THE BEST OF THE VALIDEA HOT LIST – 2014

HIGHLIGHTS OF THE TOP INVESTING COMMENTARY THROUGHOUT THE YEAR

Table of Contents

No Bull in These Lessons	Page 2
Re-evaluating Value	Page 6
The Importance Of A Plan	Page 8
Are You Ready for a Fall	Page 10
Unsexy Models?	Page 12
The Quality-Value Synthesis	Page 15
Staying Active	Page 17

No Bull In These Lessons

Excerpted from the March 14th, 2014 Validea Hot List

The bull market that began in 2009 turned five years old last week, and doing so amid all sorts of speculation about how many more birthdays it has left. Some say the bull has plenty of legs, with valuations far from astronomical and the economy seeming to be stable. Others point to factors like the end of quantitative easing and global economic concerns in arguing that the bull may not last through Year Six.

Today, I don't want to talk about where the market is headed, because, frankly, no one -- not me, not you, not Janet Yellen, not even Warren Buffett -- knows the answer to that. What we do know is this: Since stocks bottomed on March 9, 2009, the S&P 500 has risen 176% (through March 12). We also know that the average investor has missed out on a significant portion of those gains. In the three years ending December 31, 2012, for example, the average equity fund investor generated annualized returns of 7.63%, well short of the 10.87% annualized return for the S&P 500, according to Dalbar, Inc. A 2013 Gallup poll, meanwhile, found that from April 2008 to April 2013, the percentage of Americans invested in the stock market declined from 62% to 52%. Part of that, the study suggests, was likely due to the fact that more people were unemployed, and simply unable to buy stocks. But the study also showed that, among employed people, the percentage actually fell from 73% to 61%. Even those with jobs seem to have soured on stocks even as the market has surged.

The aftermath of the worst financial crisis in 80 years, a roaring bull market, individual investors missing out -- what do we make of the past five years? I think there are a number of lessons to take -- lessons that won't help you know which way the market is going next week or next month, but which should help you benefit over the long haul. Here are five.

Lesson 1: Fear Is Your Friend

Warren Buffett has famously said, "Be greedy when others are fearful, and fearful when others are greedy." The past five years have been a tremendous example of that advice paying off. Heading into this bull market, fear was everywhere. From September 2008 through March 2009, investors yanked a net of nearly $240 billion out of stock and mixed equity mutual and exchange traded funds. In the week ending March 5, 2009, only 19% of respondents on the American Association of Individual Investors weekly sentiment survey said that they were bullish on stocks, while 70% said that they were bearish. The 51% spread between those two figures was the second widest bearish spread observed in the survey's history, which goes back to mid-1987. And the Yale School of Management's U.S. Crash Confidence Index, which measures the percentage of people who are confident that there will *not* be a stock market crash in the succeeding six months, reached its all-time low for both individual and institutional investors in early 2009. (For institutional investors, the low point came in February 2009, when only 18% said they were confident a crash would not occur; for individual investors the low point came in April of that year, when less than 15% of respondents said they were confident a crash would not occur.)

Of course, it was right around then that the market's turnaround began. And, as with most bull markets, the early days featured some of the biggest gains. Those who had bailed on stocks missed out on some significant profits. But those who focused on value and didn't let fear get the best of them have made out very well.

Lesson 2: There Is No Comfortable Time To "Get In"

Those who missed the rally's early days didn't come rushing back a month or two into the bull market. In the aftermath of such a jarring decline as the 2007-2009 bear market, many investors were waiting to feel more comfortable -- to feel like it was "safe" again.

But safety -- at least the sort of safety many were hoping for -- never came. In fact, it was one mini-crisis after another: Greece's debt woes, America's debt ceiling standoff, Europe's debt crisis, America's budget sequestration, trouble in China and emerging markets -- the list goes on and on. And now, in 2014, as many of those issues seem to have been dealt with or at least contained to a large degree, the new fear is that the market has risen too much, and valuations are too high, making it a bad move to get in if you've been sitting on the sidelines. So lots of investors continue to wait as more and more gains pass them by.

Here's the thing: If you're going to invest in stocks, there's never going to be a perfect time to get in. We live in a highly complex world, with a myriad of moving pieces, and you're just not going to see them all flashing green lights at one time. Frankly, if you are investing at a time when the mood is one of supreme safety and confidence, you're probably heading for trouble. Such periods occur when exuberance is irrational, as it was right before the tech bubble burst and before the housing bubble burst.

Good investing is not about waiting for just the right time to act. It's about stacking the odds in your favor by investing in good companies that are trading at reasonable valuations, regardless of what sorts of fears may be lingering in the background. If you keep waiting for all the headwinds to disappear, you'll probably miss the boat.

Lesson 3: Don't Be A Headline Investor

In today's society, it's almost impossible not to be bombarded by the news. Twenty years ago, you might have heard about a big news story a couple times a day -- maybe once on the morning drive to work, another time while reading the newspaper, and maybe again on the nightly news. Today, with laptops and smart phones and tablet computers and 24-hour news channels and Facebook and Twitter and all the rest, you can end up reading the same headline dozens of times a day. And the more you see a headline, the more important it can seem. So when debt troubles emerge in Cyprus, and you hear about it over and over and over again, your fears can start to run away with themselves (particularly with various news outlets competing to be the most sensationalist and headline grabbing). Amid all of that, you can find yourself selling off chunks of your portfolio because of potential problems in a country that has the population of the state of Rhode Island.

During this bull market, many investors seemed to be moving in and out of stocks primarily because of The Big Story of the day. A European official says debt talks are progressing, stocks rise. Another official offers a more pessimistic view, and stocks fall. Debt ceiling talks come to an impasse, stocks tumble; talks resume, stocks rebound. Often, big market moves seemed based primarily on pure macro speculation.

