THE BEST OF THE VALIDEA HOT LIST – 2018

HIGHLIGHTS OF THE TOP INVESTING COMMENTARY THROUGHOUT THE YEAR

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Lessons from Buffett's Annual Letter

Excerpted from the March 9, 2018 Validea Hot List

Warren Buffett's annual letter to shareholders is an opportunity for investors to remind themselves of some valuable lessons, even if this year's letter didn't provide any secret insights into an eventual successor to the Oracle of Omaha.

Berkshire Hathaway is still sitting on a greater than $100 billion cash pile, unable to find great buys at a "sensible purchase price," Buffett wrote. The company even backed away from a couple of situations last year, including its well-advertised attempt to buy Texas power distributor Oncor Electric after a bidding war erupted. He's not even going on a shopping spree with the $29 billion windfall Berkshire is getting as a result of new U.S. tax laws.

Buffett's annual letter, much like Berkshire's annual shareholder meeting, is a closely watched event among Wall Street professionals as well as with regular investors, so it is usually combed through for pearls of wisdom. Buffett talks about the four "building blocks" of Berkshire: big stand-alone acquisitions, acquisitions that fit into businesses they already own, internal sales growth and investment gains on Berkshire's big stock portfolio.

While Buffett might be most famous as a stock investor in companies like Coca-Cola, Kraft and Wells Fargo, it is Berkshire's deal engine that generates a lot of interest on Wall Street.

With regard to deals, Berkshire approaches a purchase on an all equity basis, meaning they don't consider using debt to make a deal. Buffett prefers to wait instead, knowing eventually the price will be right, or it will never get there and he hasn't wasted his money. Higher valuations mean lower returns. But an investor's goal is to maximize returns given the risks. Lower valuations, on the other hand, create room for better returns in the future. This same lesson can be applied to stock investing for those who are cautious and stick to their strategies.

Buffett also is not one of those CEOs who like to pretend his stock has always been a positive story. There is a chart in his annual letter that shows the worst four periods, including three when the stock was off by more than 47%. Buffett admits his aversion to leverage had cut into Berkshire's long-term returns, but he also says debt can be a bad risk. "It is insane to risk what you have and need in order to obtain what you don't need." That might be a lesson to short-sellers of stock, who have to borrow it to sell with the hope it'll fall in value and the loan can be repaid with money left over. It could also be a warning to investors using margin accounts.

As Buffett puts it: "Even if your borrowings are small and your positions aren't immediately threatened by the plunging market, your mind may well become rattled by scary headlines and breathless commentary. And an unsettled mind will not make good decisions."

Part of his letter this year talks about a decade-old bet he made with a sophisticated hedge fund that an investment in a low-cost unmanaged S&P-tracking index found could outperform the high-fee smart money. Buffett was right. His main point is that investment fees cost investors far more than they realize and that often the best course of action is to just find the lowest-cost, broadest index you can and stick with it.

That is also the reason Buffett says investors don't have to have access to the smartest minds on Wall Street to do well and achieve their goals. They just need to be able to avoid mob mentality, resist the urge to chase the hottest trend, and stick to their tried and true fundamentals. And he advocates a set-it-and-forget-it approach. "Stick with big 'easy' decisions and eschew activity."

Buffett also looks at risk differently. As a long-term investor, the brief market turmoil we saw in early February shouldn't really matter. Investors are giving up current consumption for greater consumption down the road, with risk being the possibility this goal won't be reached. Stocks are risky in the short term, but over decades, a well-diversified portfolio becomes less risky than bonds.

Investors would be well-served by taking a conservative and realistic view of their own future returns and by following an investment strategy that works for them, versus being influenced by something from the outside or brought into an investment that doesn't fit their style.

What Gambling Can Teach Us About Process

Excerpted from the May 4, 2018 Validea Hot List

Many of us fall back on superstition when we want a good outcome. On game day, an athlete will eat the same breakfast as any other game day, put on those "lucky" socks, and follow other routines to ensure a victory. Deviating from the ritual could mean defeat.

Gamblers often have a similar process. They will always pick their "lucky" number in red on the roulette wheel, for example. Or they will abandon the blackjack dealer who seems to have the hot hand. They will choose a slot machine based on the type of fruit on its spinning wheel or based on a hunch about how it "feels."

Sometimes the athlete and the gambler are successful, confirming these processes. It could be that such rituals are soothing and boost confidence, leading to a better athletic performance. A string of successful guesses by a gambler likewise boosts confidence that the secret decision-making process is working. They are likely to keep trying their luck.

But as we all know, lucky socks aren't going to stay that way long-term, and a hot hand is going to cool, eventually. Statistically speaking, gambling in a casino skews in favor of the house, no matter how lucky individuals appear to be at any given moment. A process based on lucky socks and hunches, not grounded in fundamental analysis and hard numbers, can't produce consistent wins over the long-term.

