VALIDEA

THE BEST OF THE VALIDEA HOT LIST – 2013

HIGHLIGHTS OF THE TOP INVESTING COMMENTARY THROUGHOUT THE YEAR

Table of Contents

A (Non-random) Walk Through Graham-and-Doddsville

Excerpted from the February 1st, 2013 Validea Hot List

The results are in, and they show that 2012 was another tough year for mutual fund managers: About 65% of U.S. large-cap core stock funds lagged the S&P 500, according to Goldman Sachs and The Wall Street Journal. That was actually better than the past two years, when the figure was close to 80%. But it's still pretty dismal. So, too, is this: Of the nearly 2,000 U.S. stock funds tracked by Morningstar, only 10% beat their benchmark in both 2011 and 2012, the Journal reports.

Over the longer term, the results aren't much better. And those sort of results, some might argue, are evidence that it's just not possible to beat the market over the long haul. I disagree -- and if you want some good evidence that the market is not, as efficient market hypothesis proponents say, a "random walk", Warren Buffett has provided it. In a 1984 speech he gave at Columbia University entitled "The Superinvestors of Graham-and-Doddsville", Buffett examined the remarkable track records of a small group of investors who studied under Benjamin Graham, the man known as "The Father of Value Investing". He explained that from 1954 to 1956, there were four "peasant level" employees working under Graham at the Graham-Newman Corporation (David Dodd and Jerome Newman were among the firm's other directors). Three of those "peasants" (Walter Schloss, Tom Knapp, and Buffett himself) established easily traceable track records after leaving the firm, Buffett said -- and all of those track records were tremendous.

Schloss, who passed away last year at the age of 95, produced gains of 16.1% and 21.3% annualized at two partnerships over a 28-year period, while the S&P 500 gained just 8.4% per year, according to a revised version of Graham's The Intelligent Investor (which used Buffett's 1984 speech as its introduction). Another of the "peasants", Tom Knapp, produced annualized gains of 20% and 16% at two funds over a 15-year period, vs. 7.0% for the S&P. And Buffett, of course, may have the best investment track record of all-time. Prior to taking over Berkshire Hathaway, he produced annualized returns of 29.5% and 23.8% at two partnerships over a 13-year period, while the broader market was returning 7.4% per year. Then he moved on to Berkshire, where his track record is well known.

Those three weren't the only Graham/Dodd/Newman disciples who produced stellar long-term returns. Bill Ruane, Charlie Munger, John Templeton, John Neff -- all of these gurus and others worked under or learned from Graham and company. To Buffett, that was proof that the value investing tenets Graham espoused were a real way to beat the market over the long haul. "A concentration of winners that simply cannot be explained by chance can be traced to this particular intellectual village," he said in his speech. In other words, the results show that Graham-style value investing works.

It's hard to argue the point, and my success with Graham's strategy only bolsters the already impressive case. Since its mid-2003 inception, my 10-stock Graham-based portfolio is up 242.6% (through Jan. 30), compared with 50.1% for the S&P 500. That's a 13.8% annualized gain vs. 4.3% for the index. My 20-stock Graham-inspired portfolio has been even better, returning 334.2% (16.6% annualized) over that period. All of the stocks in those portfolios were chosen using a strategy inspired by the "Defensive Investor" approach Graham laid out some 64 years ago in his book.

The "Superinvestors" aren't the only evidence that value investing works over the long haul. Other value-focused strategists, like Joel Greenblatt, Donald Yacktman, and David Herro, have also put up very strong long-term track records. And, in past newsletters I've examined studies done by the Brandes Institute and by Elroy Dimson, Paul Marsh, Mike Staunton, and Jay Ritter, both of which showed that value stocks (identified using a number of different valuation metrics) have outperformed the broader market for decades and decades.

While there are different value-focused approaches one can take to beat the market over the long haul, I have found that the best value investors generally share two key similarities: They focus on numbers -- that is, a company's financials and fundamentals -- rather than hype, and they stayed disciplined over the long haul. That's how they distinguish themselves "in kind -- not in a fancied superior degree," from the rest, as Graham said one needed to do in order to succeed in investing. In his day, just as today, most investors weren't investors at all -- they were speculators, buying and selling stocks based on rumor, hunches, and emotions. Succeeding in the market, Graham believed, wasn't a matter of being a better speculator than others. It was a matter of using a different tactic altogether -- that is, being analytical, rational, and disciplined. To invest well, one needed to analyze the numbers on the company's balance sheet and in its fundamentals, determine what its shares were worth, and pay less for them. That meant going against the crowd, buying stocks that were unloved, and avoiding the popular, overpriced shares that everyone seemed to be buying. It also meant sticking with that mindset, even during very rough short-term periods -- no small task. "Successful investment," Graham wrote, "may become substantially a matter of techniques and criteria that are learnable, rather than the product of unique and incommunicable mental powers. The intelligence here presupposed is a trait more of the character than of the brain."

