# THE BEST OF THE VALIDEA HOT LIST – 2015

## HIGHLIGHTS OF THE TOP INVESTING COMMENTARY THROUGHOUT THE YEAR

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# Lessons From The Oracle

***Excerpted from the March 13th, 2015 Validea Hot List***

As you may know, Warren Buffett recently released his annual letter to Berkshire Hathaway shareholders. Buffett's letters are always filled with valuable pearls of wisdom, and this year's -- which marked the 50th anniversary of Buffett's acquisition of Berkshire -- was particularly flush with insightful advice. Given the impact that Buffett has had on my investment philosophy, I thought I'd take a look at how some of the key points in his letter relate to our approach.

**Graham vs. Munger**

In his early years, Buffett espoused the "cigar butt" approach of his mentor, the great Benjamin Graham. He bought very cheap shares that he compared to discarded cigar butts. "Though the stub might be ugly and soggy, the puff would be free," Buffett explained. "Once that momentary pleasure was enjoyed, however, no more could be expected."

Buffett would later change his approach to one practiced by his Berkshire partner Charlie Munger. Rather than cigar butts, he started looking for extremely high-quality businesses with durable competitive advantages, even if they were nowhere near as cheap as those cigar butts. But Buffett didn't change strategies because the cigar-butt approach wasn't working. "My cigar-butt strategy worked very well while I was managing small sums," he wrote. "Indeed, the many dozens of free puffs I obtained in the 1950s made that decade by far the best of my life for both relative and absolute investment performance." A big reason for the shift was, instead, that Berkshire was getting too big. "Cigar-butt investing was scalable only to a point," he said. "With large sums, it would never work well."

When a portfolio grows as large as Berkshire's did, opportunities become limited. With billions and billions of dollars to invest, you simply can't move the portfolio's needle by investing in smaller stocks anymore -- and small, less followed stocks are often where the most mispricings occur. Most individual investors are not, however, running multibillion dollar portfolios. That allows them to still make use of Graham's approach. Our 10-stock, monthly rebalanced Graham model portfolio is a great example of that. Since its mid-2003 inception, it has returned 11.7% annualized compared to just 6.3% for the S&P 500. Just as Buffett wrote that the Graham approach helped him generate better returns than the Munger approach, our Graham approach has beaten our Buffett model, which is based on Buffett's more recent Munger-inspired method. The 10-stock Buffett-based portfolio is up 8.6% annualized since its early 2004 inception, vs. 6.0% for the S&P.

**The Ballad of Jimmy Ling**

Buffett talked in his letter about conglomerate LTV, which enjoyed remarkable success in the late-1960s under the leadership of Jimmy Ling. "Through a lot of corporate razzle-dazzle, Ling had taken LTV from sales of only $36 million in 1965 to number 14 on the Fortune 500 list just two years later," Buffett wrote. "Ling's strategy, which he labeled 'project redeployment,' was to buy a large company and then partially spin off its various divisions. In LTV's 1966 annual report, he explained the magic that would follow: 'Most importantly, acquisitions must meet the test of the 2 plus 2 equals 5 (or 6) formula.' The press, the public and Wall Street loved this sort of talk."

But the success was the result of smoke and mirrors, not good business sense, and before long LTV was a mess and Ling was fired, Buffett says. The lesson here is simple: "Periodically, financial markets will

become divorced from reality -- you can count on that. More Jimmy Lings will appear," Buffett writes. "They will look and sound authoritative. The press will hang on their every word. Bankers will fight for their business. What they are saying will recently have 'worked.' Their early followers will be feeling very clever. Our suggestion: Whatever their line, never forget that 2+2 will always equal 4. And when someone tells you how old-fashioned that math is -- zip up your wallet, take a vacation and come back in a few years to buy stocks at cheap prices."

Whether the "housing prices can't go down" mantra of the mid-2000s, or the "new economy" rhetoric of the tech bubble, or the Dutch tulip mania of the 17th century, history is filled with examples of instances in which investors ignored value and rationality in favor of supposed new paradigms. And without fail those paradigms are proven illusory. What works over the long haul is investing in businesses with good fundamentals and reasonably priced shares. End of story.

**The Forest for the Trees**

Buffett also talked about both Berkshire's and America's long-term prospects, and he sounds quite optimistic on both. "Despite our conservatism, I think we will be able every year to build the underlying per-share earning power of Berkshire," he says. "That does not mean operating earnings will increase each year -- far from it. The U.S. economy will ebb and flow -- though mostly flow -- and, when it weakens, so will our current earnings. But we will continue to achieve organic gains, make bolt-on acquisitions and enter new fields. I believe, therefore, that Berkshire will annually add to its underlying earning power."

"In some years the gains will be substantial, and at other times they will be minor," he added. "Markets, competition, and chance will determine when opportunities come our way. Through it all, Berkshire will keep moving forward, powered by the array of solid businesses we now possess and the new companies we will purchase. In most years, moreover, our country's economy will provide a strong tailwind for business. We are blessed to have the United States as our home field."

These bullish long-term sentiments are nothing new for Buffett, but they're well worth mentioning. The financial headlines are filled with reason after reason to worry. Turn on any financial news channel or go to any financial website, and you're likely to find some headline that makes you think twice about owning stocks. Recently we've heard about weak retail sales, rising oil stockpiles that could trigger a collapse in oil prices, and the "danger" of interest rate hikes. Before that it was valuations, before that it was Europe's woes, before that it was ... well, you get the idea.

If you want a reason to ditch stocks, you'll always be able to find one. But history has shown that doing so will likely lead to more trouble than profit. Stocks have been the best investment vehicle over the long term, and America is still the best place in the world to do business. Buffett knows this. He lets others fret about each and every economic report, each and every speculation about interest rate policy, and other shorter-term issues. In fact, he probably welcomes their fretting -- it allows him to swoop in and pick up shares of great companies at good prices when others turn pessimistic.

The reality is that, whatever happens in the short term, there will always be good businesses (if ever there aren't, we'll likely have bigger problems than your portfolio), and some of those businesses' shares will always be trading at attractive valuations (sometimes there will be more than others). Ebbs and flows in the economic strength of the US and movements of the stock market are inevitable -- and unpredictable. But if you focus on the long-term and shut out as much of the day-to-day noise as you can, you should be rewarded over the long haul.

