. You must continually reassess what the stock's prospects are going forward, not what they were a month ago, six months ago, or whenever you bought it.

The next question, then, is what "continually assess" means. Should you check once a day to make sure your holdings still meet your criteria? Once a week? Once a month? Once a year? Since mid-2003 we've been running model portfolios based on each of our Guru Strategies. For each model, we've constructed separate portfolios that use different rebalancing periods - monthly, quarterly or annually. The model portfolio returns reported at the end of each guru chapter are those of our 10- and 20-stock portfolios using the monthly rebalancing period. On average, this monthly rebalancing tends to produce the highest raw return; the quarterly and annual portfolios, while still ahead of the market, tend to produce less excess return over the time period for which we have results.

The prevalence of inexpensive discount brokerages has made trading very cost-effective today (especially for larger portfolios) and, for many reading this, a monthly portfolio rebalancing is attractive and can be done easily and cheaply with the right online broker. Nevertheless, it's important to understand that the monthly rebalancing approach does require more a bit more work, time, and commitment. If you're a busy professional, a retiree who likes to travel or a stay-at-home-mom with young children a less frequent rebalancing approach might work better for you and give you a better chance at following the strategy more consistently. So the important point here, whether you use a one-month rebalancing or a different time frame that works for you, is this -- you need to re-examine your portfolio at set intervals, to assess how your holdings stand relative to the reasons you bought them. If they no longer meet the criteria you used to pick them, you should consider replacing them with new stocks that do make the grade.

You can also use your rebalancing period to reweight your portfolio in case some of your holdings have gained or lost a bunch, and now make up a disproportionate part of your portfolio. The idea here is to keep things close to equally weighted. It doesn't have to be perfect, though; if one stock gains a little ground so that it makes up a few more percentage points of your portfolio than the other stocks, you don't need to go selling a couple shares and getting hit with trading charges just to even things out exactly. To keep this simple, you might want to set a reweighting target percentage. For example, anytime a holding's weight in your portfolio becomes 10 percent more or less than your target weight, you buy or sell shares of it to bring it back to that target.

By sticking to a firm rebalancing plan, you keep emotion and hype from impacting your selling decisions. You sell at regular intervals, and you sell based on fundamentals. Just as with buying stocks, there's no place for hunch-playing or knee-jerk reactions here. There are a couple rare occasions, however, when you

should sell a stock without waiting for the rebalancing date to arrive. If a firm is involved or allegedly involved in a major accounting or earnings scandal, you should sell the stock immediately, because you can no longer trust its publicly disclosed financial data. In addition, if a firm has become a serious bankruptcy risk since the last rebalancing, you should also sell its stock immediately.

Nobody's Perfect

Another thing to keep in mind when it comes to selling stocks is that no investor, not even the greatest investors in the world, are right all the time. Remember what Martin Zweig says: "In the long run, a 60 percent success rate translates into huge gains, a 50 percent rate into solid gains, and even a 40 percent rate can beat the market." When it comes to the stock market, no one is right all the time or even nearly all the time. Even the great Warren Buffett makes bad investments. Just read Berkshire Hathaway's annual report, and Buffett will often speak candidly about where he's gone wrong.

While you'll never be right all the time, you can be right more than you're wrong, however. In the end, the key is to develop a fundamental-based selling and rebalancing plan and stick with it, no matter what. When your portfolio does lose ground from time to time, you'll inevitably feel the urge to sell certain stocks and go after others on a whim or a hunch to make up ground. But if you have a detailed, quantitative selling system in place, you can help keep short-term emotions from wreaking havoc with your long-term performance.