In his book Money Ball, the author Michael Lewis describes how the Oakland A's baseball team tried its hand at using statistical analysis to build a winning club. Rather than relying on the opinion of scouts who identified promising athletes based on speed and contact (RBIs and home runs), they started looking at on-paper metrics such as on-base percentage and slugging percentage, which they believed were better indicators of future success. And those attributes were less expensive to obtain. Eventually the A's were able to build a team that was able to keep up with the likes of the New York Yankees and their nine-digit payroll.

The A's didn't get immediate results, but they had a process that made sense and gave them an edge. While a gambler working on a hunch might have a burst of success, the A's using a systematic approach to analyzing talent were much more likely to be successful long-term.

One of the biggest mistakes investors make is valuing outcome over process, particularly giving significant weight to outcomes over short periods of time. When an investment manager does well over one, three, or five-year periods, investors flock to them and their assets under management rise. Most investors don't take the time to understand why managers achieved those results and whether that can be repeated in the future.

Jim O'Shaughnessy, the author of "What Works on Wall Street" and founder of his own asset management firm, boils successful investing down into a few rules. First, a full market cycle is more than five years. Second, between three and five years, the factors investors have to

evaluate managers are being clouded by some signals and noise. And it gets worse the shorter the time frame. Shorter than one year, and an investor is getting all noise.

In other words, an addiction to short-term market news is like making decisions on noise alone.

Noise refers to data that is not predictive of the future. Signal refers to data that is. What O'Shaughnessy is saying is that performance over periods less than five years tell you very little about whether an investment strategy is going to work going forward. As performance periods get longer, the predictive power rises and the weight you can give to the outcome relative to the process rises as well, but process is always key regardless of time frame.

A good process should have a few important characteristics. First, historical data should be able to demonstrate that it works over long periods of time. Also, it should have a logic behind it that holds up to scrutiny, and the inputs should relate to the outputs. It's the difference between picking a winning racehorse based on the color and pattern of the jockey's silks, rather than the skill of the jockey and the abilities of the horse.

In addition, the manager should show discipline in following the process despite the inevitable ups and downs of the market. Strategies will go in and out of favor. And, perhaps the most important point, the process should demonstrate that it is repeatable.

In 20 years at Validea, we have been developing strategies based on the factors followed by investing greats like Warren Buffett, Benjamin Graham and Peter Lynch. These investing greats did the work in fundamental research that led them to success, and our computer-generated models track these same fundamental strategies.

The key to success is ignoring the latest fad or hot stock and finding a strategy that speaks to your goals and risk tolerance and then sticking with it. At any one time, it could be outperforming or underperforming, but the investors who understand the benefits of a process based not on hunches but on consistency and data will find success over the long-term.

Common Mistakes in Factor Investing

Excerpted from the June 29, 2018 Validea Hot List

Most investors hate admitting mistakes, but those are often the most valuable lessons.

Even the world's savviest of investors make them, for starters. Michael Batnick chronicled them and their lessons in his new book "Big Mistakes: The Best Investors and Their Worse Investments." In it, he writes about Benjamin Graham, Warren Buffett, Chris Sacca and Stanley Druckenmiller, arguably among the greatest of all time.

Graham lost 70% of his money during the Crash of 1929 and Great Depression. Buffett paid for a company that no longer exists with stock that is now worth $7 billion. Sacca passed on investing in Dropbox and Snap. Druckenmiller bought tech stocks during the bubble.

Not surprisingly, these gurus spend a lot of time ruminating over their failures. More so than over their successes.

That's human nature. It's easier to assume your success comes from your own ability. Failure? That's bad luck or other outside circumstances beyond our control. This mindset can be damaging for an investor because it glosses over the opportunity to learn from those mistakes. Own it, and perhaps the same thing won't happen in the future.

Qualitative and factor-based investing would seem to be the logical answer for investors who want to avoid making mistakes. The truth is in the numbers. Computers don't have impulses, so the results should be less prone to bias. But that isn't always the case. There are still plenty of ways to make errors.

1. Believing the past is bound to repeat itself.

Factor investing is a way to boost returns by focusing on nuances, and the idea is that your odds of outperforming increase by relying on one or more factors in your portfolio. But the problem is factors, like other strategies, can run out of gas. What has worked before with one set of variables stops working or deviates. And there's no telling when or if it will recover.

Take a look at one of the tenets of value investing: Price to book. Despite decades of success and plenty of research supporting it as an indicator of value, in the current market, price to book as an indicator has failed. Corey Hoffstein of Newfound Research found that the factor hasn't established new highs in over a decade, and many investors no longer consider it to be a valid stand-alone factor. O'Shaughnessy Asset Management concluded that changes to accounting rules have made it a less valuable measurement of value.

So here's the first lesson: What has worked in the past is not 100% predictive of future success, something investors need to know and embrace.

