THE BEST OF THE VALIDEA HOT LIST – 2017

HIGHLIGHTS OF THE TOP INVESTING COMMENTARY THROUGHOUT THE YEAR

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Why Value Investors Need "Mental Toughness"

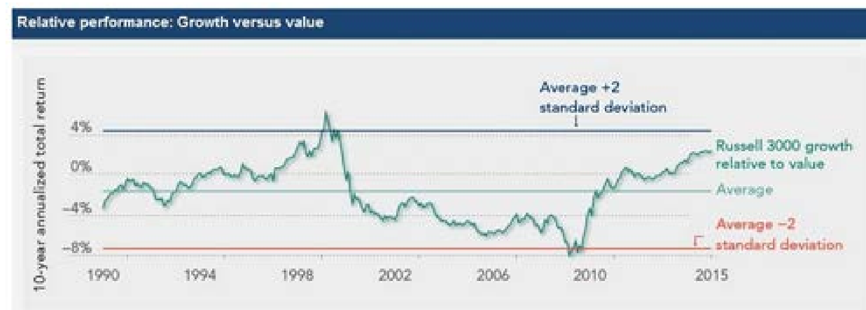
Excerpted from the February 10, 2017 Validea Hot List

If you watched the Super Bowl all the way to the very end, you would have seen a jubilant Tom Brady attribute the Patriot's win to the "mental toughness" the team had demonstrated all year- which, no doubt, came in handy when they entered the fourth quarter trailing the Falcons by ten points.

Unless we're talking about basis points, things would be pretty dismal for any investor entering the fourth quarter down by ten. But the idea of mental toughness applies to investing as well as to football, whether it be for a day, month, quarter or, for that matter, a year.

Value investing, particularly systematic value investing, is a perfect example of this. We know, based on research from Fama and French, that buying low valuation stocks can reap rewards over long periods of time. It is important to understand, however, that buying value stocks doesn't work all the time. Value stocks, as group, can go through lengthy periods of underperformance, and the investor with the *mental toughness to stick with the strategy* stands the best chance of coming out a winner.

The following graph shows the relative performance of growth and value stocks and reflects the cyclicality of their relative performance. Historically, growth stocks have often outperformed for extended periods, but value eventually rebounded and over most long periods of time value wins out. In the chart below, when the green line, which represents the Russell 3000 growth relative to value performance, is rising these are periods when growth is outpacing value (i.e. late 90s). When the green line is falling and below the average, value is winning. From around 2010 to the end of 2015, growth stocks had a long run over their value counterparts, and many investors buying low priced value stocks, and this includes many of our value models, saw their portfolios lag most major indices and portfolios with a growth stock bias. It was a tough 5 years to be a disciplined value investor.



For illustration only. Standard deviation measures variation around an average. Two standard deviations is the level that includes 95% of data points. Data based on the Russell 3000 Growth Index versus the Russell 3000 Value Index. ***Past performance is not a guarantee of future results.*** *Source: Morningstar.*

The Super Bowl, in fact, can be viewed as a microcosm of the investing world. Tom Brady and the New England Patriots have an impressive, long- term track record. During the first half of this year's game, however, the Atlanta Falcons played outstanding football while the Patriots performed poorly. But the Patriots kept their head in the game and remained focused on their strategy while filtering out the stadium noise. As a result, despite trailing the Falcons heading into the fourth quarter, the Patriots rebounded all the way to victory.

Sean Gavin, portfolio manager of Fidelity Value Discovery Fund, was quoted in a 2016 Forbes article as saying, "At times, value investors have to ride out periods of underperformance but, over the long term, value strategies have proven their ability to deliver performance for investors." While growth had been outperforming for years, the tables turned in 2016 and value stocks became the winners. In 2017 so far, growth is on top again but a long term value stock reversion is more likely than not given the performance of value vs. growth over the last few years.

According to Ben Johnson, co-author of the book Strategic Value Investing, "Successful value investing requires independent thought and going against the herd." That means tuning out the stadium noise and staying true to your strategy, even when things aren't going exactly the way you'd like them to in the near term.

It's not surprising that Johnson's book ended up on Warren Buffett's reading list for both the 2015 and 2016 Berkshire Hathaway annual meetings. Buffett, like Brady, is a legend in his game. By keeping a level head and sticking to his mantra of investing in fundamentally sound businesses at good prices, Buffett's been winning at the investing game for a very long time. A big factor in his success, however, is patience.

"No matter how great the talent or efforts," Buffett says, "some things just take time."