**The Bottom Line**

While financial commentators of all sorts -- including myself -- have been dissecting and digesting Buffett's letter, it's important to remember that the "Oracle of Omaha" isn't perfect. In fact, Buffett spent much of this year's letter talking about mistakes he's made over the course of his stellar career -- including the purchase of Berkshire itself (he says he would've been better off buying an insurance company to start his conglomerate rather than a textile mill). And, to be clear, while I always listen carefully to what Buffett has to say, our investing styles do differ significantly in many ways, in part because of circumstance and in part because of preference. But when it comes to the broad principles, Buffett's advice is both priceless and timeless, and I try to incorporate it in our investment approach. The ability to think long-term, the discipline to keep emotion at bay, the belief that sticking to solid, proven investment principles wins out over fads and flavor-of-the-month strategies -- these are all principles that Buffett has built his empire and reputation on. I think any investor would be wise to embrace them, whatever the specifics of their own strategy.

# The Case For Guru Strategies

*Excerpted from the April 10th, 2015 Validea Hot List*

After a rough 2014, our guru-inspired strategies bounced back nicely in the first quarter. All our 10-stock, monthly rebalanced portfolios are ahead of the S&P 500 year-to-date, as of this writing. The Hot List has fared particularly well, already making up all of its 2014 losses.

While I had no idea about the timing of our portfolios' bounce-backs, the fact that our strategies have rebounded is not a surprise. We've been using these strategies long enough to know that they are strategies that work over time -- if you stick with them. The principles behind the strategies our gurus developed -- buy shares of solid companies at good prices -- are timeless, we believe. So while these approaches won't work all the time (no strategy will), we're confident that they will work more often then they won't work, which over the long term makes for very strong returns.

Not everyone has that kind of faith in long-term, guru-inspired strategies. Recently I read an article contending that the strategies of Benjamin Graham -- "the father of value investing" -- can't work in today's environment because times are so different from when Graham managed money. The reasoning sounds logical -- after all, there was no high-frequency trading back in Graham's day, markets were far, far less global, and the 401(k) and retirement account investing that drives a lot of today's equity purchases wasn't a factor. Then there is the notion that once a successful strategy is revealed and becomes widely known, its effectiveness wanes. And, finally, certain variables can go in and out of fashion as investors develop new techniques for evaluating businesses and stocks. All of that makes it seem that yesterday's winning strategies are doomed to fail today.

Nonetheless, our experience and testing shows that successful strategies tend to continue to work long after they are revealed. In fact, Graham's Defensive Investor approach is the basis of one of our top-performing strategies, despite the fact that Graham published it 65 years ago. How can this be?

I think there are a few key reasons. The first is that our Graham strategy (like our other strategies) uses a variety of fundamental criteria that look at a stock from multiple angles. The Graham model looks at valuation from three perspectives: the price/earnings ratio using trailing 12-month earnings per share; the P/E using three-year average EPS; and the price/book ratio. That helps ensure that a) a one-year anomaly in earnings doesn't make a stock look deceptively cheap, and that b) the strategy doesn't fail if the P/E or the P/B goes out of vogue for a while. (By combining a variety of strategies, we add further "variable diversification" to our consensus portfolios.)

Secondly, good strategies don't work because of some numerical hocus-pocus. The variables they use are not magic bullets. We're not buying Graham-style stocks with stable earnings, more net current assets than long-term debt, and low P/E and P/B ratios because we think that, in a year or two, people will greatly value stocks with those qualities. (In fact, when we sell the shares, we hope the P/E and P/B ratios will be much higher.) We're buying them because those numbers tell us a story about a company and its shares. Each variable gives another piece of the puzzle, whether it be the information on a company's balance sheet, the effectiveness of its management, or the attractiveness of its share price.

Sure, certain variables may go in and out of favor at certain times. But good strategies work because the variables they use get at the heart of good business and good investing. Might a metric have come along that is better than the Graham strategy's net current assets to long-term debt comparison? Yes, perhaps. But the goal of that variable is to give a good assessment of the company's balance sheet. While one could

argue that there is now a better variable to do that, I find it extremely hard to argue that looking for firms with more net current assets than long-term debt will ever be a bad way to assess a company's financial health. Think about what that metric measures -- essentially, it tells you whether a company could liquidate its assets and use the profits and any other cash it has to pay off all of its debts, without going into the red. In what kind of financial world would that not be an attractive characteristic?

As for the issue of strategies becoming less effective once they are known, that can be true. Good strategies succeed because they exploit some inefficiency in the market -- a blind spot that the investing world has -- allowing you to buy good stocks that were mispriced. Kenneth Fisher's development of the price/sales ratio is a great example of that. Up until he published Super Stocks in the mid-1980s, most investors were focused on price/earnings and price/book ratios when valuing a stock. But in his book, Fisher showed how sales were often a better indicator of a firm's business than either book value or earnings. Earnings, for example, can fluctuate greatly from year to year based on decisions to replace equipment or facilities in one year rather than in another, initiatives to put money into new research that will help the company reap profits later on, or changes in accounting methods. That can all turn one quarter's profits into the next quarter's losses, without regard for what Fisher thought was truly important in the long term -- how well or poorly the company's underlying business was performing. While a stock might look unattractive based on its earnings or P/E, its price/sales ratio might more accurately signal that it was a bargain.

Theoretically, once that concept became well-known, it should have stopped working. The more investors who moved to exploit the inefficiency, the higher the prices of low-price/sales stocks would become, and the less lucrative their returns. But that assumes that humans are rational, and decades and decades of market history show that they are not. Most people, whether individual investors or professional fund managers, don't buy stocks based on cold, hard fundamentals and financials. Instead they follow the crowd, or trying to capitalize on macroeconomic factors, or base their decisions on their biased evaluations of a company's products and services. And if they try to follow a fundamental-based strategy, they often end up ditching it as soon as it hits short-term problems (which any strategy will do), as they can't take the emotional toll of staying the course when things aren't going well. Or, they alter the strategy by vetoing some of its picks that they find too anxiety provoking.