Today, one might think that our high-tech world has made it harder for value investing to work, because information is now so easily accessible. In Graham's day, it took a lot of legwork and effort to analyze even one company's financials and fundamentals. But those who had the time, desire, and initiative to find and crunch the numbers could get a huge leg up on others. Today, the Internet gives us financial and fundamental information on thousands of stocks with just a few mouse clicks. Finding a company with a strong return on equity, low debt, and dirt-cheap shares is something that just about anyone can do, and do quite easily.

Why then, is a value strategy like Graham's continuing to work today? After all, when a metric or strategy becomes known, it can become endangered -- if too many people start following it, the prices of the stocks it targets will shoot up to overvalued levels, essentially killing the usefulness of the metric or strategy. Why hasn't that happened with Graham's approach and other value-focused strategies? I think it's because the technological forces that have helped level the playing field in terms of timely access to financial and fundamental data have also made it much harder for people to focus on the long-term. As easy as it is to get financial and fundamental data that can help you identify strong value stocks, it's even easier to get another piece of data: stock prices -- get them anywhere, anytime. Turn on the TV, pop open your laptop, click on your phone -- all of them give you a front row seat to every up and down of every stock in your portfolio, and the rest of the market. And your computer and your smartphone give you the ability to act on any one of those ups or downs in a matter of seconds. Because we humans are emotional creatures, many, if not most, investors end up acting far more than they should, selling goods stocks that have had a bad day, or buying hot stocks that have had a good day, without regard to what truly matters: what those shares are really worth.

So, while it is far easier for average investors to find good value stocks today than it was in Graham's day, it's also far more difficult to hold onto them. And that's a good thing for disciplined value investors. Since many investors will dump shares of good companies when they see one negative Tweet or get an alert telling them that the stock is down a few percent today, those investors who are rational and disciplined can swoop in and snatch up the bargains left behind. It's a difficult task, of course, because the whims and emotions of the market can take those bargain-priced shares any which way in the short term. But eventually, more often than not, the market recognizes the value in a bargain, something Graham knew well. If you have the stomach for those short-term gyrations, and the discipline to stick with a good value-focused approach over the long term, you can thus still generate some very nice returns over the long haul. That's how my Graham-based portfolios have fared so well, and how the Hot List has produced some exceptional long-term returns of its own. If you focus on the fundamentals and stay disciplined over the long haul, you can do the same.

The Trouble With Timing

Excerpted from the March 15th, 2013 Validea Hot List

As stocks continue to head higher and higher, it gets more and more tempting to try to call a market top. After all, the last time stocks were this high, few investors realized they were about to be hit by one of the sharpest, most painful bear markets of their lifetime. It's thus natural to think back on those events and fear that similar pain is going to follow again this time.

That, however, is a very, very dangerous game, and a couple recent studies showed just how difficult -- and detrimental to your portfolio -- trying to time the market can be. One came from Dalbar, Inc., the research group that tracks how well mutual fund investors actually do compared to the funds in which they invest. Dalbar has found that investors have a strong tendency to make bad market timing decisions, jumping into overheated markets and selling when prices are low, and the latest data from the firm is sobering. Over the past 20 years through December, the average individual stock mutual fund investor earned 4.25% per year, while the S&P 500 returned 8.21%, The New York Times reported. A $10,000 investment at 4.25% annualized would be worth $22,989 after 20 years; at 8.2%, it would be worth $48,456 after 20 years.

The gap in performance is due in part to the fees mutual funds charge, but also to investors making emotional decisions to jump in and out of the market at inopportune times. "They get excited or they panic, and they hurt themselves," Dalbar President Louis S. Harvey said. His advice: Unless you can time the market (and who can?), Harvey says to "make sure that you select a reasonably defensive asset allocation strategy first," adding, "The most important thing, once you have a strategy is to find a way to actually stick with it."

The other study came from Mark Hulbert, who for decades has been monitoring the performance of dozens of investment newsletters through his Hulbert Financial Digest. In a recent Barron's column, Hulbert looked at returns since October 2007 of the more than 100 market-timing newsletters and web-based advisors monitored by HFD, looking to see who correctly called both the market top in 2007 and the market bottom in 2009. No one called the top and bottom on the exact days, he found, but that's an incredibly tough standard. So he used a relaxed standard -- a much relaxed standard -- and he found that the results were still very poor.