The fact that speculation is risky is only part of the problem. Even if you correctly guess that a macro story does mean trouble for stocks, by the time you've heard about it, millions of others have probably heard it before you, and a good deal of the impact has already gotten baked into the market's price. What's more, all too often the big story of the day doesn't move the market in the direction we thought it should. When the Federal Reserve announced its plans to start tapering its quantitative easing program -- a move that many had expected would send a shudder through the market -- stocks actually moved higher. Why? Who knows. Perhaps the speculation that the move would be coming for some time had led investors to already price it into the market. Perhaps other factors were occurring that day that investors thought were more important. Maybe investors finally started to think that QE might be more of a hindrance than a solution.

There probably were a number of factors that went into the market's rise that day. But what matters is that things didn't go the way many had expected, and in the stock market that's far from a rare occurrence. Those who've bought and sold on the headlines have likely left considerable profits on the table during this bull.

Lesson 4: Beware "Paradigm Shifts" and "New Normals"

The great Sir John Templeton once said that the four most dangerous words in investing are "this time is different". The past five years have been a great example of why it's hard to argue with that. When the financial crisis hit in late 2008 and the stock market plunged, pundits and strategists -- some of whom are very smart people -- said that we had entered a New Normal in which both the economy and the stock market were doomed to subpar returns. To a degree, they were right about the economy. Growth hasn't been gangbusters since then, though it's been decent. But stock returns have been tremendous, And those who bought into New Normal/paradigm shift arguments have left a tremendous amount of money on the table.

Yes, in a sense things were different this time -- the specifics of what's happening with the economy, financial markets, and stock market are always shifting and evolving. Just think about what I discussed in the previous lesson -- there's no doubt that social media and 24-hour financial news have changed things in the investing world. But I think what Templeton meant was that the core principles behind investing don't really change. The economy will go through expansions and recessions; investors will waver between fear and greed; and investing in solid companies when shares are cheap should provide you with good returns over the long haul. Those concepts have remained the same throughout history, and I don't see them changing anytime soon, if ever. A testament to that notion is the exceptional performance of my Benjamin Graham inspired portfolio, which has been one of my best performers since its mid-2003 inception even though it's based on a strategy that Graham developed more than six decades ago. To me, that's proof that the real fundamental tenets of good investing don't change that much over time.

Lesson 5: Think Long-term, and Stay Disciplined

Nothing highlights the importance of discipline like a crisis. When fears are erupting, all of the rational, solid investing mantras you think you believe in can go flying out the window really quickly. That's why it's so important, I think, to have a good systematic approach. With the Hot List, as you know, we buy and sell stocks only on regularly scheduled monthly intervals. By setting up those rules, we've developed a routine and system that we can trust in when times get particularly tough. We've thought it through, and believe in the logic and principles behind that approach. Just knowing that a system is in place makes it easier to stay calm amid a crisis.

Staying disciplined over the long term also involves knowing and understanding history. If you know, for example, that people were proclaiming the "death of equities" back in 1974 during a treacherous bear market -- just before a bull market began -- you're more likely not to panic and do something rash when people start proclaiming that stocks are dead a few decades later. If you familiarize yourself with research such as that done by Kenneth Rogoff and Carmen Reinhart, you know that financial crises have occurred many times throughout history, and that, while difficult, they pass and countries recover. Understanding as much as you can about market history, investor psychology, and the underlying principles of good investing can give you so much perspective and help you stay focused when others panic.

That's why I think it's so important to learn from The Gurus. Highly successful investors like Peter Lynch, Ben Graham, Warren Buffett, Kenneth Fisher, and the other gurus I follow have lived through numerous ups and downs in both the economy and the stock market. (In addition, many of them, if not all, are great

students of market history and have extensive knowledge about periods they didn't live through.) They know what to expect, and how to weather the storm. These investing greats have so much knowledge to offer, and, luckily, they've been quite generous in offering it. Their words and advice were of course the basis for the models that drive the Hot List, but they were also a sense of comfort and reassurance during those dark days of 2008 and 2009. Trusting their wisdom was key to the portfolio faring so well since the crisis, and you can bet we'll continue to draw from that wisdom going forward.

Re-evaluating Value

Excerpted from the May 9th, 2015 Validea Hot List

Over the long-term, small-cap value stocks have well outperformed larger growth stocks. For decades, that notion has been a pretty widely known one in the investing world, thanks in large part to the research of highly regarded finance professors Kenneth French and Eugene Fama. Fama and French's research found, for example, that from 1927-2009, small value stocks beat large growth stocks by an average of more than five percentage points annually. In addition, large value stocks beat large growth stocks and small growth stocks by about two percentage points each annually.

That data would seem to indicate that simply buying stocks with low price/book ratios -- the metric Fama and French used to assess value -- should be a good investment strategy. And many analysts have supported the idea of such a strategy by contending that the market must reward investors who buy value stocks (which are often in some kind of distress) for taking on additional risk -- that, at least, is what efficient market hypothesis supporters usually say.

But new data -- from none other than Fama and French themselves -- seems to turn that notion on its head. In a working paper that was released last year, Fama and French analyzed historical stock returns again, this time adding in two new factors: profitability and investment intensity (the level of capital investment a company makes). While the paper didn't get a whole lot of attention, one of its initial findings appears to be quite significant: The profitability and investment factors made redundant the value factor. "In other words, value stocks -- defined as those with low price/book -- only beat growth stocks because they historically tended to be more profitable and less voracious users of capital," wrote Morningstar's Samuel Lee in a recent piece discussing Fama and French's new paper.

The redundancy of the value factor might seem to be contrary to what many of the value-focused gurus I follow preach. In reality, the takeaways from French and Fama's new data fit quite well in a several key ways with the gurus' teachings, and I think they are well worth touching on.

