THE BEST OF THE VALIDEA HOT LIST – 2016

HIGHLIGHTS OF THE TOP INVESTING COMMENTARY THROUGHOUT THE YEAR

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David Dreman On Why Analysts' Predictions Are Like Powerball Tickets

Excerpted from the January 29th, 2016 Validea Hot List

The huge recent Powerball jackpot captured the attention of just about everyone, sending millions of Americans to their local convenience stores in search of a winning ticket. Of course, if you were buying tickets for any other reason than sheer entertainment value, you were throwing your money away: The odds that you would be the winner were lower than the odds that you will become president of the United States.

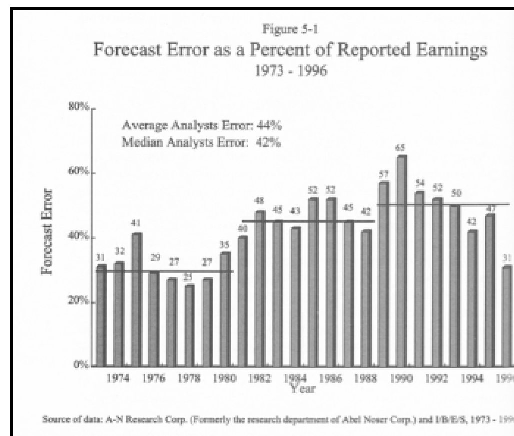
Unfortunately, the Wall Street analysts who so often get cited for their predictions of companies' earnings -- predictions that often get investors in a tizzy -- have success rates similar to those of lottery ticket buyers. Consider what David Dreman wrote in his 1998 classic Contrarian Investment Strategies:

"There is only a 1 in 130 chance that the analysts' consensus forecast will be within 5 percent for any four consecutive quarters," he wrote. "To put this in perspective, your odds are ten times greater of being the big winner of the New York State Lottery than of pinpointing earnings five years ahead."

Ouch.

One reason Dreman gives for analysts' poor performances involves something that affects individual investors, too: overoptimism. Analysts know that high-flying stocks will plummet if earnings come in below the Street's expectations. Yet the same analyst will still recommend high flyers because he is confident he knows enough about the stocks he has recommended so there is no chance they will experience negative surprises. That might happen to other analysts, he thinks, but not to him. Of course, given the unpredictability of the market and events surrounding it, there's a good chance it will happen to him.

From Contrarian Investment Strategies: The Next Generation, 1998 (Simon & Schuster)



I don't mean to pick on analysts. They have a tough job. The real problem may be less about their inaccuracies and more about the way that the investing public takes their word as gospel. But however you look at it, the fact that analysts are so often wrong is good news for disciplined contrarian investors, Dreman says. To understand why, you need to understand to beliefs that are at the core of his strategy. First, he found that investors -- being emotional human beings -- are prone to overreaction. If a stock is considered "good" -- it's one of the "hot" stocks you read about in the paper, hear about on cable TV, or get tips about from your friends and coworkers -- investors consistently overprice it. If a stock is "bad" --

its price has been dropping, the company is making negative headlines, there are concerns about its industry's future -- investors underprice it. What's more, this overvaluing of the supposed "best" stocks and undervaluing of the supposed "worst" often goes to extremes.

Second, Dreman found that surprises occur frequently in the stock market, and that many of those surprises involve earnings results that differ significantly from analysts' estimates. When you put investors' tendency to overreact together with the frequent surprises in the market, you get to the crux of why Dreman believed so much in a contrarian approach: Because the "best" stocks are often overvalued, good surprises can't increase their values that much more. Bad surprises, however, can have a very negative impact on them. On the other hand, because they already tend to be undervalued, the "worst" stocks don't have much further down to go when bad surprises occur. When good surprises occur, however, they have a lot of room to grow.

His conclusion: Buy out-of-favor stocks because surprises (positive and negative ones), including earnings surprises, are commonplace. If you own favorites, you'll get clobbered by negative surprises but won't get much upside by positive surprises; whereas if you own out-of-favor stocks, you'll hardly be penalized for negative surprises but will be rewarded handsomely by positive ones. And given how inaccurate analysts are, there are bound to be some positive ones.