In fact, Joel Greenblatt, another of the gurus we follow, found that over a two-year period investors who were able to pick and choose between stocks his quantitative strategy approved of (and pick the timing of their trades) fared far worse than those who had their buying and selling done on automated fixed intervals, with no ability to veto picks the formula recommended. While the latter beat the market by 21.4 percentage points, the former actually lagged the market by about 3 points. One big reason: They tended to miss out on many of the best performing stocks -- beaten-down value plays that were the subject of scary headlines.

Successful, publicly disclosed strategies can continue to work over the long term if they incorporate a diverse set of variables that measure real and timeless concepts like profitability, debt levels, and valuation -- if, that is, you stick to them through the inevitable short-term ups and downs, as their creators no doubt intended. I believe this not because it sounds good or makes sense theoretically. I believe it instead because I have seen our guru-inspired strategies have great success over the past dozen years. Such strategies won't work on every pick and they won't work all the time. But neither will new, successful strategies -- I guarantee you that the most successful new stock-picking method of 2015 will stumble at some point. The key is to pick a strategy whose variables analyze important, fundamental business concepts -- profitability, debt levels, revenue growth -- and which buys at attractive prices stocks that rate highly in those areas. If you employ those types of strategies in an unemotional, systematic manner, you should continue to enjoy success long after the strategies are well-known.

# 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.

# How Many Stocks Is Enough?

*Excerpted from the September 25th, 2015 Validea Hot List*

Amid the volatility that the market experienced in the second half of the summer, the Hot List has, unfortunately, had its fair share of fairly sizable losers. I've noted before that these short-term periods of trouble are to be expected when running a concentrated portfolio like the 10-stock Hot List. But perhaps you're asking, if that's the case, why run a concentrated portfolio at all?

It's a good question. After all, a bad apple in a 10-stock portfolio is going to have a much more dramatic impact than a bad apple in, say, a 500-stock index fund. And the truth is that in the stock market, there are lots of bad apples. From 1980 through 2014, about 40% of all Russell 3000 companies suffered a decline from their peaks of at least 70% and failed to rebound significantly, according to a report from J.P. Morgan. The report also found that, over the same period (or over its lifetime, if the stock did not exist for the full period), the median stock in the Russell 3000 underperformed the index by 54%, and that 40% of Russell 3000 stocks had negative returns.

Those are daunting numbers, and the thrust of the J.P. Morgan report was that, given how many companies fail in capitalism's competitive "creative destruction" environment, investors should make sure they are properly diversified. But Morgan did not seem to be saying that investors should be holding hundreds of stocks -- indeed, one standard the report used to determine whether a concentrated holder of a particular stock would have benefited from diversification was whether risk/reward metrics indicated that, in an optimal portfolio, that stock should have a weighting of no more than 20%. That's twice the target weighting for Hot List holdings.

So what does the research show about portfolio size and risk management? Well, much of the prevailing research indicates that you can get enough diversification without having to get anywhere near the couple hundred stocks that most mutual funds own. Nobel Prize-winning researcher William Sharpe wrote in a 1972 article, for example, that once you have 25 to 30 stocks in a portfolio, the addition of more stocks offers only a very minor decrease in risk. Edwin Elton and Martin Gruber published a paper five years later showing that most of the advantages of diversification are reached once you hold 15 or so stocks, though going beyond that amount did appear to offer "significant" additional benefit. In their later book Modern Portfolio Theory and Investment Analysis, Elton and Gruber found that if you own 1,000 stocks, your portfolio will be 61% less volatile than if you own just one stock, James Glassman recently noted in a piece for Kiplinger. But, they found that if you own just 20 stocks, your risk decreases almost as much -- 59%.

A 2003 study that I highlighted in my book, *The Guru Investor*, meanwhile, was performed by California State University-Chico Professor H. Christine Hsu and H. Jeffrey Wei. They found that "the benefit of risk diversification is somewhat limited when the number of stocks in the portfolio goes beyond 50."

So, if these studies show that portfolios of 15 to 50 stocks provided optimal diversification, why do we have only 10 stocks in the Hot List? Well, keep in mind that most of those studies are operating under the premise of randomly selected portfolios -- essentially, they are saying that if you were to randomly pick stocks, you should pick 15 to 50 to get proper diversification. It's not accidental that these studies focus on random picks - efficient market hypothesis thinking is prevalent in the academic world, and the EMH stipulates that the market is too efficient for any stockpicker to consistently do better than a randomly selected portfolio. I respectfully disagree, as I think that successful investors like Warren Buffett, Peter Lynch, Joel Greenblatt, and Benjamin Graham have proven that you can use careful stock analysis to beat the market.

This issue has a big impact on optimal portfolio size, and helps explain why the Hot List has 10 stocks. The idea of diversification is that you need to have enough holdings so that a bad apple (or a few bad apples) won't ruin your whole basket. And there are more bad apples out there than you might think -- think about the J.P. Morgan study I mentioned above, which showed that over a three-decade-plus span, 40% of all stocks in the Russell 3000 sustained a decline of at least 70% from which they did not recover.

But let's talk about what sort of stocks sustain those kind declines. Generally, stocks that suffer that type of terrible loss are likely to be companies that go through significant financial distress, or stocks that are so greatly overvalued that much of their market valuation is just fluff. If you are randomly selecting stocks for your portfolio, you are bound to get a few of these - in fact, based on J.P. Morgan's research, you're likely to get more than a few. You better have a good amount of stocks in your portfolio to diversify away the risk that risk.

But these types of stocks -- those in financial distress and those that are wildly overvalued -- are just the types of stocks that the Hot List is designed to avoid. Its rigorous financial and valuation tests analyze companies and their stocks from numerous different angles to make sure that the company is both financially healthy and trading a reasonable valuation. It's always possible that a small number of high-risk stocks might slip through the cracks if their financials are misleading. But from the outset, the Hot List take steps to remove from consideration many of the most risky stocks in the market -- stocks you very well might end up with in a randomly chosen portfolio, which would require you to have a greater number of holdings to offset those risky positions.