Hulbert considered an advisor to have called both the top and bottom if they had decreased their allocation to stocks by at least 25% within a month of the October 9, 2007 top, and increased their stock allocation by at least 25% within a month of the March 9, 2009 bottom. He found that of 140 strategies tracked by HFD, only 15 had significantly lower equity exposure a month after the 2007 top. Of those, just six had markedly higher equity exposure a month after the bottom. "In other words," Hulbert said, "96% of the market-timing strategies monitored by the HFD failed to jump over these seemingly modest hurdles."

What's more, the six that did meet the timing criteria had other issues. Each gave a number of other buy and sell signals in the intervening periods "that had the unfortunate effect of frittering away the gains they otherwise would have realized if they had left well enough alone," Hulbert says. He did say that about 25% of the market-timers he tracks have beaten the market since stocks hit their 2007 high, but "none of them did so by getting out at or near the top and getting in at or near the bottom."

Like Harvey, Hulbert also says discipline is crucial when following a market-timing approach. And he says investors shouldn't expect they'll come close to timing market tops and bottoms correctly. "Realistic expectations are crucial," he says. "Without them, you are more likely to try something rash and end up losing even more money. For example, you should give up hoping to both catch anything like the top and the subsequent bottom."

I agree completely. There are some effective market-timing strategies out there, and if you do feel strongly about using one, a few words of advice: Make sure the approach you choose is quantitative in nature; do not try to jump in and out of the market based on hunches or guesswork. In addition, the approach should have a proven, long-term track record of success. And, most importantly, once you find that approach, stick with it, no matter how rocky the road gets in the short term.

For most investors, however, market-timing is best left alone. As Warren Buffett noted in his latest letter to Berkshire Hathaway shareholders, "Periodic setbacks will occur [for the market], yes, but investors and managers are in a game that is heavily stacked in their favor. Since the basic game is so favorable, Charlie [Munger, his partner at Berkshire] and I believe it's a terrible mistake to try to dance in and out of it based upon the turn of tarot cards, the predictions of 'experts,' or the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it."

The Hot List, as always, will continue to stay in the game. While others will try to jump in and out of the market in an impossible quest to catch market tops and market bottoms, the Hot List will keep focusing on strong companies with attractively valued shares. On today's regularly scheduled rebalancing, for example, the portfolio is adding four new stocks, including Royal Dutch Shell. Though it has taken in nearly a half-trillion dollars in sales over the past 12 months, sports a 15% return on equity, and has a 5.2% dividend yield, Shell trades at exceptionally cheap valuations: just 7.8 times trailing 12-month earnings, 8.2 times projected 12-month earnings, 0.46 times TTM sales, and 1.1 times book value. It seems that lingering fears of an economic catastrophe in Europe that has not materialized are keeping investors away from very attractively priced stock in a solid company.

Those types of stocks -- good companies whose shares are trading on the cheap -- are what the Hot List portfolio has focused and will continue to focus on. In the short term, as emotions drive investors' actions, that can lead to some big ups and downs. But over the long term (and the long term is the only thing you should be concerned about), value wins out more often than not, and stocks follow the businesses behind them. If you focus on good companies with cheap shares and stay disciplined, you should produce some very strong long-term returns, without ever having to call a single market top or bottom.

The Rewards -- and Challenges -- of Keeping It Simple

Excerpted from the June 7th, 2013 Validea Hot List

Economies and financial markets are incredibly complex mechanisms. Every part -- and every piece of data -- is impacted (and impacts) scores of other parts, creating a giant web of seemingly endless outcomes. Financial advisors like to remind you of this. One ad I saw recently, for example, asks, "How can power consumption in China impact wool exports from New Zealand, textile production in Spain, and the use of medical technology in the U.S.?" Then, of course, it implies that its advisors have the knowledge and experience to fully understand such complicated economic and financial relationships.

Perhaps they do, though I'm somewhat skeptical. But here's the more important point: Just because economies and markets are incredibly complex, that doesn't mean your investment approach needs to be. I was reminded of that this week while reading an insightful piece that Robert Seawright wrote for the "Above The Market" blog. "We love complexity," Seawright said. "We should of course go with the simpler explanation or approach unless and until something more complex offers greater explanatory power. But we don't. We want to include our pet political ideas, convoluted conspiracy theories or favored market narratives. We are ideological through-and-through, and the more complex the better." Over the past 10 years, however, he says, while hedge funds (which are often known for using strategies described as "complex") have collectively struggled, a simple portfolio with 60% in a broad stock index fund and 40% in bonds has put up annualized returns of more than 7%. Not bad for a decade that included the worst financial crisis in 80 years.