The approach I base on Dreman's writings thus involves looking for unloved stocks (those that are in the market's cheapest 20% using at least two of the following: price/earnings ratio, price/book ratio, price/sales ratio, price/cash flow ratio) that have strong underlying fundamentals (high returns on equity, strong recent earnings growth, high and sustainable dividend payouts). The strategy has been a very up-and-down performer for me. At one point a few years back, my 10-stock Dreman-inspired portfolio was my best performer over the long-term. But as value stocks have struggled in recent years, this deep value strategy has had its problems. Last year, for example, it lost more than 20%. The growth/value pendulum is fickle, but it always swings back the other way. When that happens, I expect the Dreman-inspired model will rebound fiercely. Human nature doesn't change, and the behavioral biases that Dreman highlighted aren't going anywhere. Over the long-term, investors who follow his advice should be able to take advantage of them.

What Bernie, Donald, Hillary, And Ted Will -- And Won't -- Do To Your Portfolio

Excerpted from the March 11th, 2016 Validea Hot List

If you are an investor, the lead-up to the 2016 Presidential Election has likely make you feel something between discomfort and downright terror. That's because, with the main candidates espousing such a wide range of economic policies, there is almost certainly someone in the race whose plans seem dangerous and foolish to you. Conservatives shudder at the thought of Bernie Sanders' tax hikes and self-proclaimed socialist agenda. Liberals think Ted Cruz's flat tax plan will put the country on the road to ruin. Those who blame the Obama Administration's policies for our tepid recovery cringe at the thought of a Hillary Clinton White House; those who think the administration's policies helped contain the troubles of 2008-09 are appalled when Donald Trump starts promising big tax cuts with few details.

I'm here to talk you down. Whether you think Trump is a con man or you think Sanders' policies are un-American or you just can't stand Hillary, my message is the same: Stop Googling "How to move to Canada." It's going to be alright.

Ours is a government of formidable checks and balances. Over the past eight years, we have seen just how hard it is for a President to accomplish major goals without Congress on his side. For all of the significant changes today's Presidential hopefuls are promising, the reality is that, without major alterations to the makeup of our legislature, he or she won't be able to enact the sweeping changes that you fear.

What's more, the economy and stock market are far too complex for any one person -- even the President of the United States -- to exercise real control over. Whatever you think of Bill Clinton and George W. Bush, for example, it's hard to argue that the Internet bubble that juiced stock returns in the latter part of Clinton's tenure and crushed stocks in the early part of Bush's first term wouldn't have popped just the same had Clinton still been in office. The animal spirits of millions of Americans are no match for one person, however powerful he or she may be.

The millions of Americans who are continually innovating, creating, and building also have a lot more to do with our economy than any one leader. In his latest letter to Berkshire Hathaway shareholders, for example, Warren Buffett said that, despite claims to the contrary, "America's economic magic remains alive and well." The big driver of America's long-term growth has been remarkable gains in productivity, he said, and he sees that trend continuing. "Nothing rivals the market system in producing what people want - nor, even more so, in delivering what people don't yet know they want," he wrote, noting how unexpected inventions like television and computers completely changed our lives and our economy. "For 240 years it's been a terrible mistake to bet against America, and now is no time to start. America's golden goose of commerce and innovation will continue to lay more and larger eggs."

All of this isn't to say that the choice for President has no impact on the economy or the stock market. And, to be sure, there are a host of other noneconomic issues that the President can greatly impact. What I'm saying is that, regardless of who becomes the next President, long-term investors in American businesses will be able to prosper. In fact, I bet that a number of simple actions you can take regarding your portfolio will have a much bigger impact on your long-term wealth then will your choice about which lever to pull in the voting booth this November.

What sort of actions am I talking about? Here are a few:

Focus on Business Fundamentals: In Buffett's recent letter to shareholders, you'll find little, if any, discussion of short-term share price movements, analyst upgrades or downgrades, or volume levels. You

will find extensive discussion of things like a business's "intrinsic value", management's performance, and "competitive advantages" that a business possesses over its peers. To Buffett, the business is the key. He knows that, while stock prices can depart from business performance in the short term, over the long term a stock follows the performance of the business behind it.