Buffett's View on Market Valuations

Excerpted from the March 24, 2017 Validea Hot List

A few weeks ago, Warren Buffett released his letter to Berkshire Hathaway shareholders, which was full of interesting facts, figures and insights. One of the many important takeaways was his view on the market's current valuation, which differs from that of many investors as we move ahead in this 8th year of the bull market.

In a CNBC interview that aired last month, Warren Buffett shared his thoughts on current market valuations and how he would respond to investors that feel they missed their opportunity to buy into the market. "Well, I would say they don't know, and I don't know. And if there's a game it's very good to be in for the rest of your life, the idea to stay out of it because you think you know when to enter it -- is a terrible mistake."

Buffett believes the U.S. stock market is a good game to be in. In fact, the dominant theme of his 2016 letter to Berkshire shareholders (which was released immediately prior to the interview) is the unwavering belief that America continues to be the best bet around. "This country," he declares, "always comes back and wins. We have not lost the secret sauce.

The investing legend's eternal optimism extends to what many regard as a swollen market teetering on the edge of correction. This contrasts with Nobel Laureate Robert Shiller's argument, shared in a recent Bloomberg interview, that the CAPE ratio, then at 29, is a "bad sign." Shiller says, "This could be like 1997, when the CAPE was at 29 and held on for 10 years, but it doesn't look good." In 1997, he explains, "the country didn't have the hope it has now." The president, he says, "dominates our attention."

Earlier this month, Ritholtz Wealth Management's Ben Carlson wrote that the CAPE reached 30, an event that occurred two other times since 1871 and, in each case, was followed by stock market "doom." Carlson points out, however, that a sample size of two events is "far too few to draw conclusions about what is going to happen this time around." Every cycle, he says, is different in its optics; interest rates, inflation and general economic and political conditions are unique and can lead to widely different market reactions and outcomes. "Valuations alone," the article asserts, "can't force the market to crash and mean reversion doesn't run on a schedule, but investors need to be aware of the potential risks in the market from current levels."

According to Buffett, "We're not in bubble territory or anything of the sort." For him, the crux of investing remains in the companies themselves, not in the value the market places on them. His belief that stocks represent a good value notwithstanding current valuation levels is built on the comparison of earnings yield against the 10-year Treasury bond. "Measured against interest rates," Buffett argues, "stocks actually are on the cheap side compared to historic valuations -- I would say this, if the ten-year stays at 2.3% and would stay there for ten years, you would regret very much not having bought stocks now."

Since owning a share of stock equates to owning a small part of a company, Buffett focuses on

earnings yield to evaluate the return he will receive on an investment (the assumption being that a company's management won't distribute all earnings through dividends).

Earnings yield is calculated as follows:

Earnings Yield: (Annual Earnings Per Share / Market Price) X 100

The lower the stock price is in relation to its earnings, the higher the earnings yield-- which is actually the inverse of the P/E ratio -- and the calculation can be applied to individual stocks and the market as a whole. When the yield of the market index is higher than that of the 10-year Treasury bond, stocks can be considered as undervalued in comparison to bonds, a prime investing scenario for Buffett. The current median P/E of all stocks tracked by Validea is 23.4, implying a 4.3% earnings yield. The chart below shows the 10-year Treasury bond vs. the market's earnings yield (using the median P/E in the Validea database). As you can see, the earnings yield has been coming down as valuations have been going up. In March of 2009, based on our own internal figures, the market has an implied earnings yield of 8.8%, using the median P/E, while the 10 year was trading at 2.8%. For a small period of time, the earnings yield on the market was 3x that of the ten year yield, which signaled an excellent buying opportunity.

So what's the takeaway -- while stocks may not look cheap based on most traditional measures their value relative to the alternatives suggest that they still may hold promise for investors.

As Buffett so astutely points out during the interview, "The ten-year bond is selling at 40 times

earnings. And it's not going to grow. And if you can buy some business that earns high returns on equity and has even got mild growth prospects, you know, at much lower multiple earnings, you are going to do better than buying ten-year bonds at 2.3% or 30-year bonds at three, or something of the sort. But that's been true for quite a while."