At the same time that humans are drawn to complexity, Seawright notes, we are in a "fascinating paradox also drawn to extreme simplicity. "We want sure-thing formulae," he says. "We want black-and-white. We don't want the hassle of fine distinctions and careful analysis."

What Seawright really seems to be getting at is that we want to believe we can have*control*, and I think that's particularly true in the stock market. We want to think that we can master it, whether it's thanks to an incredible amount of esoteric, in-depth knowledge that we've compiled, or the result of some "silver bullet" strategy or variable.

The truth, however, is that with so many moving, interconnected parts in the economy and the market, such control is -- and will always be -- beyond our grasp. You can study for decades, soaking up every ounce of investing knowledge you possibly can, and you are still not going to be right on all of the stocks you pick. Nor will you make money and beat the market every year.

The good news is, you don't need to. In his book, *Winning on Wall Street*, the late, great Martin Zweig said that you'll never be perfect when it comes to picking stocks. But, he added, "You can, however, be right more than you are wrong. If you are right 60% of the time, ride your profits, and rein in your losses, you'll find that when you're right you're very right, and when you're wrong you're only moderately wrong. In the long run, a 60% success rate translates into huge gains, a 50% rate into solid gains, and even a 40% rate can beat the market."

Zweig found that his approach, which, like that of the Hot List, involved screening thousands of stocks to find those with specific fundamental characteristics, had a built-in error rate of about three-eighths over the long term. "That is, out of eight stocks that I pick, three, or 38 percent, will underperform the market," he wrote. Beating the market 62% of the time still ended up netting him huge profits.

I've had similar results with my Guru Strategies. Of the 14 ten-stock portfolios I track on Validea.com, 13 have beaten the market since their inceptions (most of which were July 15, 2003), and on average they have more than doubled the S&P 500. But the most accurate portfolio -- that is, the one that has made money on the highest percentage of its picks -- has an accuracy rate of 61.0% (the Kenneth Fisher-based portfolio). Some have barely been right on more than half their picks -- the Motley Fool-based portfolio, which has returned 14.6% annualized (nearly tripling the S&P) has an accuracy rating of 51.3%. The Momentum Investor model has actually picked more losers than winners, with an accurate rate of 46.0%, but it is far ahead of the S&P (The Hot List, by the way, stands at 56.4%.)

All of this is evidence that good investing isn't about finding "The Answer", or figuring it *all* out. It is, rather, about putting the odds in your favor as much as possible. As Seawright says, "The best we can hope for is to create and test an appropriately probabilistic outlook, recognize its limitations, and act accordingly."

That may sound boring, lacking in confidence, and perhaps even a bit defeatist. But the reality is that if you are willing to accept that notion, you can produce returns that are far from boring. For example, had you invested $10,000 in the Hot List portfolio at its inception, you'd have more than tripled your investment today.

The Hot List has done that with what in some ways is a very simple approach. It doesn't try to time the market, it doesn't try to sort through the convoluted macroeconomic landscape to make predictions. It simply uses strategies that have identified winning stocks in the past, and employs them today. And the strategies don't employ mysterious, inscrutable methods -- we're not using pork belly prices in the Malaysian market to miraculously forecast inflation expectations for the United States. We're using strategies that focus on good old-fashioned business concepts like earnings and sales growth, debt levels, and returns on equity and capital, as well as valuation metrics like the price/earnings and price/book ratios.

That being said, the strategies aren't overly simplistic; they are quite thorough. Even the Joel Greenblatt-based strategy, which at first look may appear very simplistic, digs pretty deep into a company's financials and fundamentals. That's because, while it looks at only earnings yield and return on capital, the way it calculates those two figures encompasses several other data points. (For earnings yield, for example, it uses earnings before interest and taxes and divides that by enterprise value, which includes not only the value of the company's shares but the amount of its debt as well.) Seawright advises using approaches that are "as simple as possible, but no simpler", and I think our strategies fit that description.

To be clear though, using strategies like these may make for a relatively simple investment process, but that doesn't mean it's easy. But the hard part comes not in the form of complexity. Instead, it has to do with emotional fortitude. Emotions of all sorts will confront you at every turn when you are investing, telling you to buy stocks because some pundit on TV said so, or telling you to sell when you see a scary headline about Europe's debt problems, or telling you to snatch up the hot stock that everyone else seems to be buying. Those emotions will make you think that you need to act *now*, or else you'll lose your retirement savings, or you won't have enough money to pay for your children's college education, or you'll end up far behind your friends and neighbors in the end.