Value Matters: People are always shopping for bargains in their everyday lives -- they want good deals on clothes and cars and houses and everything else in between. But when it comes to stocks, most people want to buy things that have been rising in price, and all too often (though not exclusively) what has been rising has become quite expensive. And just as you would if you bought a very overpriced coat or car, you will probably end up disappointed if you buy an overpriced stock.

A recent piece in ValueWalk highlighted research done by StarCapital Research showing how valuation has impacted future stock returns in 17 countries since 1979. The study used the 10-year cyclically adjusted price/earnings ratio as and valuation gauge, and looked at how equities did in each country over the subsequent 10 to 15 years (on average) when starting at various "CAPE" levels. The results show clearly that cheaper stocks deliver better long-term returns than pricier stocks. Here's the average annual returns that followed over the next 10 to 15 years (on average) when stocks started from various CAPE levels:

CAPE Return

- Under 10 -- 11.7%
- 10 to 15 -- 8.7%
- 15 to 20 -- 7.2%
- 20 to 25 -- 5.7%
- 25 to 30 -- 4.1%
- Over 30 -- 0.5%

The lesson is clear: Valuation matters over the long term.

Think Long-Term: Turn off CNBC. Stop checking your smartphone every 10 minutes to see what your holdings are doing. Investing is about the long term, and "the long term" doesn't mean until the end of this year or even the end of next year. It means 5 years, minimum, and preferably 10. If you need your money for your son or daughter's college education in two years, don't put it in the stock market. If you expect you will need it for a down payment on a house three years from now, don't put it in the stock market. Mutual fund legend Peter Lynch said that "time is on your side in the stock market". Don't forget that -- and don't forget that you can't speed up time, no matter how badly you want to.

Rebalance Regularly: Thinking long-term doesn't mean that you have to hold every one of your stocks for the long term, however. Even Buffett, who says his favorite holding period is forever, will ditch a stock whose prospects have dimmed significantly. The trick is being able to sell a stock because its prospects have dimmed, not because its share price has fallen. We humans are an emotional bunch. It's just the way we are built. That means that we see danger in every short-term stock decline and want to sell, even though short-term machinations mean very little in terms of a stock's long-term prospects.

The solution, I believe, is using a fixed schedule to buy and sell stocks. Whether it's once a month, once a quarter, or once a year, the key is picking a schedule and sticking to it. On your scheduled rebalancing days, you keep the stocks whose fundamentals remain attractive, and sell those that don't, replacing them with better options. This way, you are buying and selling based on facts and fundamentals, not emotions.

Each of these four tips is something we incorporate into our approach with the Hot List and all of our other guru-based portfolios. They allow us to stay disciplined, take advantage of mispricings in the market,

and keep dangerous emotions --which derail so many investors -- at bay. Over the long haul, doing those things should have a much bigger impact on your portfolio than the man or woman in the Oval Office.

Peter Lynch On What Investors Can Learn From The Maya

Excerpted from the April 22nd, 2016 Validea Hot List

As soon as the dust settled from Lehman Brothers' collapse and financial markets stabilized in 2009, pundits and investors were all on the lookout for the other shoe to drop. Any negative economic report was seen as "the beginning of the end". Whispers were everywhere about double-dip recessions. Investors saw bubbles everywhere -- even though most assets had been hit so hard that they were trading at bargain values.

It's not surprising. Few people saw the housing bubble -- which triggered the bank woes and Great Recession -- coming, so investors and talking heads were blindsided. And no one likes to be blindsided. When we are, our defenses go up and we do everything we can to avoid, or at least brace ourselves for, a repeat. A driver who has been rear-ended a couple times might start to obsessively check the rearview mirror. He might tense up anytime he has to come to a stop with someone behind him, even if the car behind him is keeping a safe distance. After the financial crisis, investors were obsessively checking their rearview mirrors, seeing dangers that were no longer present. Wells Capital Management's James Paulsen called it "post-traumatic-armageddon-hypochondria," and it was understandable, given how severe the pain of late 2008/early 2009 was.