First, it's important to note that the value gauge French and Fama use is the price/book ratio, which is not one of the more used gauges by the gurus. In fact, in a research report earlier this year, James O'Shaughnessy's firm wrote that "Despite its popularity, we do not use price-to-book in [the] OSAM Value [composite] because of several problems with the factor." The price/book ratio "consistently has one of the lowest annualized returns of all value factors," O'Shaughnessy Asset Management said in the paper. "Also, in half of the time periods shown, price-to-book underperforms the market." While that particular paper was looking at the Canadian stock market, OSAM said the issue was not isolated to Canada. "In the U.S., price-to-book has been a very inconsistent value ratio with prolonged periods of underperformance," the group said. "From 1927 to 1963 the cheapest ten percent of stocks by price-to-book underperformed the U.S. market by an annualized 205 bps; and over the next 36 years by more than 200 bps." O'Shaughnessy, for the record, initially found the price/sales ratio to be the best value factor -- that's what I use in my O'Shaughnessy-based growth model, which has been one of my better performers over the long haul. (Today O'Shaughnessy actually uses a "value composite" that includes several value gauges, similar, in effect, to what the Hot List does.)

What I find interesting about OSAM's work in relation to Fama and French's work is that in almost all cases, the gurus upon whom I base my strategies used valuation metrics that focused on earnings, sales, or cash flow -- in other words, the concept of profitability was at work within the value metrics. The price/book ratio, in contrast, is based on the value of the company's assets, not its ability to generate

profits -- and Wall Street is less concerned with what a company already *is* than with what it *could grow into* in the future. It's also worth noting that of the three guru-inspired models I run that do use the price/book ratio, two of them (the David Dreman and Benjamin Graham approaches) use other value metrics (the price/earnings, price/cash flow and price/dividend ratios for Dreman, and the P/E for Graham) as well. The one strategy that uses price/book (actually its inverse, the book/market ratio) as its sole valuation gauge -- the Joseph Piotroski-based approach -- includes among its other variables the return on assets rate and gross profit margin, both of which get at a firm's profitability, as well as cash flow from operations, which is designed to eliminate firms that are burning through cash. Those three variables jive quite well with the profitability and investment factors that French and Fama added to their analysis in their paper.

Then there's Warren Buffett. Of all of the guru-inspired strategies I use, the Buffett-based approach probably has the least stringent valuation measure -- it simply requires that the company's earnings yield be higher than the yield on long-term treasury bonds. It focuses a great deal on earnings persistence, return on equity, return on retained earnings, and return on capital -- profitability. In addition, it looks for companies that have good free cash flows, the idea being that that will weed out firms that require a high amount of capital investment. High profitability, low investment requirements -- that's exactly what French and Fama's study found made the value factor redundant.

So what does all this mean? Does it mean that value no longer matters? Most definitely not, in my opinion. Price is always important when you are buying anything, stocks included. As O'Shaughnessy's research has shown, a number of non-price/book ratio valuation metrics have been great ways to identify winning stocks throughout history (metrics like the Price/sales and price/earnings ratios).

Just as importantly, I think French and Fama's new research highlights the importance of using a well-rounded strategy that looks at a company and its shares from a number of different angles. Profitability, balance sheet, valuation -- you should consider all of those factors when analyzing a stock. As Kenneth Fisher, another of the gurus I follow, wrote, "Never assume you have found the one silver bullet." My Guru Strategies do not look for a silver bullet. Most of the strategies use between seven and 10 different variables; the Motley Fool-based approach uses no fewer than 17. And those are just individual models. With a consensus approach like the Hot List, which gets input from all 12 of my models, you're talking about putting a stock through dozens and dozens of financial and fundamental tests. Those that make the grade are thus some of the most fundamentally sound stocks in the market, showing strength across a number of different levels. Take Hot List newcomer NetEase, which is being added to the portfolio today. The $9-billion-market-cap tech firm has grown earnings at a 24% pace over the long term, and much more rapidly in the most recent quarter. It has no long-term debt and a 5.4 current ratio, indicating a very strong balance sheet, and it has been extremely profitable, averaging a 10-year return on equity north of 28% and a return on retained earnings over that period of more than 20%. All of that, and it trades for about 12 times earnings and has a free cash flow yield of close to 8%.

Of course that's no guarantee that the stock will be a huge winner for the portfolio. But over the long term, stocks with those kind of well-rounded fundamentals and financials tend to perform quite well. By investing in baskets of stocks like those, we stack the odds greatly in our favor over the long haul. The proof is in the pudding -- the Hot List's stellar long-term track record is in large part due to its deep, thorough fundamental analysis of companies and their shares. Moving forward, I'm confident that this approach will continue to pay off with returns well ahead of the market average.

The Importance Of A Plan

Excerpted from the May 8th, 2015 Validea Hot List

The investment research firm Dalbar recently released its annual Quantitative Analysis of Investor Behavior, and, as usual, the data was not encouraging for individual investors. In 2014, according to Dalbar, the S&P 500 returned 13.7%, but the average equity mutual fund investor gained a mere 5.5%. And while the Barclays Aggregate Bond Index was gaining nearly 6%, the average fixed income mutual fund investor was gaining just 1.2%.

While the 2014 results were particularly bad, they are merely part of a broader, long-term pattern of investors underperforming the broader market indices by wide margins. Over the past 30 years, the S&P 500 has returned 11.1% annualized, while the average equity mutual fund investor has gained just 3.8%, according to Dalbar. Returns for fixed income investors have been even worse. Over the past 3 decades, the Barclays index has averaged annualized returns of 7.4%; investors in fixed income funds gained an average of 0.7%.

While fees no doubt take a bite out of investor returns, Dalbar indicates that the main reason for individual investors' terrible collective performance is behavioral. "Investor behavior is not simply buying and selling at the wrong time, it is the psychological traps, triggers and misconceptions that cause investors to act irrationally," the group says. "That irrationality leads to the buying and selling at the wrong time which leads to underperformance."