In addition, the Hot List uses a dynamic stop-loss that starts at 40% and moves up or down depending on what the broader market is doing while a particular stock is in the portfolio. So even if the portfolio does buy a problem stock, the downside is going to be minimized much more than it would be in a randomly selected portfolio with no stop-loss system. You're not going to see a Hot List position fall 80% or 90%. By limiting the potential loss for any one holding, we can hold a smaller number of stocks. That's important because it means we can put more of our portfolio into our best ideas.

The numbers bear all of this out. As you probably know, while the 10-stock Hot List portfolio is our flagship portfolio, we also track a 20-stock version. And we track both 10- and 20-stock portfolios for each of my individual Guru Strategies, as well as for the Top 5 Gurus strategy (which selects the same number of stocks from each of five top-performing strategies).

The data shows that 10-stock portfolio performance versus 20-stock portfolio performance can vary widely from strategy to strategy. (All of the performance data here and below is through September 22, 2015.) On average, however, the results for the 10-and 20-stock portfolios have been remarkably similar over the long term. The fourteen 10-stock portfolios have averaged annualized returns of 8.16% since their inceptions; the fourteen 20-stock portfolios have averaged 8.08%. When you look strategy by strategy, in six cases the 10-stock version has performed better, while in eight cases, the 20-stock version has performed better.

What's also very interesting is the betas for the different size portfolios. (Beta is a measure of volatility, and shows how closely a portfolio tracks the broader market.) For six of the strategies, the 10-stock version has a lower beta. For seven of them, the 20-stock version has the lower beta. (In one case, the betas are the same.) Overall, the fourteen 10-stock portfolios have an average beta of 1.12. The average beta on the fourteen 20-stock portfolios? It's 1.12.

In other words, on average, the larger portfolios have performed no better than the 10-stock portfolios,

and have offered no less volatility.

I also looked at the worst year for each portfolio, wondering if the 10-stock portfolios may have been more susceptible to a big down year. I found that for 8 of the 14 strategies the 20-stock version's worst annual loss was better than the 10-stock version's worst annual loss. But the averages were extremely close. The worst year on average for a 10-stock portfolio involved a 38.64% loss; the worst year on average for a 20-stock portfolio involved a 38.57% loss. Again, bumping the portfolio size up to 20 hasn't offered much more protection. (What it would do, however -- and this is important -- is add to trading costs.)

As for the Hot List itself, its 10-stock version has outperformed the 20-stock version over the long haul, producing annualized returns of 9.6% versus 9.1% for the larger portfolio. It's done so with almost exactly the same beta (1.18 for the 10-stock and 1.17 for the 20-stock), and its worst year was actually better than the worst year for the 20-stock version (2008, when the 10-stock fell 35.0% and the 20-stock lost 38.9%). And it may be worth noting that the other multi-strategy approach we track, the Top 5 Gurus strategy, has produced much better results over the long term with its smaller portfolio. The 10-stock version has averaged 14.1% annualized returns, while the 20-stock version has averaged 6.7%. The 10-stock version also has a lower beta than the 20-stock portfolio (1.07 to 1.08), and it lost significantly less in its worst year (31.0%) than the 20-stock portfolio lost in its worst year (39.1%).

In the short term, running a 10-stock focused portfolio like the Hot List means that a big loss on an individual position will of course be felt more than it would in a larger portfolio. But our data shows that even if we double the portfolio size, we don't get any real benefit in terms of risk or performance over the long haul. In fact, our testing shows that a 100-stock portfolio picked using the Hot List system wouldn't have produced significantly better risk-adusted returns than the 10-stock portfolio since the Hot List's July 2003 inception.

This doesn't necessarily mean that a 10-stock portfolio is the right option for you. As is often the case in investing, your personal temperament should drive a lot of your portfolio management style. If you are the type of investor -- and many people are -- who would become extremely agitated if you only held 10 stocks and one of them took a tumble, you very well may want to have a somewhat larger portfolio in terms of the number of holdings. The important thing is that you feel comfortable enough that short-term losses don't lead you to scrap your strategy and bail on the market. What I'm saying here is that, if you have the right temperament, a portfolio of just 10 stocks can work over the long haul.

The bottom line is that risk management comes in a variety of forms, and diversification in terms of your number of holdings is just one of those forms. With the portfolios we run, the rigorous stock-selection methodologies we use serve as another form of risk management, by screening out financially troubled stocks or those that are wildly overvalued. And our stop-loss system adds another layer of risk management.

Over the long-term, our results have shown that this multifaceted approach to risk management can, indeed, allow us to run fairly concentrated portfolios without adding high amounts of risk. That doesn't mean we won't have some sizable losers from time, as we have in recent months. But I'm confident that over the long haul, this system will allow us to continue to beat the market.

# A Quant's Journey (Part I)

*Excerpted from the October 23rd, 2015 Validea Hot List*

One of the reasons that I love investing is that it is a constant learning process. With so many factors impacting stocks day in and day out, no one -- not Peter Lynch, not Carl Icahn, not even Warren Buffett -- has learned all there is to know about the market, and I doubt anyone ever will. To succeed, you must constantly be looking at things from different angles, evaluating and re-evaluating your assumptions as the market tests you over and over again. Trying to wrap your arms around the enormous, dynamic machine that is the stock market is a fascinating, and sometimes humbling, endeavor.

But while the specifics of financial markets are constantly changing, that doesn't mean you can't extract some enduring lessons from the shifting landscape. Given that we recently hit the 12-year anniversary of running the Hot List and our other guru-inspired portfolios, I've been thinking a lot about just what lessons I've learned over these past dozen years, and there are plenty of them. In this week's newsletter and our next rebalancing newsletter, I'd like to share those lessons with you.

To start, this week I'll look at what I've learned from the copious amounts of data that we've compiled while monitoring these model portfolios. In Part Two, I will focus more on the psychological lessons I've taken away from the past dozen years.

**Lesson 1: Quantitative Strategies Work:** The ubiquity of the Internet has made stock market information available far and wide to the masses over the past 12 years. In theory, efficient market hypothesizers would say, that should make quantitative strategies lose their effectiveness. According to the EMH, the market digests all well-known information and factors it into stock prices. The advantages that one used to get from digging through newspapers and financial reports should largely disappear when just about anyone can instantaneously get access to that information through stock screening websites.