But there's a lesson here, and it's not a new one. In fact, mutual fund legend Peter Lynch pointed it out a couple decades before the Great Recession. In his One Up on Wall Street, which is the basis of my Lynch-inspired Guru Strategy stock-picking model, Lynch talked about human beings' penchant for "penultimate preparedness" -- that is, the tendency to plan for the crisis we've just been through (and which is unlikely to repeat). Here's an excerpt from his discussion of this phenomenon:

Taken from One Up on Wall Street (Penguin Books, 1989)

PENULTIMATE PREPAREDNESS

No matter how we arrive at the latest financial conclusion, we always seem to be preparing ourselves for the *last* thing that's happened, as

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opposed to what's going to happen next. This "penultimate preparedness," is our way of making up for the fact that we didn't see the last thing coming along in the first place.

The day after the market crashed on October 19, people began to worry that the market was *going* to crash. It had already crashed and we'd survived it (in spite of our not having predicted it), and now we were petrified there'd be a replay. Those who got out of the market to ensure that they wouldn't be fooled the next time as they had been the last time were fooled again as the market went up.

The great joke is that the next time is never like the last time, and yet we can't help readying ourselves for it anyway. This all reminds me of the Mayan conception of the universe.

In Mayan mythology the universe was destroyed four times, and every time the Mayans learned a sad lesson and vowed to be better protected—but it was always for the previous menace. First there was a flood, and the survivors remembered it and moved to higher ground into the woods, built dikes and retaining walls, and put their houses in the trees. Their efforts went for naught because the next time around the world was destroyed by fire.

After that, the survivors of the fire came down out of the trees and ran as far away from woods as possible. They built new houses out of stone, particularly along a craggy fissure. Soon enough, the world was destroyed by an earthquake. I don't remember the fourth bad thing that happened—maybe a recession—but whatever it was, the Mayans were going to miss it. They were too busy building shelters for the next earthquake.

Two thousand years later we're still looking backward for signs of the upcoming menace, but that's only if we can decide what the upcoming menace is. Not long ago, people were worried that oil prices would drop to $5 a barrel and we'd have a depression. Two years before that, those same people were worried that oil prices would rise to $100 a barrel and we'd have a depression. Once they were scared that the money supply was growing too fast. Now they're scared that it's growing too slow. The last time we prepared for inflation we got a recession, and then at the end of the recession we prepared for more recession and we got inflation.

Someday there will be another recession, which will be very bad for the stock market, as opposed to the inflation that is also very bad for the stock market. Maybe there will already have been a recession between

In investing, there's a huge cost to penultimate preparedness. Just ask those who have been preparing for the second coming of the 08-09 crisis, or the second dip in the double-dip recession that so many people feared was coming. They have missed out on one of the longest, strongest bull markets of our lifetimes, one that has lasted more than seven years and included gains of more than 200% for the S&P 500.

To be clear, the mistake that these investors made wasn't trying to be prepared; structuring your portfolio so that it can hold up in tough times is certainly a good thing to do. The problem comes when you start making decisions that are based on fear, not facts. In early 2009, equities by just about any standard were cheap. Later in the year, improvement in the US economy was evident, and, while there have been a few ups and downs, the economy has continued to improve ever since then.

The penultimate preparers ignored those facts, however, failing to realize that the conditions that caused the 08-09 crisis had changed markedly. By piling into bonds or cash, they let their fears dictate the amount of risk they took. That is something that gurus like Lynch and Warren Buffett never did. They focused on cold, hard facts and figures, digging into balance sheets and fundamentals as they assessed companies' financial strength and valuation and growth prospects. By keeping their emotions in check and focusing on the facts, they were able to beat the market over long stretches. If you want to do the same, you'll have to demonstrate a similar type of levelheaded discipline while managing your own portfolio.