James O'Shaughnessy's Warning Against Headline Investing

Excerpted from the April 21, 2017 Validea Hot List

James O'Shaughnessy is an investment guru who sticks to the numbers, focusing on cold, hard facts and steering clear of hype and glamor when evaluating opportunities. He casts aside subjective factors such as analysts' reports, economic trends and media reports that can lead to emotional (and ill-advised) investment decisions--a strategy that has been highly successful over the long term. By conducting one of the most in-depth quantitative stock market studies in history, O'Shaughnessy was able to back-test dozens of stock-picking approaches over a period spanning more than four decades (from the early 1950s to the mid-1990s). Using this data, O'Shaughnessy constructed a "United Cornerstone" strategy, a combination of both a growth and a value approach. Together, these approaches averaged a compound return of 17.1% from 1954 through 1996 (compared to the S&P 500's 11.5% during that period) while maintaining relatively low levels of risk. Each strategy starts with a simple market capitalization screen: The Value model looks for bigger stocks (market cap of over $1 billion) while the Growth model allows smaller companies (market cap of at least $150 million) to screen out illiquid shares. Both models also look at the number of shares outstanding (preferring numbers exceeding the market mean) and target healthy cash flow. Other key metrics include price-sales ratio, which O'Shaughnessy considers one of the best indications of value, and dividend yield.

Today, Connecticut-based O'Shaughnessy Asset Management oversees approximately $5.3 billion in assets. Since its inception in 2003, our portfolio based on O'Shaughnessy's investment strategy has returned 213.2%, outperforming the market by 79%. In 2016, this portfolio returned 19.8% versus 9.5% for the S&P 500.

During a recent talk at Google, the legendary investor told a cautionary stock market tale.

The story centered around his highly-intelligent, "switched-on" friend Art, who would become extremely reactive when the market rose, call O'Shaughnessy and instruct him to go "all in" on his most aggressive strategy-one which would have done well over the prior several years. O'Shaughnessy (founder of the asset management firm bearing his name) would advise his friend against the move, but to no avail. At which point, O'Shaughnessy recalled, "I would hang up the phone, get on the speaker so that everyone in the office could hear and say, 'We've just called a market top.'"

Art became a bellwether, a contrary indicator supporting the notion that, when it comes to investing, going against the herd mentality is a more prudent course. O'Shaughnessy, author of the stock market tome What Works on Wall Street, underscored the unfortunate yet predictable outcome of his friend's approach, who applied his knee-jerk tack only with" his own investments, not those he made for his children. "Five to seven years later, " O'Shaughnessy asserted, "the kids were much richer."

While not unusual, the tale of "Art the Contrary Indicator" rarely ends well. Emotional investing

will get you into trouble since, typically, by the time you want to buy in most of the easy gains have been made and, conversely, once you decide to sell most of the damage has been done. "We just can't help ourselves," says O'Shaughnessy. Human nature, he argues, leads us to predict, a tendency difficult to overcome and a recipe for trouble when shopping for stocks. It also conditions us to bolt when faced with fear or uncertainty. Back when the writing was literally on the wall, "the guy who ran away from the rustling bush," argues O'Shaughnessy, was the one who survived and continued to evolve.

When it comes to buying stocks, it is essential for investors to value process over outcome, to understand the concrete facts about the stocks that they (or their fund manager) are choosing to purchase and the basis for their appeal. Underlying fundamentals, not headlines, lead to good investing decisions.

"We live in a world where people believe more in possibilities than in probabilities," O'Shaughnessy told his audience. For an investor, probability is the more meaningful aspect. And to properly evaluate it, says the guru investor, "you want to see a lot of data."

https://www.youtube.com/watch?v=w9x09O-csEY

Why Disciplined Investment Strategies are Best

Excerpted from the October 6, 2017 Validea Hot List

Imagine a scenario in which you're unsure about directions, so you ask a friend if you could follow him in your car. He happily agrees, then tells you to turn right a mile before he does.

In some ways, talk about strategies to protect investors from "black swan" events-negative occurrences that lead to significant market declines--is similarly puzzling. The term, popularized in a 2007 best-selling book by scholar and risk analyst Nassim Nicholas Taleb, is derived from the once widespread but misguided belief that all swans are white. Rare, black swans are an ominous signal. For investors, black swan events have included the dot.com crash of 2000, the financial crisis of 2008, Black Monday (August 2015), and the Fukushima nuclear disaster of 2011.

But while there were certainly known forces at work leading up to each devastating event, the timing and scope of any one of them would have been impossible to predict.

This goes directly against human instinct to try to predict things, specifically, bad things. In a Collaborative Fund article earlier this year, Morgan Housel explains, "Hearing the world is going to hell is more interesting than forecasting that things will gradually get better over time, even if the latter is accurate for most people most of the time."

Billionaire investing legend Warren Buffett's investment philosophy is firmly rooted in the notion that investors should resist this human urge to predict catastrophe and guard against fear-based, knee-jerk reactions of any kind. In his opinion, this is an emotional attempt at market timing -- that is, moving in and out of markets based on what you *think might happen.*

Explaining his philosophy in the wake of the 2008 financial crisis, Buffett explained, "If I had owned 100% of a solid business with good long-term prospects, it would have been foolish for me to even consider dumping it. So why would I have sold my stocks that were small participations in wonderful businesses? True, any one of them might eventually disappoint, but as a group they were certain to do well."