I've often talked about the behavioral biases that hamper investors, and Dalbar offers its own list of nine specific behaviors that "tend to plague investors based on their personal experiences and unique personalities." They are:

Loss Aversion -- Expecting to find high returns with low risk
Narrow Framing -- Making decisions without considering all the implications
Anchoring -- Relating to familiar experiences, even when not appropriate
Mental Accounting -- Taking undue risk in one area and avoiding rational risk in others
Diversification -- Seeking to reduce risk, but simply using other sources
Herding -- Copying the behavior of others even in the face of unfavorable outcomes
Regret -- Treating errors of commission more seriously than errors of omission
Media Response -- Tendency to react to news without reasonable examination
Optimism -- Belief that good things happen to me and bad things happen to others

One of the particularly interesting pieces of data from this year's QAIB involves Dalbar's "guess right ratio". This measures the frequency that the average investor makes a correct call on the market's direction by looking at whether the market goes up or down the month after an investor has net inflows. While the average mutual fund investor greatly lagged the broader market in 2014, the average investor "guessed right" about the market's direction the following month in 8 of 12 months of the year. But some of the months when investors were wrong were months in which they made their largest bets. According to Dalbar, equity mutual fund inflows in December 2013 were the highest they'd been since December 2007, and the 4th highest they've ever been. The next month, January 2014, the S&P 500 lost 3.5%, its worst performance in more than 2 1/2 years. That's apparently not unique -- over the past 20 years, investors have "guessed right" at least 50% of the time in all but four years, but greatly lagged the market. The timing of *when* you guess right and guess wrong is critical.

Other data from Dalbar shows just how critical it can be. The firm looked at the 10 months over the past 30 years in which investors lagged the S&P by the greatest percentage. The gap for a single month was as high as 7.4 percentage points -- that was in October 2008, around the height of the financial crisis.

Not coincidentally, many of those 10 worst performing months came at major inflection points for the market -- September and October 2008, October 1987 (Black Monday), November 1997 (when markets rebounded after the October mini-crash associated with the "Asian Contagion" financial crisis), August 1998 (the Russian financial crisis), March 2000 (the end of the bull market/start of the tech crash), and November 2000 (during the indecision surrounding the US's Presidential election) are all on the list. All of these were highly emotional times, and it's when emotions are high that we humans make mistakes and let those pesky biases worm their way into our decision-making processes -- just when our potential returns are really on the line.

Dalbar says that "no amount of prior education can adequately prevent the enveloping fear that exists when the [emotion-triggering] event is actually taking place," and to an extent that's true -- you will feel fear when markets are swinging wildly no matter what. But I believe that you can mitigate the impacts of fear and other emotions on your behavior (and your portfolio) through preparation. In a recent piece for Kiplinger magazine, Anne Kates Smith talked about the biases that impact investors and how you can combat them. "Crafting an investment policy statement -- and an exit strategy -- before the going gets rough helps take the emotion out of buying, selling and rebalancing decisions," she said, and I agree with that sentiment. As is the case with just about anything in life, the more you prepare for difficult times, the less likely you are to panic when difficult times do hit.

With the Hot List, we've thought a great deal about how to handle market declines and turbulent times. In fact, our entire portfolio management system is designed to overcome the biases that dog investors. By using a purely quantitative system and buying and selling only at fixed intervals, we've created a system in which emotion has no place. When times get tough and the market starts falling, rules like these help us focus on the long-term and not get swayed by stress or emotion. If you set rules with the intent of keeping your emotions at bay, you feel as though you've failed if you break the rules; that's a good incentive to help keep you on track.

I also think it's very important to familiarize yourself with market history. If you have researched past market cycles, you become familiar with several important notions -- that stocks have always rebounded from terrible economic, political, and social crises; that times when fears are high and the market is tumbling tend to be the best times to invest; that overly exuberant periods are often followed by market declines. Knowing all of that can offer comfort when things get tough. Those who aren't familiar with the market's resilience and behavioral finance, on the other hand, are likely to get overwhelmed when the market gets volatile.

When and how the next market crisis hits is anyone's guess. But at some point, trouble will occur -- it's just the nature of the beast. Instead of trying to predict when it will happen -- which few, if any, people can do -- I'd advise that you think about what you will do when things get rough. Have a plan that will best serve your needs. Write down how you want to react when big declines hit, and what your rationale is. Then return back to that document when the going gets tough. Ready yourself while the skies are relatively clear, because when thunderstorms hit, most people are too busy worrying about the rain and lightning to think clearly.

Are You Ready For A Fall?

Excerpted from the July 3rd, 2014 Validea Hot List

Lingering concerns about the US debt crisis, Europe's own financial crisis, the debt ceiling debacle of a few years ago, Congress's sequestration of the budget, uprisings in the Middle East, major trouble in Iraq -- the bull market that began in March 2009 has climbed a steep wall of many, many worries over the past five-plus years. But while investors have had plenty of reasons to be fearful, the bull has actually had very few major hiccups. Perhaps because so many fled the market in late 2008 and early 2009 and were then very cautious about getting back into stocks, there just weren't enough market-timers left to bail when these issues heated up. Whatever the case, the trouble-filled last five years have included only two corrections (declines of at least 10% in the broader market). Currently, the S&P 500 has gone more than 1,000 days without a correction, according to Birinyi Associates, one of the longest stretches ever.

Make no mistake, however: A correction will come at some point. And, as Jason Zweig wrote in a recent Wall Street Journal piece, it's best to prepare for one now, and not get complacent because of the lengthy stretch we've had between corrections. "In a downturn, you won't be the same investor that you are now -- unless you rely on rules and procedures, rather than willpower alone, to regulate your behavior," writes Zweig. "New research shows that the kind of stress brought on by a collapsing stock market fundamentally changes how people make financial decisions."