Is Another Correction in the Offing? If So, Stay The Course

Excerpted from the July 29th, 2016 Validea Hot List

The S&P 500 experienced an official correction earlier this year, with a decline of more than 10%. Specifically, the Index dropped just over 13% from its Nov. 2015 closing high to its closing low in Feb. 2016. This correction occurred over a span of 70 trading days, consistent with the average time span of a typical correction, which is a little more than three months, according to Josh Brown of The Reformed Broker. Brown makes note of this useful nugget of information as well as many other interesting facts regarding the nature of stock market corrections in his piece entitled "Field Guide to Stock Market Corrections" (which uses data from Dow Jones, Morningstar, and Bloomberg). Brown notes that during the post-World War era, corrections have occurred 27 times, more than twice as often as bear markets over the same period. And, the average loss during a market correction is 13.3%. Thus the 2016 Nov. 2015-Feb. 2016 correction again fell right in line with the norm.

However, what this latest correction did not conform to was average frequency. Top fund manager Bill Nygren, in a 2014 interview with Fortune, noted that "through long periods of history, we've seen 10% corrections about every year and a half on average." But, the Nov. 2015-Feb. 2016 correction began just about two and a half months following the July-August 2015 decline which shaved just over 12% off the S&P 500. Could it be that, at six and a half years into this bull market, corrections may begin to occur at a greater frequency? The potential for more frequent corrections, along with the fact the S&P 500 has recovered smartly from its first quarter slide and advanced to new all-time highs, raises the concern - could the S&P 500 be vulnerable to another impending drop of 10% or more?

It appears that investors are indeed anxious over such a development taking place. According to the Wall Street Journal, "investors are pouring billions of dollars into funds that promise to minimize market swings, highlighting the anxiety that prevails after [nearly] seven years of stock gains." Risk avoidance, achieved by investing in low or minimum volatility funds, is a theme that has prevailed this year. According to Morningstar, the top-five low-volatility exchange-traded funds added a net $12.5 billion through June 30 while, over the same period, investors pulled about $52 billion from U.S. equity funds.

However, is prepping for a downdraft in the market a wise idea with the S&P 500 still hovering near its recently established new record highs? Granted, embarking on a more defensive strategy can reap worthwhile benefits, provided the timing of the move is right. And therein lies the rub, the timing of the move. Such market timing is rarely a strong suit of the vast majority of investors, a theme that I have expounded upon frequently in my writings. My opinion on this topic has been derived by my adherence to the principles of the gurus -- a group of investors whose performance has been nothing short of spectacular over extended periods of time.

There is a common theme among the gurus I follow -- they don't claim to be able to time the market to avoid the inevitable corrections which are a normal part of stock market price behavior. For example, Warren Buffett, considered to be the greatest investor of all time, advises against trying to sidestep market declines. In their book, The New Buffettology, Mary Buffett and David Clark wrote that "Warren believes that corrections and panics are perfect buying opportunities for the selective contrarian investor." And, in regard to market forecasting, Buffett has been quoted as stating, "We have long felt that the only value of stock forecasters is to make fortune-tellers look good." In addition, mutual fund legend Peter Lynch, another guru I follow, once told PBS that bear markets are inevitable. "When they're gonna start, no one knows," Lynch said. "If you're not ready for that, you shouldn't be in the stock market. I mean stomach is the key organ here. It's not the brain. Do you have the stomach for these kind of declines?"

And, the problem with attempting to time a market correction, is that two key decisions must be made -- when to exit the market and when to get back in. Timing such moves is of utmost importance, particularly since the most dramatic gains tend to occur coming off the lows of a correction. Take the advance following the Feb. 2016 low. In the first thirty trading days off the bottom, the S&P 500 advanced 11.4%. Thus, you would have missed out on a rather sizeable gain had you moved to the sidelines during the decline and then been a month late getting back into the market.

What about now, with the S&P 500 sitting at all-time highs and the possibility that, at the current stage of this old and persistent bull market, the potential for more frequent corrections could be increasing, given the diminished time span between the last two downturns relative to the historical norm? Or, even worse, perhaps the end of the bull market is near, given its lengthy duration. Granted, depending upon the source, the reported average length of a bull market can vary widely. But, there is no arguing that, at nearly six and a half years old, the current bull market appears to be long in the tooth.