Seawright touches on the "simple-but-hard" concept -- and so does Warren Buffett. Asked by Fortune a few years back for his best investing advice, Buffett offered this: "Investing is simple but it's not easy. The reason it's not easy is because emotions get in people's ways. They get all excited about stocks when they've gone up recently and then the get depressed when they've gone down." Investors can make money, he said, "if they can take the emotion out of it, and just simply stick with good businesses. ... You have to sit back and have a [long-term] philosophy."

As usual, Buffett's comments are incredibly wise. That's why we manage the Hot List in such a methodical, unemotional, disciplined manner. We never buy and sell on hunches or headlines. We focus on the fundamentals. And we think long-term. That makes for what may seem like a relatively simple strategy, compared to those who spend their time glued to financial news and/or poring over the latest day-to-day, minute-to-minute market news. But it sure isn't easy, particularly when the negative headlines are piling up and the market is heading downward. But in the end, although it's hard, it's worth it. That's what the gurus we follow and our own experience with our portfolios has taught us.

The Cash Conundrum

Excerpted from the July 5th, 2013 Validea Hot List

Whether it's a slowdown and housing bubble in China, lingering problems in Europe, or the unknown landscape of a post-QE environment, the investment world seems to be teeming with frightening risk factors these days. All this, combined with a hangover from 2007-2009 bear market, is enough to make you want to pull your money out of stocks and shove it under your mattress, where it is seemingly safe from the unwinding of the Federal Reserve's quantitative easing policies, China's troubles, and Europe's woes.

The problem is that, while those risks grab the headlines, the biggest risk of all may lie underneath that proverbial mattress.

I realize this sounds like the kind of thing investment advisors say when trying to sell you something. But the data backs it up. A quick look at historical returns shows just how dangerous holding too much cash can be for an investor -- and the reasons involve inflation and taxes. According to data from BlackRock, Morningstar, and the Tax Foundation, stocks averaged annual compound returns of 9.8% from 1926 through 2012. After inflation, however, the return fell to 6.7%. And after taxes are also factored in, the average returns were 4.5%. (Thanks to Josh Brown of The Reformed Broker blog for highlighting the data).

But if you think that's disappointing, look at bonds. They averaged a compound annual return of 5.4% over that period -- not bad at all. After inflation, however, the figure dips to just 2.3%. After taxes? A paltry 0.6%.

Still, at least that paltry 0.6% means bond investors took home something after inflation and taxes. While conventional wisdom is that you can't lose money you put in the bank, that is exactly what has happened to cash holders over the long haul. In that 1926-2012 period, cash earned a nominal average compound return of 3.5%. After inflation, they earned just 0.5%. Throw in taxes, and the return on cash turns negative, at -0.8%.

If, as contrarian guru David Dreman has said, risk is *not* short-term volatility, but instead "the probability your investment will preserve your capital over your investment time horizon [and] the probability your investments will outperform alternative investments during the period," it's clear that cash has been a risky choice over the long term. It's a hard concept to wrap your mind around. "Indeed," Dreman wrote in Contrarian Investment Strategies, "it goes against the principle we were taught from childhood -- that the safest way to save was putting our money in the bank."

All this isn't to say that having a lot of cash in the bank is inherently bad. It can be a very good thing, and a very wise move -- the key is *why* you're holding it, and what your time horizon is. If you need to use that money in the shorter term -- you're retiring next year, or your child is heading off to college, or you're buying a house, etc. -- then the bank is probably a good place for it, because the risk of cash losing value in the *short term* is far smaller than stocks or bonds or gold losing value. And, of course, you should always have some cash available in case emergencies (job loss, health issues, etc.) pop up.

But if you are trying to build wealth for the long haul, holding excess cash becomes risky. And if the "why" behind your decision to hold a lot of cash has anything to do with a belief that the market is going down in the short term, you're really asking for trouble. Sure, it's easy now to look back and think how much money you'd have saved if you'd moved out of stocks and into cash anytime between late 2007 and early 2009. But think back to that period. Could you really have predicted that there would be such a huge decline -- and could you have gotten the timing right? Long-term data shows investors who try to make such calls far more often than not fail. Dalbar Inc., for example, found that in the 20 years ending at the end of 2012, the S&P 500 averaged 8.21% annual returns, and the Barclays Aggregate Bond Index averaged 6.34%. Average equity fund investors, meanwhile, earned just 4.25% annualized, while average fixed-income fund investors earned just 0.98%. The reason: Investors tend to exercise terrible timing in their decisions about jumping in and out of both equity and bond funds. (I'd also note that Dalbar said inflation averaged 2.43% over that period, which would have brought actual returns to less than 2% for stock fund investors and well into the red for fixed-income investors -- and that's before taxes).