Zweig examined the research of Mauricio Delgado, a neuroscientist in the psychology department at Rutgers University, who has found that even a moderate amount of sudden stress can make people more sensitive to losses and indifferent to small gains. "In these experiments, people are put under stress by immersing their dominant hand in ice water (at about 39 degrees Fahrenheit) or wearing an arm wrap cooled to the same temperature," Zweig writes. "Shortly thereafter, most people show an impaired short-term memory and an elevated level of the stress hormone cortisol. People are then asked to choose between simple gambles with varying odds and different amounts of money at stake."

The results: When under stress, the participants tended to make bets that gave them a higher probability of making a smaller amount of money. Successful gambles resulted in a smaller-than-usual reaction in the brain, blunted by stress, says Zweig. "Exposure to stress makes people more loss-averse and diminishes their overall sensitivity to reward," says Prof. Delgado. "And if a reward is of low magnitude, [people under stress] often don't care about it very much." If investors are more loss-averse, they are more likely to want to limit short-term losses during market declines; such moves, however well-intentioned, usually lead to selling low, which hurts long-term performance.

That's decision-making with a cold hand; just think about how decision-making is impacted with the stress of having your nest egg on the line in a falling stock market. One impact, says Delgado, is a reversion to "habit-based" decisions. "Stress tends to exacerbate your typical biases," he says. "If you usually make conservative choices, it will make you more conservative." If you typically make risky choices, stress "will make you more risk-seeking."

Zweig says that investors should have procedures in place on how they will deal with market downturns before the downturns occur. I couldn't agree more. The fact that times of stress can alter your decision-making is one reason that we at Validea use a highly systematic, disciplined approach to investing. We try to remove the possibility for emotional, stress-driven decision-making through a few key processes:

Stick to the Numbers: My guru-inspired portfolios buy stocks based purely on quantitative factors (the

criteria outlined in books or papers by or about the gurus themselves). We never pick stocks based on headlines, or because the broader market (or a particular stock) has been hot. The models pick stocks because they have sound fundamentals and financials -- in good times, bad times, and everything in between.

Scheduled Selling: When it comes to selling, meanwhile, we buy and sell only at regularly scheduled intervals. With the Hot List portfolio, that means every four weeks, without fail. We don't allow ourselves to be tempted to try to guess which way the market or our stocks are headed tomorrow or next week or next month. Doing so, history shows, is a recipe for failure.

Disciplined Rebalancing: One of the things Zweig recommends investors do now, before a correction hits, is rebalance their holdings, decreasing their stake in holdings that have risen a lot and increasing their stake in holdings that have declined. We believe that doing so isn't just a good idea right now; it's a good idea to do on a continual, systematic basis. On our designated buying/selling days, we also return any holdings that have gotten particularly overweight or underweight back to their equal target waiting within the portfolio. Doing so ensures that we are spreading the portfolio's risk pretty evenly across all holdings. It also helps us to buy when a stock's price is lower, and sell when it's higher -- the opposite of what most emotion-driven investors do.

By putting rules like these in place, you add an extra line of security against your pesky emotions. When times get tough and the market starts falling, rules like these will help you focus on the long-term and not get swayed by stress or emotion. If you set rules with the intent of keeping your emotions at bay, you feel as though you've failed if you break the rules. That's a good incentive to help keep you on track.

Of course, setting rules doesn't mean that you won't break them. You have to believe in the rules, to believe that they really are in your best interest. That's why I recommend learning as much as you can about stock market history and strategy. Go through Warren Buffett's old Berkshire Hathaway shareholders letters. Read Peter Lynch's *One Up on Wall Street*, or Joel Greenblatt's *Little Book that Beats the Market* (or if you're crunched for time, read my book, *The Guru Investor*, which summarizes the writings and strategies of Buffett, Lynch, Greenblatt and several other gurus). Check out the research of Dalbar Inc. on why investors underperform. Review charts of historical sentiment readings (such as the American Association of Individual Investors sentiment survey or Robert Shiller's Crash Confidence survey) to see for yourself how times when investors are most fearful usually are the best times to buy stocks.

We've done all those things, and the lessons we've taken from doing so have led us to believe very strongly that a systematic, quantitative approach to investing is the best way to beat the market over the long haul. That data-driven belief helps us stick to our system when times get tough and emotions run high. Whether it's our approach or another that you develop, you'd be very wise to make sure that you or your financial advisors have rules or systems in place that you believe in, to ensure your portfolio is managed in a disciplined manner. If not, you run the risk of letting emotion -- not reason -- drive your returns. History shows that's a recipe for failure.

Unsexy Models?

Excerpted from the August 1st, 2014 Validea Hot List

Enron and WorldCom: They are two of the most infamous names in stock market history. Both of these apparent growth dynamos went up in flames amid major accounting frauds in the early 2000s. And, in both cases, investors who thought they were hitting paydirt were left with nothing.

What's amazing is that if the investing world had paid a little more attention to quantitative models, a lot of that pain could've been avoided. That's one of the many interesting things I've learned from Wesley Gray and Tobias Carlisle's book Quantitative Value. In the book, Gray and Carlisle examine how using quantitative models can help investors beat the market over the long haul. One of the areas they delve into is how to detect accounting manipulation. They found several studies, largely unknown to investors, in which academics developed quantitative models that were able to do a very good job identifying companies that were likely manipulating their financials and/or in danger of going bankrupt. The models they turned up, some of which were several decades old, looked at many different factors, ranging from scaled total accruals to depreciation rates to standard deviations of stock returns.