But our experience shows a much different scenario. Since their respective inception dates (most of which came in 2003), the 14 ten-stock portfolios we track (which include 12 individual guru-based portfolios and our 2 consensus portfolios) have returned an average of 8.32% annualized. Over the same timeframe, the S&P 500 has returned 5.69% annualized. Of the 14 portfolios, 11 have beaten the S&P, many by a wide margin.

It's not just the 10-stock portfolios. The 20-stock versions that we track have returned 8.16% annualized, compared to that 5.69% figure for the S&P. For the larger portfolios, 12 of the 14 have beaten the index.

How can this be? It's because markets are not completely efficient, and investors are far from completely rational. When times are tough, they expect the difficulties to go on forever, whether it applies to an individual company or the broader market. When the good times are rolling, they expect them to go on forever. Their frequent overreaction creates an environment in which disciplined investors can take advantage of mispricings, and quantitative strategies are a great means to do so because they can give you an almost instantaneous look at cold, hard financial data for thousands of stocks.

**Lesson 2: Blending Strategies Helps:** While many of the individual guru-inspired strategies we track have fared quite well, we have found that using multiple strategies in a single portfolio -- like we do with the Hot List -- can further enhance returns. Both the Hot List, which looks for stocks that get consensus from multiple models, and the Top 5 Gurus portfolio, which selects the top 2 picks from 5 of our best strategies, are among our best 10-stock portfolios since their inceptions 12 years ago. The Top 5 Gurus portfolio has returned 13.8% annualized, while the Hot List is up 9.8% annualized. The 20-stock versions of these portfolios also both beating the S&P, with the Hot List up 9.1% and the Top 5 Gurus up 6.7%. The average

annualized return for these 4 multi-strategy portfolios: 9.85%, topping both the average for our individual-guru portfolios and the S&P 500.

**Lesson 3: Relative Strength Provides Consistency:** One of the interesting things we found over the past dozen years is that strategies that include a 12-month relative strength component -- that is, those that look for stocks that have fared well over the past year compared to other stocks in the market -- have been more consistent than those that do not. The 10-stock Motley Fool-inspired portfolio has finished in the red in just one year since its 2003 inception; a 20-stock version of the portfolio has been in the red in just two years. The 10-stock Momentum Investor portfolio, meanwhile, has posted negative returns in just two years over that span, while its 20-stock version has done so just three times. And the James O'Shaughnessy-inspired 10- and 20-stock growth portfolios that we track internally have each been negative in just two of the years since their 2004 inceptions. In contrast, many of our other portfolios (including some of the top performers) have been in the red in 4 or more years.

Whether or not this trend continues to hold up remains to be seen. The relatively small number of down years for strategies with a RS component could, perhaps, be due to the lengthy stretch of outperformance that we've seen from growth and momentum stocks in the past 5 to 10 years. But it may also be because a relative strength component can act as a sort of stop-loss. When a stock declines, there's a good chance that its relative strength will also decline (unless the whole market is declining). So, if a strategy is looking for stocks with high relative strengths, a sharply declining holding will likely lose points on that criteria, and could find itself out of the portfolio before it declines much further. That doesn't mean using a relative strength component automatically leads to better returns -- such strategies will miss out on the strong rebounds that beaten-down value stocks can have. But it does appear that it can make for smoother returns and less of a downside in a given year.

**Lesson 4: Concentrated Portfolios Can Provide All The Diversification You Need** -- With One Big Caveat: "Don't put all your eggs in one basket" is timeless wisdom, and it certainly applies in the stock market. But our experience shows that to give yourself enough diversification, you can use far fewer baskets than you might think.

As I noted in a recent newsletter, many studies show that portfolios of 20 to 50 stocks provide sufficient diversification. But keep in mind that most of those studies are operating under the premise of randomly selected portfolios -- essentially, they are saying that if you were to randomly pick stocks, you should pick 20 to 50 to get proper diversification. It's not accidental that these studies focus on random picks - efficient market hypothesis thinking is prevalent in the academic world, and the EMH stipulates that the market is too efficient for any stock-picker to consistently do better than a randomly selected portfolio. I disagree, as I think that successful investors like Warren Buffett, Peter Lynch, Joel Greenblatt, and Benjamin Graham have proven that you can use careful stock analysis to beat the market. A good quantitative stock-picking strategy should screen out financially troubled stocks or those that are wildly overvalued -- the types of trouble stocks that would require you to hold more stocks in order to get proper diversification. Over the past 12 years, our 20-stock portfolios have on average not provided better returns than our 10-stock portfolios, nor have they come with less overall volatility or smaller maximum drawdowns.

The caveat is that, when you do get a big loser in a 10-stock portfolio (and it's inevitable that you will), it can have a significant impact on your short-term returns. It also just looks bad. Seeing that one of your 10 holdings is down, say 30%, can make your stomach churn in a way that it wouldn't if you held, say, 100 stocks -- and that is very likely going to make you want to jump ship and ditch your strategy. After a few big losers, you might also start wanting to veto some of your model's picks, fearing that some of the more unloved stocks that pop up on your "buy" list could end up driving down your entire portfolio.

If you want to succeed, however, overriding your strategy is a line you cannot cross. Why? For the answer to that, you'll have to wait until Part Two, when I look at the psychological lessons I've learned from my 12 years of quantitative investing.

# A Quant's Journey – Mental Lessons (Part II)

*Excerpted from the November 20th, 2015 Validea Hot List*

In our last rebalancing newsletter, I looked at some of the lessons I've learned in my dozen years of running quantitative strategies, focusing on what I've learned from the copious amounts of data that we've compiled while monitoring our model portfolios. In Part Two this week, I will focus more on the psychological lessons I've taken away from the past dozen years. These lessons are a bit broader and more abstract, but in the end they may be even more important because they involve the ways in which one can combat the many emotional and behavioral biases that we humans face as investors.