But what about Warren Buffett, you might be thinking. Perhaps the greatest investor ever, Buffett and his Berkshire Hathaway tend to carry a good amount of cash -- it had nearly $50 billion on hand at the end of the first quarter. But Buffett doesn't use cash as a way to side-step market downturns. He keeps cash on hand in case excellent new opportunities pop up. If the opportunity is there -- that is, if he can buy the stock of a good company, or the company itself, at a good price, he'll do it regardless of what the broader market is doing. But I think it's important to remember that Buffett's opportunities are limited by the size of Berkshire Hathaway. You won't see Berkshire buy shares in, say, a $250-million-market-cap company, because even if it bought all of the firm's shares it would be just a drop in the bucket for a $275-billion-market-cap company like Berkshire. Part of the reason why Buffett sometimes holds a good amount of cash likely has to do with the fact that he's thus forced to wait for legitimate opportunities to arise. (I'd also note that while Berkshire had close to $50 billion in cash on hand at the end of Q1, it also had almost $90 billion of stock in its portfolio, and hundreds of billions more invested in companies that it has purchased and taken private, like Burlington Northern Santa Fe. In that context, $50 billion doesn't seem so huge.)

Individual investors, meanwhile, have far more opportunities available to them. (Buffett himself has said that he would invest a lot differently if he were managing a $1 million portfolio rather than Berkshire's enormous portfolio.) There are almost always opportunities out there to buy strong, undervalued stocks, no matter what the economic or market environment. That's one advantage that individuals have over Buffett and other gurus who manage large funds.

To me, the most important thing is to determine an asset allocation plan that takes into account all of the things I've discussed above when it comes to cash -- short-term expenses, emergency funds, and whatever other sort of cushion you need to feel comfortable. Then, stick to that allocation mix and your investing strategy. If something changes in your life where you will need more cash (or less cash) in the short term, you can adjust your mix. But don't adjust it because the market is up this month or down this month, or because Europe's having problems, or because you are worried about all of the post-quantitative-easing uncertainty.

As you earn new cash, one way to keep yourself disciplined is dollar-cost averaging. By putting a fixed amount of money into stocks and other assets (as per your pre-set allocation mix) at a regular interval (such as every month), you force yourself to stay disciplined, regardless of what is happening in the short term. You also buy more shares when prices are low and fewer shares when prices are high, decreasing the risk that you'll deploy a big sum of cash at a time when stocks are overvalued.

The bottom line, to me, is that stocks have proven to be the best long-term investment vehicle -- if you stick with them. Because of that, investors who have long time horizons and don't have special circumstances are wise to focus on them, and not get scared into cash when short-term trouble arises. That's hard to do at times like these, when a number of different fears are prominent in investors' minds.

But if you forget what history has shown and get too cash-happy, you may leave yourself exposed to far more risk of not reaching your long-term goals than you realize.

The Sultan of Swat, Syria, and Storytelling

Excerpted from the August 30th, 2013 Validea Hot List

In baseball lore, few events are as celebrated as Babe Ruth's "called shot". The story goes like this: In the fifth inning of Game 3 of the 1932 World Series, Ruth came to the plate, and, while engaged in some serious back-and-forth jawing with Chicago Cubs players, pointed to Wrigley Field's centerfield bleachers as if to say, "That's where I'm hitting the next pitch." Then, incredibly, he did just that, crushing a home run that gave the Yankees the lead -- and Ruth's legend one of its signature moments.

There's just one small problem: The called-shot story may well be completely false -- over the years, plenty of eyewitnesses, including some of Ruth's teammates, have cast doubt on it. But once one reporter portrayed it that way, others followed, and soon the facts didn't really matter. Many, if not most, baseball fans simply accepted it as true.

That's not uncommon. As human beings, we want to believe in stories. In a world full of unpredictability and chaos, we look to stories to give us understanding, to give us a sense of order. (Barry Ritholtz recently had a great column on this on The Big Picture blog that I'd recommend checking out.) That's all well and good when it comes to a baseball legend. But in the investing world, putting stories ahead of facts is very dangerous. Since the 2008 financial crisis, for example, investors have been giving credence to a number of fear-filled stories. One of the most prominent: the tale of the tapped-out American consumer. According to this story, the housing market crash, stock market implosion, and near-collapse of the entire financial system dealt U.S. consumers a knockout blow in 2008, one from which they wouldn't be able to recover for years, perhaps even decades. Huge declines in consumer spending would mean years of struggle for the economy, and for retail firms in particular.