Still, not all investors have the iron will and deep pockets Buffett has to withstand a black swan event, which is why strategies to help investors hedge the risk, such as hedge funds, rose in popularity in the aftermath of the crisis. Lately, hedge funds have fallen out of favor. The present bull market has seen a long stretch with nary a black swan in sight, and active managers until recently were having a tough time keeping up with the market.

But some fear that factors including today's stretched market valuations make a black swan more likely. Even if that's true, however, it doesn't necessarily mean that an investment strategy designed to protect an investor from a future black swan event will end up doing its job. Ben Carlson of Ritholtz Wealth Management offered a particularly keen perspective on the post-crisis investor's desire for "insurance" against a black swan event in a 2014 blog:

"In the aftermath of the crash, the fund industry took full advantage of the change in sentiment and rolled out a host of new funds that were supposed to help investors if there was another downturn -- long/short funds, tail-risk strategies, absolute return funds, option hedging strategies, tactical asset allocation funds and the like. Investors poured money into these funds with a heavy dose of hindsight bias by allowing the recent past to shape their investment decisions. Those who piled into these funds missed the idea completely. They were trying to plan

ahead for uncertain events that could surprise everyone. Of course, this is impossible, because you can't hedge out the risks of unknown events ... they're unknown after all."

It may be easy to look back, now, eight years into a bull market, and make judgments about strategies that look to capitalize on black swan events given how poorly many have performed. However, the key lesson for investors is that the markets are never completely black and white and no strategy will always be the winning approach (as we've seen on Validea the models we run come in and out of favor every few years). Trying to time, or predict, the end of the current bull market, start of a bear market, beginning of a bull market or some exogenous and unforeseen event should be left to those who claim to be better equipped to make such predictions, as foolhardy as they may seem. The better plan is to find strategies that you understand, are built on long term track records, such as the the fundamental guru strategies we run here, are aligned with your risk tolerance, that you can stick with even if the markets don't deal you a good hand. In the end, investing with this mindset is better than betting too much on seeing a rare black swan that may not ever fly into view.

Your portfolio's success depends on these two decisions

Excerpted from the December 1, 2017 Validea Hot List

The flood of investor money into passive funds and strategies would seem to suggest that people have given up trying to pick their own stocks or even professional managers to find ways to beat the market. Investing in an index takes all the hard work out of investment decision-making. There's no need to make up spreadsheets comparing price to book ratios or long-term EPS trends; no need to scour annual reports for nuggets of information. An investor can just set it and forget it.

And yet the most important decisions investors make are far more fundamental than that. As my partner Jack Forehand wrote recently, an investor's two critical decisions are asset allocation and consistency. Get these two right, with realistic expectations, and success will follow.

Broadly speaking, asset allocation, more than the choice of individual stocks or securities, is what determines the outcome over the long-run. If you take all active and passive funds together, they will match the return of the asset class they track before fees, and this is the case with stocks as well as bonds. Once you accept that, it becomes clear that the way to change performance outcomes is to change the allocation mix between assets.

Investors who are all in on the major stock indexes may be overexposed to a handful of large-cap tech stocks that have dominated the markets this year. Since the S&P 500 and the Dow Jones industrial average are market-cap weighted, they tend to favor the biggest companies. An investor who is paying mind to asset allocation will ideally work to reduce this risk of overexposure by allocating some money to other asset classes or geographies.

In the same way allocation helps control for risk. Investors with longer-term goals can afford the greater risk associated with higher weightings to stocks, while those who need the money in the near-term would be better off avoiding stocks. This is where setting realistic goals kicks in.

Once an investor settles on the asset allocation that is going to achieve the pre-determined goals, the next big decision is to stick with that plan. Behavioral science has demonstrated how difficult this is for investors.

In any financial decision big or small - from daily finances to saving for retirement - emotions, personal biases and lack of discipline are generally thought to be the investor's worst enemy.

One of this year's Nobel Prize winners, Richard Thaler, has devoted his life's work to studying this phenomenon. A common mistake is what he calls the "hot hand fallacy," which is when people think that what is happening now will continue to happen in the future, like a gambler on a lucky streak or a house flipper in 2007. Another mistake is what he calls the "endowment effect", when an investor places a greater value on what he holds than what he doesn't. People suffering from the endowment effect have the tendency to hold a stock too long, hoping it will come back.