**Lesson 1: Don't Try To Be Perfect**

As an investor, we all have the urge to be perfect. Want to be right on all of our stock picks, and we envision that great investors like Warren Buffett are, indeed, right far, far more than they are wrong. But the reality is that they aren't anywhere close to perfect, and you don't need to be right all the time. As Martin Zweig said, "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."

My Guru Strategies are proof of that. The Hot List has just about doubled the S&P 500 since its mid-2003 inception, yet its accuracy rate (that is, the percentage of stocks that it has made money on) is 54.1%. My other 13 ten-stock portfolios -- all but three of which are beating the market since their inceptions -- have accuracy rates no higher than 59.6% and as low as 46.7%. Yes, that's right -- the Momentum Investor portfolio has actually been wrong more than it has been right, but despite its 46.7% accuracy rate it has nearly doubled the market since its mid-2003 inception.

What's the significance of all this? To me, it is that the "shotgun" approach, as Zweig called it, is the way to go. As opposed to the "rifle approach", which calls for intensely studying a very small number of individual stocks, the shotgun method involves buying up a larger basket of stocks through the use of systematic fundamental analysis. Sure, this approach means you might get some duds, but that's okay. If your winners outnumber your losers (sometimes even if they don't), you can still make a heck of a lot of money. If you focus all of your energy on intense research of a small number of firms, you're going to spend a lot more time, be a lot more (perhaps too) concentrated, and still be wrong sometimes.

In addition to the time and diversification benefits, the shotgun approach also lends itself to systematic, unemotional investing. Since you are just screening for stocks that have particular fundamental qualities, there's no hunch playing or guesswork. If the stock meets your criteria, you buy it; if not, you pass. With a rifle approach, you're going to get into more subjective analyses of the firm's products and business. Rare investors like Buffett, who have exceptional business acumen and the ability to keep their emotions at bay, can have great success doing that. But most individual investors lack the discipline (and time, frankly) needed to thoroughly analyze a business and not be swayed by what the rest of the world thinks. A quantitative, shotgun approach keeps emotion at bay, if you ...

**Lesson 2: Stay Out Of The Way**

Just about every guru I follow stresses the importance of discipline, and my own experience has done nothing to refute their advice. Believe me, there been many times when I've seen a stock pop up on the Hot List's "buy" list and wished we could just skip that one. But many times, those are just the types of stocks that perform the best -- their low expectations or abundant fears hovering over them create incredible value opportunities.

Remember USANA Health Sciences? Fears of its multi-level marketing approach for years created all sorts of negative headlines around the nutrition/personal care product maker, so I wasn't jumping for joy when the Hot List picked it up in late 2012. About 16 months and 115% of gains later, I was glad I had trusted my models.

There are numerous other examples like this, and I believe that the Hot List's purchase of these sort of stocks -- and our willingness not to override the portfolio's decisions -- is one of the big reasons that it has been so successful over the long-term.

Of course, not overriding a model's picks can be incredibly hard. Because of that, any investor using quantitative strategies should ask himself or herself some hard questions before beginning: Will I trust the models even when times are tough and my portfolio is struggling? How big a loss will I be able to handle before I jump in and start overriding the models' decisions? What safeguards can I put in place to keep myself from meddling with the models? If you haven't asked yourself these questions -- and come up with good answers -- you're not ready to start investing via quantitative strategies.

**Lesson 3: Different Styles Win At Different Times**

In terms of dealing with the inevitable ups and downs of investing, it's critical to remember that strategies go in and out of favor over time. At one point early in our existence, the David Dreman-based portfolio was our top performer. Today, it is bringing up the rear. That's an extreme case, but it illustrates what can happen as difference forces lead the market. From 2003 to 2006 or 2007, value strategies were very successful, and the Dreman model flourished. Since then, however, growth has been on a major run, and the Dreman portfolio has felt the reprecussions.

Ideally, you'd like to have a portfolio that is as "all-weather" as possible. We try to do that with the Hot List by using multiple, uncorrelated strategies that use a wide assortment of variables to assess stocks. Still, unless you have a portfolio that is, essentially, the market, your portfolio will ebb and flow relative to the market depending on what sections of the market are doing best. Being aware of these cyclical trends can help you ride out the tough times, just as it can help prevent you from jumping onto a hot strategy that is simply reaping the short-term benefits of a broader cyclical trend that may well run out soon after you get on board.

It is not just the growth/value, large-cap/small-cap cycles that you need to be aware of. You also need to be aware of other strategy-specific issues. For example, in 2008, our Benjamin Graham-based model did far better than the broader market. Part of that, I believe, is because it is a good strategy, but there's no getting around the fact that it benefited greatly from circumstance: the model does not invest in financial stocks, which were the bane of the market during the 2008 meltdown.

The Graham strategy's exceptional relative performance that year led to a lot of interest from investors, and I tried to be clear with anyone who was interested in the model that, while it is a very good long-term strategy, no one should expect it to beat the market by 20-plus percent every year, as it did in 2008. Indeed, because it did not invest in financials, the Graham-based strategy didn't get some of the bounce back that occurred following the financial crisis. Investors who did not understand that may well have been disappointed by the short-term results, and bailed on a very good long-term strategy.

**Timeless Lessons**

Twelve years is a good amount of time, but I'd be foolish to think that these past dozen years have taught me all there is to know about using quantitative strategies -- or that the specifics of what has happened over that time won't change. But while specifics will change, I would be stunned if the lessons I've learned

and shared with you today become less relevant in the next dozen years, or the dozen years after that. In particular, preparation, discipline, and value, which are at the center of these lessons, are concepts that have been crucial to investing success since Benjamin Graham's day. Their importance endures because they get to the heart of good business principles and provide ways for us to deal with our own hard-wired emotions and behavioral biases, which aren't likely to change any time soon. Over the next dozen years and beyond, I'll be keeping these lessons at the forefront of my investment process, and I hope you will, too.