One of the models was based on a paper by Dr. Messod Beneish of Indiana University's Kelley School of Business, entitled "The Detection of Earnings Manipulation". Using this model, Gray and Carlisle looked back at Enron's financial statements to see what the model would have thought of Enron's likelihood of manipulation. They found that Enron's 2000 score on this model "sent a very strong signal that something fishy was occurring." In 2000, Enron stock was flying high; but not long after -- December of 2001 -- the company filed for bankruptcy and its fraud was exposed. Investors who were aware of and willing to use Beneish's model would have been able to get out of the stock before it came plummeting back down.

Another of the studies that Carlisle and Gray looked at used a quantitative model to classify stocks as being likely or not likely to go bankrupt within the next year. It worked very well, correctly classifying 94% of bankrupt stocks and 97% of non-bankrupt stocks one year prior to filing for bankruptcy -- and it was developed back in 1968, over 30 years before WorldCom went bankrupt. What did the model think of WorldCom? Well, Carlisle and Gray note that two researchers looked at how WorldCom would have scored in the years leading up to its 2002 bankruptcy. The researchers found that "WorldCom's [score] deteriorated precipitously between 1999 and 2001... If investors had not done so in 2000, WorldCom's 2001 [score] was flashing neon warning light to get out of the stock ... At this point WorldCom could be said to be unequivocally in trouble, and probably heading to bankruptcy absent some deus ex machina like a substantial capital raising."

Keep in mind, these models didn't somehow tap into Enron's and WorldCom's true financials; they simply used the "cooked" results that the companies provided to the public. Given that they had been created before WorldCom and Enron went belly up -- and had been proven to be pretty darn accurate -- why didn't they get more press prior to those companies' bankruptcies?

I think the answer involves the same reasons that investors habitually underperform the broader market averages. People are emotional creatures, and we love stories that tug on our emotions. Quantitative models may have cold, hard data, but they don't excite us. Stories about successful companies with brilliant leaders and groundbreaking products and services, on the other hand, send our imaginations running wild. No matter how objective you might try to be, you can't completely turn off those emotions. Once you read that article about "The Next Apple," it's tough to get it out of your head.

Another factor: People like to do things themselves, and they are overconfident in their abilities to do those things. As Philip Tetlock wrote in his book Expert Political Judgment, "Human performance suffers because we are, deep down, deterministic thinkers with an aversion to probabilistic strategies that accept the inevitability of error." We humans want to be right every time. And we think we can be. It's just a matter of learning enough, gaining enough experience, or focusing well enough, we think. Models, on the other hand, come with the near guarantee that they will be wrong a good chunk of the time. For example, history shows that my most successful Guru Strategies tend to be accurate -- that is, make money -- on between 55% and 60% of their picks. If you're going to use these models, you can bet that, over the long term, you'll be wrong 40% to 45% of time.

Humans think we can do a lot better than that, or we think that, unlike models, we can improve our predictive abilities exponentially over time. But the reality is that when it comes to the stock market and all of its unpredictable drivers, we just can't. In fact, in general in terms of predicting political or economic events, 55% to 60% accuracy is far beyond what humans achieve. Tetlock's research detailed a seven-year study he conducted in which supposed experts and non-experts were asked to predict an array of political and economic events. His findings: While the "experts" tended to beat the non-experts, the best human forecasters "were hard-pressed to predict more than 20 percent of the total variability in outcomes" of events. Adjusting for factors like amount of experience, college degree level, or type of expertise made little difference. (One factor that did, however: fame. The more famous, the worse the alleged expert tended to perform!)

Statistical models, meanwhile, aren't perfect at forecasting the future -- but they're a lot better than humans. Tetlock found that sophisticated algorithms could explain 47 percent of outcomes in his study -- more than twice as much as "expert" human forecasters.

James O'Shaughnessy gives some excellent insights into this phenomenon in What Works on Wall Street. In the book, O'Shaughnessy cites additional studies that all found that human prognosticators couldn't match statistical-actuarial forecasting models. In one study, for example, an actuarial model did better in predicting whether certain high school students would be successful in college than did admissions officers at many colleges. In another, a researcher named Jack Sawyer reviewed 45 different studies that compared human and actuarial predictive ability. "In none [of the 45] was the clinical, intuitive method -- the one favored by most people -- found to be superior," O'Shaughnessy writes. "What's more, Sawyer included instances in which the human judges had more information than the model and were given the results of the quantitative models before being asked for a prediction. The actuarial models still beat the human judges!" Several studies have also shown that human forecasters tend to underperform models even when they are given the results of those models' forecasts ahead of time.

How can all of this be? It's because people are emotional creatures, and emotions lead to inconsistency in how we assess problems. Explains O'Shaughnessy: "Models beat human forecasters because they reliably and consistently apply the same criteria time after time. Models never vary. They are always consistent. They are never moody, never fight with their spouse, are never hung over from a night on the town, and never get bored. They don't favor vivid, interesting stories over reams of statistical data. They never take anything personally. They don't have egos. They're not out to prove anything."

The boring consistency of models is why they beat humans -- and why humans avoid models. And their boring consistency highlights a great irony of the stock market: The investors who produce the flashiest returns usually do so in the unsexiest of ways. They don't load up on high-risk, exciting tech stocks, or try new, flavor of the month strategies. They stick to the basics. Whether they use models or not, they analyze a company's balance sheet, competitive position, and valuations. And when the numbers tell them to buy, they buy -- regardless of what their own fickle emotions might be saying. As hedge fund guru

George Soros once said, "If investing is entertaining, if you're having fun, you're probably not making any money. Good investing is boring."

Fundamentals and balance sheets and quantitative models may be boring to many investors. But over the long haul, they work -- far better than our own gut instincts. So whatever particular strategy or strategies you use in management managing your portfolio, think "boring". In the market, after all, boring is beautiful.

The Quality-Value Synthesis

Excerpted from the September 26th, 2014 Validea Hot List

Given that we live in an age of endless analytical data, intricately interconnected global markets, and esoteric financial instruments, it's amazing to think how simple the concepts behind good investing are. Consider what Joel Greenblatt, one of the gurus upon whom I base my models, said recently in summing up the philosophies of two of the other gurus who inspired my strategies.