Passive investing removes a lot of the emotion from the equation, but the investor still has to embrace the strategy over the long haul, through ups and downs, in order to maximize performance. There is a direct correlation between how often investors check their accounts and their ability to stick with their strategies and not make changes. Not surprisingly, the more they check, the worse they do.

At Validea we began building stock screening model portfolios in 2003 that took their cues from the strategies of great investors like Warren Buffett, Peter Lynch and Benjamin Graham. The models are quantitative and focus on fundamental criteria, and the portfolios are rebalanced on a fixed-interval basis. When it comes time to rebalance, stocks are run through the screen and either held or replaced with higher scoring names. This takes the emotion out of the process.

For most investors, performance in the stock market can be maximized by putting money into low-cost passive funds, but for the select few that want to aim for above market performance, disciplined investment models like the ones we run on Validea present the opportunity for above average long term returns by investing in only the very best stocks from the very best strategies. But in either case, the true measure of an investor's success in either active or passive is whether they stick to their strategies. Eliminating emotion from the decision-making process will bring investors a long way to achieving their goals.

Pick a Star? Or Develop a Process?

Excerpted from the December 15, 2017 Validea Hot List

Wall Street has a solid tradition of star money managers falling from grace as market forces outrun their ability to predict the next big winner. As we know, it's difficult to draw a direct relationship between skill and outcome, especially in investing. Even the best managers will underperform for a period of time during their careers, usually coinciding with buoyant markets, such as we see today. Winners are measured in decades, not months.

We tend to base our choices on the events of the recent past, assuming what works will continue to work and assigning the blame when things fail to forces other than ourselves. Ben Carlson of Ritholz Wealth Management has written about this phenomenon: "When we have success in our lives we tend to attribute that success to skill or hard work. When something goes wrong and we fail, we attribute it to bad luck." When choosing an asset manager, therefore, it might seem reasonable to make a decision based on a firm's track record and return history. But that isn't always the case.

Even experts have trouble predicting outcomes, according to research a decade ago by Wharton School professor Philip Tetlock. He discovered experts could explain only 20 percent of the variability of the outcomes in their own predictions. The more famous the expert, in fact, the less accurate the prediction.

Human bias causes stock pickers to fall short sometimes because they let emotion get the better of them. They can be overconfident and make inconsistent judgments. They can be short-sighted and ignore information that doesn't fit their narratives.

To highlight the problems with humans trying to predict the market, consider how often forces have defied expectations this year. The stock markets have hit dozens of record highs. The dollar is down as are Treasury yields and inflation is falling below even the Fed's own target.

Behavioral finance experts make the point that investing is rife with the illusion of skill, namely an investor's inflated confidence in his own ability to choose winning stocks. Nobel Laureate Daniel Kahneman has even argued that much of the investment industry is built on such an illusion

That's not to say that all forecasts are wrong. But even when a forecaster is correct, there's a good chance the underlying assumptions didn't include everything that influenced the outcome. That's right, there are "unknown unknowns" that gum up the process, too.

If there's no way to get around the complexities of prediction -- no way to completely answer or understand what is not known -- the best course of action is to stick to what is known, quantifiable and concrete. The known knowns.

This is why at Validea we have designed portfolios based on quantitative stock screening models that take the emotion out of investing and help us avoid buying or selling equities at the worst possible times. The models track the strategies of successful investors such as Warren Buffett, Peter Lynch and Benjamin Graham, who made their fortunes investing in strong companies with sustainable operations. By removing hunches from the selection process, the models are able to identify stable businesses with strong fundamentals based on data, the types of companies that will withstand the ups and downs of the market over the long-term.

So, instead of luck or skill, investors should focus on process - developing goals and then creating a clearly defined strategy to go about achieving them without straying. We created models that evaluate stocks systematically by sorting through market data and selecting names in a highly disciplined, consistent and repeatable way.

Our models use the following metrics:

- **Debt:** since high leverage can put a strain on cash flow and make earnings figures misleading.
- **Price-to-Book Ratio:** While our various guru models might define book value slightly differently from each other, the basic idea is always to determine the true value of a business.
- **Return-on-Equity:** While there is no single, sure-fire way to ascertain whether or not a company has what Warren Buffett calls "durable competitive advantage," companies that do have this distinction share a fundamental strength in return-on-equity.
- **Relative Strength:** This measures the price performance of a stock against the market as a whole. The higher the relative strength, the better the stock is performing relative to other stocks.

By focusing on known metrics and removing hunches from the process, we are minimizing the effect of unknowns on investment portfolios. Whether you're lucky or smart, a well-constructed investment process might be your best chance at generating returns above the market over time.