# Believing In Value

*Excerpted from the December 18th, 2015 Validea Hot List*

It has been a rough stretch for the broader market and, to a greater degree, the Hot List. Several of the portfolio's holdings have stumbled over the past few weeks, most notably Banco Macro, which is down about 20% since joining the portfolio a month ago, and Cal-Maine Foods, which is down about 17% over that span (through Dec. 15). Neither of these firms has had any significant deterioration in its fundamentals that would merit such a decline. In the case of Banco Macro, the US interest rate increase (and the preceding expectation of an increase), as well as Argentina's tumultuous political situation, may well have played a role. But in times of broader market turbulence, it can be particularly hard to pinpoint exactly what is driving a stock's day-to-day machinations.

With less than two weeks left in the year, the Hot List's recent struggles mean that the portfolio will almost assuredly lag the S&P 500 in 2015. That would mark the first time in its twelve-year history that the portfolio has underperformed the index in consecutive years.

While we are of course disappointed with the past two years' performance, we are not alarmed; all strategies, even those used by history's best investors, go through losing periods, and sometimes those periods can last two or even three years. We do think it's important to understand the reasons behind the underperformance, however, and in this case there seem to be a couple main factors.

First, while history has shown that smaller stocks tend to beat their larger peers by a significant margin over the long haul, we've seen a divergence from that trend over the past couple years. As of Dec. 11, US large-cap stocks were slightly in the black in 2015, posting average gains of 0.2%, according to Morningstar.com. US small-cap stocks, meanwhile, were *down* nearly 6% for the year.

Part of that wide spread may be due to the normal ebb and flow that occurs between different market segments. But we think that a big part of it may be the result of something else: the rise of index funds. Index-tracking funds have become so popular in recent years, and the majority of them are weighted by market capitalization. This creates a cycle in which investors load up on index funds, pushing prices of the market's biggest stocks higher, which in turn makes those stocks comprise an even greater portion of the index, which means investors are buying more of those stocks when they buy index funds, and on and on.

The results of that is a very top-heavy market, and the data bears that out: Through October, the 10 largest stocks (by market capitalization) in the S&P 500 were up 13.9%. The other 490? They were down 5.8%. That spread of nearly 20 percentage points has been higher only twice -- in 1998 and 1999, the height of the Internet bubble. The tremendous outperformance of large-cap stocks was not sustainable back then, of course, and we doubt that it is sustainable right now. As of December 15, five of the 10 largest US stocks traded at price/earnings ratios of 36 or higher; three of them at P/E ratios of 98 or higher. It will be nearly impossible for multi-hundred-billion-dollar companies like these to produce the sort of growth that would sustain those lofty valuations. And it's not just that handful of the largest stocks that look pricey; mega-capitalization stocks have been more expensive than small stocks only 4% of the time over the past 10 years, according to our data.

Which brings me to the second major reason for our underperformance: the struggles of value stocks. Over many, many decades, value investing has proven to be a winning strategy. That doesn't mean it always works, however, and 2015 has been one of those years. Through Dec. 11, US growth stocks were

up 4.5% year-to-date; US value stocks, meanwhile, were *down* 4.4%, according to Morningstar. When you combine the underperformance of small stocks with the underperformance of value stocks, the results are much worse: US small value stocks are down close to 10% this year. On the opposite end of the spectrum, large US growth stocks are up nearly 7%. That gap of nearly 17% is completely antithetical to the long-term historical averages; according to the data of noted financial researcher Kenneth French, from 1927 through 2014, small value stocks outperformed large growth stocks by an average of 5.1 percentage points annually.

But the underperformance of value goes beyond 2015. Since February 2007, US value stocks have lagged the most expensive US stocks by 2.6 percentage points annually, according to Barron's. The eight-year, seven-month stretch of underperformance is the longest losing streak on record, going back to 1926.

So, are value stocks dead? We find that notion very unlikely. That's because we don't think the historical outperformance of value stocks is due to circumstance or coincidence. Value stocks have outperformed because of human nature and the very nature of business itself.

We humans are an emotional bunch, and we have a tendency to overreact to events. We also have an innate desire to follow the crowd, and a great ability (and need) to recognize patterns. Thousands of years ago, those instincts helped us avoid danger, find food, and survive. When our ancestors saw a group of people sprinting out of the jungle with looks of terror on their faces, those who had the instinct to follow the crowd increased their chances of survival, for example. Similarly, if every time it rained, a river overflowed into the surrounding area, those who recognized the pattern and avoided that area when it started to rain increased their chances of survival. These characteristics thus were passed down to us in our DNA.

The problem is that, in investing, those same instincts and abilities work against us. We see danger in stocks that have short-term problems and are falling. We see a pattern in a declining stock price, and instinctively think the pattern will go on forever. The danger and the apparent pattern cause us to sell, and run as fast as we can away from the stock -- likely into a far more popular, and pricey, stock. Investors do this even when the first stock is already trading levels well below what its underlying business fundamentals would suggest, and even when the second stock is trading well above what its underlying business fundamentals would suggest. That's how we get value stocks, on one hand, and growth (or, more accurately, "glamour") stocks, on the other.

That's what happens in the short term. But at some point, fundamentals of business and investing dictate that a company must justify its glamorous valuation. And it's incredibly hard to produce the sort of earnings growth that justifies an earnings multiple of 40 or 50, let alone 100 or more, over the long-term. That's why glamour stocks tend to eventually tumble. Value stocks, on the other hand, have such low expectations that even minor improvements can lead to major increases in share price.

So, what is more likely: that, after decades upon decades upon decades, human nature and the nature of business have changed and the valuation of something that you buy has forever ceased to be relevant; or, that something else has been happening to temporarily distort the natural way of things?

Obviously, we believe it to be the latter. It is likely that several factors have combined to create this extended stretch of underperformance by value stocks. First, as I've discussed several times before, many investors are still feeling the trauma of the 2008-09 financial crisis. The events of that jarring period have caused many to become extra sensitive to any sign of danger in the market. This risk aversion has likely led many investors to avoid -- more than usual -- value plays, which tend to have short-term problems hanging over them. Instead, they are following the crowd into glamour stocks that everyone seems to love.

Second, in recent years, US growth has been so-so, Europe has been in great turmoil, and growth in China and other emerging markets has slowed. With growth hard to come by, it is likely that investors are reaching for growth wherever they can find it -- even if it is in overpriced glamour stocks.