Like most tall tales, the tapped-out-consumer story was grounded in some truth -- Americans did cut back spending significantly amid the crisis, and they were overleveraged. But amid the fear-filled climate of 2008 and 2009, the tale spun a bit out of control, in part because it provided a great story arc -- after years of overspending and living high on the hog, Americans were getting their comeuppance. Forget Gucci handbags and Prada shoes; citizens of the most powerful country in the world would soon be on the verge of scavenging for food and weaving clothing out of leaves and branches. What drama!

Who knows -- had a few things gone differently, perhaps that scenario would have played out. But it didn't. Consider these facts: While they trended downward from December 2007 to April 2009, real personal consumption expenditures have been on the rebound ever since, and are now 4.7% above that December 2007 peak. Retail sales, meanwhile, are 11.8% above their November 2007 peak. And after climbing above 14% in mid-2007, Americans' collective debt service ratio (the ratio of outstanding mortgage and consumer debt to disposable personal income) has fallen to 10.32% in the fourth quarter of 2012 and 10.49% in this year's first quarter. Those two most recent readings are the lowest the ratio has been at any time since 1980.

Still, the tapped-out-consumer story lingers. And that's good. Because when the story and the facts diverge, opportunities are created. Some of the Hot List's biggest winners over the past few years -- such as Jos. A. Bank Clothiers (+78.2% in 2009) -- were unloved retail stocks, and my Guru Strategies are still finding great value in the retail apparel industry. In fact, it's one of the top-ranked industry in the market according to my Validea Industry Index, which ranks industries based on a composite of growth and value factors.

The tapped out consumer story is an example of the pundits and talking heads getting the story wrong. But for investors, there's danger in another type of storytelling as well -- that which involves stories that sound important, but, from investing perspective, just don't really matter that much.

The crisis in Syria looks like a good example of that. In recent days we've seen lots of headlines about the impact that potential US involvement in Syria could have on stocks. To be sure, many investors have probably sold shares just because fear has started to fill the headlines. But while Syria no doubt matters from a number of perspectives -- political, strategic, and, of course, humanitarian -- the likelihood is that for investors, the crisis won't end up mattering all that much.

In fact, in a recent column, MarketWatch's Mark Hulbert said that, historically, the market has suffered only minor losses because of geopolitical crises, and has rebounded quite quickly in many cases. He references a 1989 study performed by economics professors David Cutler of Harvard, James Poterba of MIT, and Larry Summers, who is now in the running to be the next Federal Reserve chief. In it, the professors examined how the stock market fared on 49 days in history when major geopolitical events occurred, such as the Kennedy assassination and Pearl Harbor bombing.

"They came up with little evidence that non-economics events had a big effect on the stock market," Hulbert writes. "On average, across all 49 events on their list, the S&P 500 moved just 1.46%, less than one percentage point more than the 0.56% that prevailed on all other days. Because of this small difference, the professors concluded that there's 'a surprisingly small effect of non-economic news' on the stock market."

What's more, the Syrian crisis isn't even an out-of-nowhere event like Pearl Harbor or the JFK assassination. As Hulbert notes, it has been building for years now; even the idea of American intervention isn't new, though it has come more to the forefront in recent weeks. Investors have known that US intervention has been a possibility for months, even years now. A good deal of the risk had probably been getting baked into the price of stocks since the start of the crisis.

That's not to say that if the US does intervene in Syria, it won't cause short-term problems for stocks. In the short term, emotions rule, and stocks might go through some declines. But if they do, it's just as likely that they will bounce back quickly, with little damage, if any, to your long-term returns -- despite what the headlines may be saying. In fact, disciplined investors who have some extra cash to deploy may even end up profiting from any short-term declines, which could generate some great buying opportunities.

Bottom line: If you need a "story" fix, pick up a good book or turn on a spine-tingling, heart-string-tugging, or edge-of-your seat movie. When it comes to investing your money, however, the only story you should focus on is the one that a company's fundamentals and financials are telling.