But, so what? Should simply the length of the current up-cycle in the stock market be reason enough to expect a significant downturn? In March 2015, roughly one and a half years ago, in a MarketWatch column, Chuck Jaffe said investors should beware "bad motivations" for changing up their portfolios due to the age of the bull market. One bad motivation: The idea that the market can't go up forever, and/or we are overdue for a downturn. He noted the aforementioned Bill Nygren, co-manager of the Oakmark Fund, reminded him that, for well over half of his career, he has been investing when the market was at all-time highs, and that he hoped that would continue for the rest of his career. Nygren went on to state, "Investors tend to be overly scared by the term 'record high,'" he said. "I've been in this business now for more than 30 years and more than half of the years I have been in the business, the S&P has been at a record high and -- in most of those years -- multiple record highs. And during those years, the S&P has gone up something like 20-fold. When you have an asset class like equities which you expect to offer positive rates of return, it's not odd that we're at record highs."

The bottom line is corrections are a healthy and normal part of the stock market environment. They help shake excess positive sentiment out of the market, letting valuations and prices fall a bit to set the stage for continued gains, rather than having the market get so far ahead of itself that a crash becomes likely. They can develop at any time, without much warning, and the anticipation of a potential stock market decline serves a purpose by creating the equity risk premium, or the excess return that investing in the stock market provides over a risk-free rate. The fear of a market decline will never go away, it's the nature of the business. However, instead of gearing up for a perceived downturn in the market based on extraneous factors such as time or mere worry, strategies that focus on stocks with strong fundamentals are a good bet over the long haul, regardless of what volatile swings the market may deliver. Benjamin Graham's rationale in regard to investing reflects this concept quite clearly. To quote from the Benjamin Graham chapter of my book, The Guru Investor, "In the short-term, stocks are unpredictable, but in the long run, a stock's price tends to move with and reflect the real value of the business, which is indicated by its fundamentals - its price-earnings and price-book ratios, the amount of sales it does, the level of debt it has in relation to its assets, the ratio of its assets to its liabilities." Buy cheap stocks of good companies, and you should do well over the long term, regardless of what happens day-to-day or week-to-week. A philosophy such as this is how Graham, as well as the other gurus I follow, have achieved such overwhelming success and how the Hot List's performance remains far ahead of the market's over the long run.

Combining Value and Momentum for a Winning Strategy

Excerpted from the September 23rd, 2016 Validea Hot List

After one of the longest stretches of value stock underperformance, most value investors are finally having a good year thus far relative to their growth-investing counterparts, as the Russell 1000 Value Index is beating the performance of the Russell 1000 Growth Index in 2016 by a margin of 2.9% (as of September 19th). I am clearly a proponent of value investing, as most of the strategies I follow on Validea are considered value oriented approaches and the models based on Ken Fisher, Ben Graham, Joseph Piotroski and David Dreman - all value methodologies - are on top so far this year in the Validea model portfolio system. The turn in value strategies is encouraging for many reasons.

The long drought for value stocks vs. growth over the last 10 years has most likely tested the commitment of many investors who subscribe to the value investing discipline. As may be expected, the performance of the two investment styles varies considerably based on the market environment. According to a report published by Bank of America/Merrill Lynch, "growth stocks, in general, have the potential to perform better when interest rates are falling and company earnings are rising. However, they may also be the first to be punished when the economy is cooling. Value stocks, often stocks of cyclical industries, may do well early in an economic recovery, but are typically more likely to lag in a sustained bull market."

Over the long term, however, statistics do indicate that value investing outpaces growth. Findings of another piece from Bank of America/Merrill Lynch show, "over a 90-year period, growth stocks returned an average of 12.6% annually since 1926. However, value stocks generated an average return of 17% per year over the same timeframe." Said Bank of America/Merrill Lynch chief investment strategist Michael Hartnett, "Value has outperformed Growth in roughly three out of every five years over this period." Value in most cases is determined by stocks trading at a low multiple based on earnings or assets. Ratios like the price-to-earnings multiple or price-to-book are two of the more popular metrics used to identify value stocks.