Thirdly, the basic materials and energy sectors tend to be laden with value stocks -- these unglamorous firms don't often demand particularly high valuations. Both of these sectors have been pummeled by the commodity collapse of the past year and a half, meaning that value stocks have taken the brunt of the commodity blow. The short-term pounding isn't a result of value investing failing; it is not as though investors suddenly found low valuations to be undesirable. Instead, it is a case of businesses being revalued in light of dramatic changes in commodity supply.

Finally, don't underestimate the role of the Federal Reserve in all this. When you tinker with markets, there are repercussions, and one of the repercussions of the Fed's extended period of ultra-low rates may well be a distortion of the growth/value cycle. Growth stocks are valued on future earnings -- when rates are on the rise, investors are less willing to pay high multiples. Value stocks, meanwhile, are the bird in hand, with strong existing cash flows. Given the recent underperformance of value stocks and strategies and the rate-hiking cycle that is about to begin, one would expect value to start to demonstrate better performance -- increasing rates are, in fact, typically good for value stocks.

**The Gurus and Discipline**

Above, I said that even the best strategies and strategists goes through losing periods. At times like these, it is important to remember that that's not just lip service. The gurus upon whom I base my strategies are some of history's most successful investors. But each of the 10 strategists about whom I wrote in *The Guru Investor* had multiyear stretches in which they significantly lagged the broader market.

What all of these gurus knew, however, was that ditching a proven, fundamentally sound strategy after a couple years of poor performance only compounds your trouble. Mean reversion is a powerful force, and good strategies rebound -- very often, the worse the underperformance, the bigger the rebound. Give up on a solid strategy after a bad year or two, and you are likely to miss the rebound. You end up with the pain of the bad year or two, *and* the pain of missing out when the worm turns.

The gurus didn't bail. They knew that value and fundamentals win over the long haul, so they stuck to their guns. Here are three examples of gurus who roared back from rough periods, along with an accompanying quote from each guru about the importance of sticking with a solid, fundamental-focused strategy:

<u>**Warren Buffett**</u>

**The Rough Patch**: While the S&P 500 lost 26.4% in 1974, Buffett was down 43.7%. The following year, when the S&P bounced back with a 37.2% gain, Buffett remained in the red, losing 5%.

**The Rebound**: In 1976, the S&P continued higher, gaining 23.6%. Buffett blew that away, posting gains of 134.2%. The following year, when the S&P lost 7.4%, Buffett gained another 55.1%. The rebound didn't end there. In 1978 and 1979, the S&P gained 6.4% and 18.2%, respectively. Buffett? He posted gains of 10.1% and 110.5%.

**The Quote**: "Successful Investing takes time, discipline and patience. No matter how great the talent or effort, some things just take time: You can't produce a baby in one month by getting nine women pregnant."

**John Neff**

**The Rough Patch**: In 1971 in 1972, the S&P 500 gained 14.6% and 18.9%, respectively, as the "Nifty Fifty" -- a group of popular large-caps -- grew to bloated valuations. Neff's Windsor fund wasn't keen on the overvalued giants, and gained just 7.5% and 10.2%, however. Then in 1973, when the S&P fell 14.7%, Windsor was hit much harder, tumbling 25%.

**The Rebound**: After that three-year stretch of underperformance, Windsor beat the S&P by 9.6 percentage points, 18.3 percentage points, 22.8 percentage points, 8.4 percentage points, and 2.4 percentage points over the next five years.

**The Quote**: "I watched in amazement as investors clamored for Nifty Fifty stocks at the expense of dozens, if not hundreds, of sturdy growth stocks of lesser renown. My report to shareholders in November 1973 reflected the dismal course of events and, even more forcefully, my resilient faith in Windsor's low P/E strategy: '[We] view the current devastation in the marketplace, not as a reason for alarm, but rather as one of opportunity,' [I wrote]." -- from *John Neff on Investing*

**Peter Lynch**

**The Rough Patch**: In 1981, the S&P lost 5%, but Lynch's fund tumbled 22.6%. The next year, the S&P surged 21.4%, but Lynch lost 1.3%.

**The Rebound**: Lynch followed up those two years with his best year ever, posting a whopping 82.8% gain in 1983.

**The Quote**: "When people say, 'Look, in two months it's up 20%, so I really picked a winner,' or 'Terrible, in two months it's down 20%, so I really picked a loser,' they're confusing prices with prospects. Unless they are short-term traders who are looking for 20% gains, the short-term fanfare means absolutely nothing. A stock's going up or down after you buy it only tells you that there was somebody who was willing to pay more -- or less -- for the identical merchandise." -- from *One Up On Wall Street*

**The Power of Mean Reversion**

Having faith in their fundamental-focused approaches during times when fundamentals were being overlooked was a key to these gurus' long-term successes. They knew that, sooner or later, the market would come back to fundamentals and value, and that their results would revert to their very successful means.

We have seen a similar mean-reversion with our Guru Strategies. We recently tested how these approaches have performed following one-year stretches of underperformance. We calculated results on a rolling, daily basis (i.e., we looked at subsequent performance starting on any day that followed a 365-day period of underperformance), meaning that our study covers about 2,500 one-year periods.

The results showed that some of our most heavily weighted strategies have demonstrated tremendous mean-reversion. For example, following one-year periods in which it has lagged the S&P 500, the Motley Fool-based portfolio has, on average, gone on to outperform the index by 17.2 percentage points over the next year. The Joel Greenblatt-based portfolio has outperformed by an average of 9.4 percentage points in similar circumstances, while the Benjamin Graham-based portfolio has outperformed by 7.2 percentage points.

The exceptional performance of these and other models that drive the Hot List, along with the performances and advice of the gurus who inspired them, have me very optimistic as we look ahead to 2016. I'm not saying things will turn around immediately. But what I am saying is that history has shown that investing always comes back to fundamentals and value. That means that, over the long term, fundamental-focused, value-centric strategies like ours are the best way to invest. To give up on these approaches after a couple down years would be shortsighted.

The hardest part about investing is staying disciplined through periods of underperformance. But, as the gurus have demonstrated, if you can do so, you should reap the rewards down the line. We believe that the rewards are coming, and we will continue to be patient and disciplined so that we do not miss out on them.