The Ever-Present "Stock-Picker's Market"

Excerpted from the September 27th, 2013 Validea Hot List

Since the 2008 financial crisis, one of the main investing themes you've probably heard is that of high correlations. Many have talked about the "risk-on, risk-off" environment that has existed, one in which stocks (and a number of other assets) tend to rise and fall en masse based on macroeconomic news. The presumption is that in such an environment, stock-picking isn't particularly useful. The trick is less about picking the right stocks than it is about picking the right time to be in the market and the right time to be out, the conventional wisdom goes.

At first glance, then, it seemed like very good news when correlations dropped sharply last month. As *The Wall Street Journal* noted, correlation among the 10 large-cap sectors in the S&P 500 fell to 69.9%, the lowest level in two years. The figure had been at nearly 90% a month earlier. Stock-picking, it seemed, was back in focus, and those who focused on fundamentals could well reap the rewards -- for now, at least. I say for now because, with macro factors like the Federal Reserve's tapering plans and Washington's budget impasse looming, it would also seem that a return to a high-correlation environment might not be too far away.

But while the talk of "stock-picker's markets" (or lack thereof) has been prominent over the past several years (I myself have brought up the issue in the past), it's a bit of a fallacy. That's because the truth is that it's *always* a stock-picker's market. "The problem," Investment News' Jason Kephart recently explained, "is that correlation, which measures how stocks move in relation to each other, doesn't actually tell you anything about the opportunities available to portfolio managers. Even though correlations between stocks historically have been high, meaning stocks generally have moved in one direction -- up -- since the market bottomed, that doesn't mean they're moving [up] at the same speed."

According to Kephart (citing Vanguard Group data), in every year since 2008, more than half the stocks in the S&P 500 have finished the year with a return either 10% greater or 10% lower than the index. This year (through Aug. 19), 262 of the S&P's 500 firms had returned 10% more or less than the index. That means that, while correlations have been high, there has been -- and continues to be -- plenty of opportunity for stock-pickers to distinguish themselves from the crowd.

Keep in mind, however, that distinguishing yourself from the crowd means you have to be willing to go through some periods when your returns vary significantly from the market -- on the downside. No one beats the market every month, or quarter, or even every year. That's because while you may be able to find undervalued stocks, you never know exactly how long they'll stay undervalued. Sometimes you can get lucky, and an attractively valued stock you buy will jump the week you buy it; other times, it can take months for investors to come around to recognizing the value in the stock. Still other times, they may never come around.

More often than not, however, they do come around -- you just have to stay disciplined. It can be painstaking sometimes, to watch as your portfolio takes short-term hits. But all of the gurus I follow have experienced that. And they've succeeded over the long haul by staying disciplined and sticking to their strategies during these short-term troubles. Mutual fund legend Peter Lynch, for example, was hit hard by the 1980-82 bear market, with his Magellan Fund losing 22.6% -- more than four times the S&P 500's loss -- in 1981. At times during the rough 1973-74 bear market, both Warren Buffett and John Neff took a pounding. Neff's fund lost 25% in '73 when the S&P was down 14.7%; Buffett lost 43.7% in '74 when the index fell 26.4%.

It wasn't just during bear markets that the gurus had down years. In 1989, in the middle of a lengthy bull market, the S&P gained 31.7%. Neff, however, gained just 15.0%. Martin Zweig's fund lagged by nine percentage points that year, while Lynch's Magellan lagged by nearly 8 points. In 1995, when the S&P surged 37.6%, Zweig's fund lagged by nearly 20 percentage points. Then there was the tech bubble, when value-oriented investors like Buffett had downright awful years even though the broader market surged. In 1999, when the S&P was up 21%, Buffett was down nearly 20%.

While it's been on the winning side more than the losing side, the Hot List has also had some flat-out bad years. In 2007 it lost 11.6% while the S&P rose 3.5%. In 2011, it lost 16.2% while the index was flat. But despite those hiccups, it has performed remarkably well over the long term. If you'd invested $10,000 in the Hot List on its July 15, 2003 inception, you'd have $34,850 today. The same investment in the S&P 500? You'd have less than half of that, $17,010 (both figures are through last week, not including dividends). The gap hasn't changed since the "lock-step" environment supposedly began in 2008. Since the start of that year, the Hot List is up 38.3%, while the S&P is up just 15.9%. Clearly, some stocks have been better than others -- a lot better -- despite the high-correlation environment.

The bottom line is that it's always a stock-picker's market. Yes, the general direction (up or down) of stocks may be highly correlated at times, but the degree to which individual stocks rise or fall will vary significantly. The things you need to do to be a good stock-picker -- use a fundamental-focused approach, stay disciplined, think long-term -- are thus *always* important. Lose sight of them for even just a bit, and the market will very likely make you wish you hadn't.