When I first launched the model portfolio and developed the Hot List portfolio, I wanted to offer a model portfolio that rewarded value but that also had the ability to add in growth strategies to help offset some of the style risk. The Validea Hot List Portfolio contains both value and growth components, given that it is based on a proprietary system we have developed that combines all of the guru strategies on our site. Some of the gurus are growth-oriented, such as Martin Zweig, while others are value-centric, such as the father of value investing, Benjamin Graham. However, there is a value-tilt to the selection process for inclusion in the Hot List, and I believe this has played has played a big role in its significant outperformance over the broader market, particularly in initial period for the Hot List from 2003-2007, which was a period that was very good for value stocks. Since 2003, the Hot List Portfolio has returned 202.1%, outperforming the market by 88.2%, using its optimal monthly rebalancing period and 10 stock portfolio size. While the last few years haven't been stellar for the portfolio, it's the long term record through various market cycles that is statistically significant and that should be looked at when assessing the effectiveness of a strategy.

In addition to a bias toward the value style of investing, however, another key to the Hot List Portfolio's performance is momentum. Value investing is focused on buying companies on the cheap (based on earnings, assets, cash flow). However, as we have seen over the past few years, value can, and will, go through periods of poor performance as well and that can be challenging for investors trying to follow a value approach over the long term.

But fortunately for all of us, some of history's best stock-pickers have found that stocks with strong momentum, or relative strength, are often good bets to continue rising -- if they're still attractively valued.

In fact, one of the gurus I follow, James O'Shaughnessy, in his 1996 bestseller, What Works on Wall Street, discusses Relative Strength in detail in the chapter entitled, "Relative Price Strength: Winners Continue to Win." In this chapter, he presents numerous exhaustive studies of Relative Strength and his concluding advice is this: "unless financial ruin is your goal, avoid the biggest losers."

In a piece published on Investopedia, Michael Carr succinctly summaries O'Shaughnessy's work on value metrics and relative strength:

In What Works on Wall Street (1998), O'Shaughnessy tested more than 60 investment strategies involving various fundamental criteria. His results showed that some fundamental filters beat the stock market as a whole. His test period began with data from 1951 and ran through 1996. For this test, the portfolio consisted of the top 50 stocks determined by the criteria and was revised annually. A summary of these test results are below:

Strategy	Average Annualized Return without Relative Strength
Low P/E Ratio	11.18%
Low P/B Ratio	14.38%
Low P/S Ratio	15.42%
Market Average	14%

O'Shaughnessy also tested each of these filters with relative strength. The idea behind relative strength is to find the strongest stocks, or the ones that are going up the most in price. For these tests, O'Shaughnessy calculated relative strength by looking at the stocks' returns over the past year. Those with the greatest returns and the lowest fundamental valuations were selected for the portfolio. These results are shown below:

Strategy	Average Annualized Return without Relative Strength	Average Annualized Return with Relative Strength
Low P/E Ratio	11.18%	16.66%
Low P/B Ratio	14.38%	17.27%
Low P/S Ratio	15.42%	18.14%

The conclusion from these studies is that value investing works - and so does momentum investing. That is why combining the two factors makes for a viable strategy. Such a combination may prevent a value-only investor or a momentum-only investor from suffering through extended periods of underperformance. To the contrary, a multi-faceted methodology can lead to superior returns.

Investing isn't just about growth or value or momentum; it's about all of them. Each of my Guru Strategies uses a wide array of variables (the exception being the two-variable Joel Greenblatt-based model) to choose stocks. The guru strategies use a wide host of fundamental criteria, ranging from market cap to various earnings assessments to several different valuation metrics to analyses of debt levels, putting a company through a multi-faceted test.

The Hot List then goes a step further, looking for consensus from the gurus' strategies to find its favorite picks. As you've probably noticed, most of the Hot List constituents get approval from more than one of my models, which means that they have really made it through a gauntlet of fundamental investment criteria. To me, that's one of the biggest reasons the portfolio has fared so well over time. Fundamentals

matter in stock-picking -- and those fundamentals should be diverse, combining strategies that are value, growth and momentum. Investors that can take a long term view and focus on the fundamentals are putting the odds in their favor that they can beat the market.