"Ben Graham said, 'Buy it cheap,'" Greenblatt told CNBC, "and his best student, Warren Buffett, added one little twist that made him one of the richest people in the world. He said, 'If I can buy a good company cheap, even better.'"

While they are obviously simplifications, those characterizations get at the heart of Graham's and Buffett's approaches. And that simple "little twist" to which Greenblatt refers -- adding a quality component to a value investing approach -- is at the core of Greenblatt's own "Magic Formula", and at the cores of the strategies used by most of the investing gurus I follow. John Neff, Peter Lynch, David Dreman, the Motley Fool's Gardner brothers, Ken Fisher -- all of them in one way or another used that basic concept of buying good companies at cheap prices to win big over the long haul.

But while the concept is simple, a rather fascinating dynamic is at play within what I'll call the "Quality-Value Synthesis". It involves what happens when you separate the value and quality components.

By itself, value works. Over the past several decades, numerous studies have shown that cheap stocks (determined using such metrics as the price/earnings, price/book, price/sales, and other valuation ratios) outperform the broader market over the long term, confirming Graham's "buy it cheap" philosophy. You might expect the same to be true of quality stocks. It makes intuitive sense that you'd be better off investing in firms with high returns on equity and assets, and strong, consistent margins, rather than those with low ROEs and ROAs and weak margins, right?

Nope. Vitali Kalesnik and Engin Kose of Research Affiliates recently examined the performance of stocks picked using dozens of different "quality" factors (such as return on equity, return on assets, and margin stability) over the past 50 years or so. Their findings?

"Of the 40 measures we examined, 25 have positive performance, including 6 whose results are statistically different from zero," they wrote in a piece for ETF.com. "Of the 9 reported in the literature, 8 had positive returns, and 5 of these were statistically significant. Of the 31 unpublished factors, 18 had positive performance, and only 1 was statistically significant. These results are indistinguishable from random occurrences." In other words, buying high-quality stocks in and of itself hasn't given an investor any advantage over buying low-quality stocks over the past 50 years.

But here's where things really get interesting: Kalesnik and Kose also looked at what happened when they added value factors to the mix. When they did that (focusing on cheap high-quality stocks), "the high-quality portfolio has fewer distressed, slow growing, unprofitable companies with potentially questionable accounting practices," they wrote. "As a result, the high-quality value portfolio has a better risk-adjusted return. Quality is not, in itself, a factor that generates a premium; but value investing conditioned on a properly specified concept of quality is a powerful investment strategy."

Put simply, the Research Affiliates study found that investing in quality stocks matters -- if you are looking

at a universe of cheap stocks. It's not the only study to come to that sort of conclusion. In their book Quantitative Value, Wesley Gray and Tobias Carlisle looked at how stocks picked using a variety of quality measures (the equity/total assets, free cash flow/total assets, gross profits/assets ratios, and Greenblatt's own return on capital metric) fared from 1974 to 2011. Their findings: "Other than gross profits on total assets ... no quality measure performs well relative to the Standard & Poor's 500 Total Return Index".

Gray and Carlisle did find that using multiple quality metrics within the most expensive decile of stocks made a bit of a difference, though high quality expensive stocks still well underperformed the S&P 500. In the end, their final model takes the cheapest decile of stocks and applies a suite of quality measures to it to significantly enhance returns. Again, value and quality, working together.

In addition to the obvious (you should use quality and value metrics together in an investing strategy), I think there are two other broader lessons to take away from all of this. One is that you should always use a thorough, well-rounded approach to picking stocks. As Ken Fisher has said, there is no silver bullet in the market. While you may be able to find some single valuation metrics that in and of themselves lead to outperformance over the long haul, combining multiple metrics (both in terms of combining quality and value, and in combining multiple metrics to gauge quality and value) can further enhance returns. Because 12 different strategies go into Hot List (most of which on their own use both quality and value metrics), the portfolio chooses stocks using numerous quality metrics and numerous value metrics. That thorough examination of both quality and value is one big reason I think the Hot List has performed so well over the long haul.

The other lesson is that while good investing strategies make intuitive sense, the reverse is not always true. That is, every strategy that makes intuitive sense is not a good one. Most people, I think, would assume that buying stocks with higher returns on equity or assets or some other quality measure would result in higher returns. But as Carlisle and Gray and Research Affiliates showed, that's often not true. When it comes to how specific variables perform and how they work in combination, you have to rely on facts and data, not hunches and intuition.

With the Hot List, we've tried to create a system focused on facts and data, not hunches and gut feelings. All the strategies were developed based on approaches that the gurus used over lengthy periods of time to beat the market. And now we have more than eleven years of our own data, covering several different types of market environments. And we continue to use our increasing amount of data to hone our approach. Once a year, we look at the long-term historical performance numbers and use that to adjust how much weight each individual Guru Strategy has in terms of selecting the portfolio's stocks. There's no guesswork, no hunch-playing as to which strategy might be "due" for a big year. It's a strictly analytical, quantitative process designed to eliminate emotion from our investing process.

While there are a myriad of strategies that will beat the market over the long haul, I think you'll find that most stick to the numbers and use a diverse group of quality and valuation metrics. Whatever the specifics of your own investment strategy, doing those two things should help put you on the path toward success.

Staying Active

Excerpted from the November 21st, 2014 Validea Hot List

While 2014 has thus far turned out to be another good -- albeit very choppy -- year for stocks, it's been another rough one for mutual fund managers. As of late October, more than 75% of large-cap funds were lagging their benchmarks, according to Bloomberg (citing Morningstar data). Nearly 90% of mid-cap funds lagged their benchmarks, meanwhile, and about half of small-cap funds lagged theirs.