The Truth about Forecasters

Excerpted from the November 18th, 2016 Validea Hot List

So back to our conversation about the "experts", while few were steadfast in their forecast of a Trump victory, on balance the outcome was a surprise to the American people and the vast majority of experts, reminiscent (albeit on a smaller scale) of how last summer's Brexit vote sparked a flood of uncertainty and confusion. In each case, slews of predictions ended up like candy from a busted pinata, triggering a feeding frenzy of second-guessing and back-peddling.

How could so many be so wrong?

If you were to pose the question to Philip Tetlock, he probably wouldn't raise an eyebrow. A professor at the Wharton School and author of multiple books on the science of prediction, Tetlock conducted a landmark seven-year study (detailed in his 2005 book Expert Political Judgement: How Good Is It? How Can We Know?) in which he analyzed over 80,000 predictions made by supposed experts and nonexperts regarding an array of political and economic events. The findings, as he explained to Money magazine in 2009, showed that expert forecasts "barely beat random guesses-the statistical equivalent of a dart-throwing chimp-and proved no better than predictions of reasonably well-read non-experts. Ironically, the more famous the expert, the less accurate his or her predictions tended to be."

Given the credibility-and ratings-bestowed upon media pundits and their views on economic and political issues, these findings may come as a surprise. The truth of the matter, according to Tetlock's research, is that 4 out of 5 times their predictions end up being wrong. On November 9th, Bloomberg's Barry Ritholtz put it this way: "I have written this too many times, but it bears repeating: Forecasters aren't very good at predicting the future. We have learned this about economists, market strategists and now political pollsters."

I first formed Validea in the late 1990s as a service to track the stock market recommendations of prime-time cognoscenti, and my experience supported Tetlock's general findings: The hit rate of "experts" was sub-par and lacked consistency from one period to the next. Someone might have a good quarter, but that didn't often continue for very long. What I found in creating my guru-based stock screens was that computer models are better predictors of future outcomes than most people. Says Ritholtz, "We know much less than we imagine. Our perceived expertise is wildly overstated and overrated."

Legendary investor Warren Buffett, one of the investment gurus that inspired my stock screening models, eschews any sort of predictions around what the stock market will do in the short term. In the Berkshire Hathaway 1994 annual report he wrote, "We will continue to ignore political and economic forecasts which are an expensive distraction for many investors and businessmen." Guru James O'Shaughnessy offers insights on human predictive ability in his book What Works on Wall Street, in which he cites evidence that human forecasters can't compete with statistical models.

A major factor contributing to man's predictive underperformance versus machine is the fact that people are emotional creatures. This element of the human condition leads to inconsistency in how we assess our world and, specifically, to investing-related situations and decisions. O'Shaughnessy explains that statistical models are consistent and, unlike humans, 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 have egos. They're not out to prove anything."

That's not to say that models always get it right-often they don't. In the stock market, however, perfection isn't necessary to make money. If you're right about a few more than half of your picks, you can earn solid returns. The Validea Hot List, for example, has an accuracy rate of nearly 54% since its inception in 2003

(meaning it has made money on 54% of picks), which has been enough to generate an average return of 8.6% versus 6% for the S&P 500.

Tetlock's findings aren't intended to unilaterally dismiss the prowess of experts, however. In a 2010 paper in the journal Critical Review he said, "Experts do not know nearly as much as they think they do, and they work hard to cover up mistakes, but they do still at least perform better than the general public." He considers the better forecasters to be "self-critical, eclectic thinkers" who are "willing to update their beliefs when faced with contrary evidence." When it comes to investing, we believe that the tenets of investing legends such as Warren Buffett, Peter Lynch and James O'Shaughnessy provide a strong foundation for our stock screening models-and our long-term results bear this out. We believe the best strategy is to stick with these tried-and-true approaches in a disciplined manner to ensure the best possible outcomes going forward.

Five Key Takeaways from Tetlock's Research on Forecasters

1. Most forecasters get it wrong more than they get it right.
2. Simple algorithms can produce more accurate results that humans.
3. Biases and emotions hurt human prediction accuracy while models are disciplined, unemotional and based on facts and figures.
4. The more famous the "expert" the less accurate the predictions tend to be.
5. While not always accurate, expert predictions still tend to be better than those of the general population.