That's nothing new, of course. Numerous studies show that the vast majority of mutual funds fail to beat their benchmarks over the long term. Part of that is because of fees and trading costs. Part of it is due to plain old bad management -- buying high and selling low.

Of course, individuals don't do any better. I've often cited in these pages the data from Dalbar, Inc., which shows how individual investors continually underperform the broader market because they fall prey to the same behavioral biases that trip up the pros.

Given how much data shows that pros and amateurs alike fail to outperform the major benchmark indices, should anyone practice active management anymore? Or is passive index investing the only real way to go?

Well, I certainly believe that active management can be a very successful approach -- if it's truly active. The numbers bear that out.

Consider a study that Patrick O'Shaughnessy (the son of James O'Shaughnessy, one of the gurus upon whose writings I base my strategies) recently highlighted in a piece for the American Association of Individual Investors. "A study by Yale professor Martijn Cremers and BlackRock portfolio manager Antti Petajisto showed that being different is the way to win," he wrote. "They concluded that the best way to predict how a fund manager would perform is to look at how unique their portfolio is versus the index; the more unique, the higher the average excess returns. The authors coined the term 'active share' to measure a portfolio's uniqueness. Active share is a score between 0 and 100: A score of 100 means that the portfolio is entirely different than the index (no overlap in holdings), whereas a score of 0 indicates an index fund, meaning the fund has perfect holdings overlap with the market. The authors found that even though the average manager loses to the index, those with the highest active share (top 20%) have historically outperformed by 2.4% before fees and 1.13% after fees. The message is clear: If you want to beat an index, you have to be very different than the index."

It makes sense. On a gross return basis, a "closet indexer" -- a fund or portfolio that largely mirrors its benchmark's holdings -- should perform like the benchmark index, because their holdings are so similar. Factor in fees and trading costs, and their net returns are likely to lag those of the benchmark. To offset the fees and costs, a fund has to beat a benchmark on a gross basis, and to beat it, the fund has to be different from it. (If you're managing your own portfolio, you don't have to deal with management fees, but trading costs can certainly still be a drag on performance. So if you are "closet indexing", with your portfolio, the same logic holds.)

The outperformance of funds with high active share also makes sense on an intuitive level because stocks that aren't in the major benchmark indices tend to be flying under the radar and getting a lot less attention from Wall Street than those that aren't in the major benchmarks. That means such stocks provide opportunities for significant mispricings, and fundamental-focused investors can exploit those

inefficiencies.

So, what is the Hot List's active share rate? Currently, it's quite high. Only one of its holdings -- Valero Energy -- is a member of the S&P 500, the benchmark we use.

To see if this is typical or anomalous, I looked at what the portfolio's active share percentage has been at a few different points over the past couple years. I found that, while our active share at times has been lower than its current level, it has generally been quite high: Six months ago, in May 2014, four of the Hot List's ten holdings were in the S&P 500; six months prior to that, in November 2013, only one of the ten was in the S&P; and six months before that, in May 2013, only three of its ten holdings were S&P members.

Given that my models often key on smaller and mid-cap stocks (as I discussed in one of last month's newsletters), I thought it would be interesting to also see how the Hot List's active share score looks when using the Russell 2000 index (which is composed of 2,000 smaller US stocks) as a benchmark. While the portfolio's active share doesn't appear quite as high on that basis, it is still pretty high: On average, only four of the Hot List's ten holdings were Russell 2000 members in those same four months that I examined above.

Size Matters

When it comes to constructing a portfolio that's different from a benchmark, size can certainly play a big role. The more holdings you have, the more likely it is that your returns are going to start to resemble broader market indices. Mutual funds that hold several hundred stocks must start to look quite a bit like their benchmarks.

Because it only holds 10 stocks, that's not an issue for the Hot List. But in a concentrated portfolio with high active share, the difficulty is that your returns fairly often will veer quite sharply from the broader market or your benchmark -- and not always in a positive way. That's been the case with the Hot List this year. In such times, you can't take solace in the idea that, "Well, it's been a tough stretch for everyone," the way that you could if you were closet indexing and your benchmark was down a lot, too.

We don't have a problem with that. After years of studying history's best investors and all sorts of academic research, we are confident that a concentrated portfolio of 10 stocks can do very well over the long haul, with the price being that there will be a lot of short-term ups and downs. Given the rewards, we are content to pay that price. (Incidentally, recent research from Patrick O'Shaughnessy supported this belief. He took a look at how different sized portfolios of the cheapest value stocks would have fared over the past 50 years or so. O'Shaughnessy found that the best returns came from a five-stock portfolio; the best risk-adjusted returns came from a 15-stock portfolio.)

It's important to remember, however, that most investors probably don't have the stomach to deal with concentrated funds with high active share. Joel Greenblatt, another of the gurus upon whom I base a strategy, told WealthTrack last week that he abandoned a highly concentrated approach that had been extremely successful for him for one that involves investing in a few hundred stocks on the long side and a few hundred stocks on the short side. The reason: Most clients just can't handle big swings in performance that come with a concentrated portfolio, he said. They will bail on a good strategy if it is struggling in the short term, which defeats the purpose of following it to begin with. A broader portfolio decreases short-term volatility.

In the end, I think investors should focus on the best opportunities in the market based on fundamentals

and financials. But it's not always as simple as loading up your portfolio with a small number of the most fundamentally and financially sound stocks. There's a real-world, practical aspect of investing that you have to deal with, too. Going after only the best of the best -- a very limited number of the absolute most fundamentally and financially sound stocks -- often means having high active share and returns that differ significantly from the market or a benchmark. You thus have to know yourself, to understand how much of the bad times you can handle and how you'll respond when things get tough. If you don't have good answers to those questions, the specific stock-picking strategy used may well become moot. As Greenblatt so wisely said, "The best strategy for most people is the one they can stick with."