2. Performance doesn't always match with an investor's goals.

There's that saying that the market can remain irrational for longer than you can stay solvent. Investors may gravitate to proven long-term strategies, but they need to consider the time horizon. Price to book, it has been shown, is successful but over more than a half century, longer

than many investors are actively investing. Are you able to wait that long? Or are your investments made with different goals in mind? Retirement portfolios may be able to withstand short-term underperformance, considering they need to be invested over many decades. But a down payment for a house or an account for a child's college education have far shorter shelf lives. Investors picking factors have to have complete buy-in. Many believe they do when they start out; many realize they don't have the stamina after a period of underperformance.

3. Factor investing isn't free of emotion or bias.

Computers may make things easier, but there are still decisions humans have to make. One of them is coding the computer. A human has to pick what factor to follow, or even the mix of factors. Some factors have a better track record, and it's up to human judgment to find the ones that are going to sustain that performance or even turn around from a period of underperformance. Statistics can deceive. And circumstances, like accounting rule changes, can alter the trajectory. Even the best investors need to use their human reasoning to recognize where they went wrong. Buffett steered clear of technology stocks for years and admits he missed out. He has recently embraced Apple stock. Factor investing can eliminate bad decisions but it isn't perfect.

Following a disciplined, replicable strategy with consistency can eliminate a lot of mistakes but not all of them. It can increase your odds of success if you are realistic about your goals.

At Validea, we use investment strategies inspired by some of history's most successful investors, including Graham, Buffett, Peter Lynch and Ken Fisher. These strategies are built on key fundamental and financial characteristics that help identify good buy prospects.

But no strategy will beat the market every month or even every year. If that's your goal, you might end up just jumping from strategy to strategy chasing returns or the hottest stocks. This is a recipe for buying high and selling low.

It's easy to get swept up in an exciting story surrounding a stock (and buy it) or get consumed by a negative story (and sell it). But doing so without first taking a look at the numbers can lead to ill-fated actions. Good investors don't let hype influence their decisions.

By taking a step back to find perspective and by staying focused on what matters and adhering to a sound investment process, you can help avoid many of the mistakes that get investors in trouble.

Mentally Preparing For, but Not Predicting, the Next Bear Market

Excerpted from the July 13, 2018 Validea Hot List

Hoping for the best but preparing for the worst is a good rule-of-thumb, a maxim that can help us stay measured and mindful when it comes to dealing with life's inevitable ups and downs. But it can be hard to think about potential downs when the ups have been around for a while--and the current, nearly nine-year-old bull market is a perfect example of that.

Since March of 2009, the S&P 500, including dividends, is up over 350% as of this writing, and if the current run is sustained until August of this year, it will be the longest bull market in the history of the index. But nothing lasts forever, and the stock market is no exception -- which highlights how crucial it is for investors to resist complacency and maintain a realistic perspective.

Here's some perspective to consider: If you were to look at the day-to-day undulations in equity prices, you would see that stocks are positive just a little over half the time. In a 2016 article, Ben Carlson of Ritholtz Wealth Management wrote, "Stocks don't make new highs every single day, so most of the time you're going to be underwater from your portfolio's high-water mark. This means there are plenty of chances to be in a state of regret when investing in stocks." He points out that the last 90 years have seen bear markets almost one-quarter of the time. Half the time, he added, "you're down 5% or worse. It's difficult to appreciate this fact when looking at a long-term log scale stock chart that seems to only go up and to the right."

The table below, courtesy of Yardeni Research, shows both corrections and bear markets (the text in red) going back to 1928.

S&P 500 Corrections & Bear Markets Since 1928

Table 2: S&P 500 Corrections & Bear Markets Since 1928*

Peak Date	Trough Date	Peak Price	Trough Price	Percent Loss	Number of Days**
5/14/1928	6/12/1928	20.44	18.34	-10.3	29
9/7/1929	11/13/1929	31.92	17.66	-44.7	67
4/10/1930	6/1/1932	25.92	4.40	-83.0	783
9/7/1932	2/27/1933	9.31	5.53	-40.6	173
7/18/1933	10/21/1933	12.20	8.57	-29.8	95
2/6/1934	3/14/1935	11.82	8.06	-31.8	401
4/6/1936	4/29/1936	15.51	13.53	-12.8	23
3/6/1937	3/31/1938	18.68	8.50	-54.5	390
11/9/1938	4/8/1939	13.79	10.18	-26.2	150
10/25/1939	6/10/1940	13.21	8.99	-31.9	229
11/9/1940	4/28/1942	11.40	7.47	-34.5	535
7/14/1943	11/29/1943	12.64	10.99	-13.1	138
2/5/1946	2/26/1946	18.70	16.81	-10.1	21
5/29/1946	10/9/1946	19.25	14.12	-26.6	133
2/11/1947	5/19/1947	16.14	13.77	-14.7	97
7/24/1947	2/14/1948	16.12	13.84	-14.1	205
6/15/1948	6/13/1949	17.06	13.55	-20.6	363
6/12/1950	7/17/1950	19.40	16.68	-14.0	35
1/5/1953	9/14/1953	26.66	22.71	-14.8	252
9/23/1955	10/11/1955	45.63	40.80	-10.6	18
8/2/1956	2/12/1957	49.74	42.39	-14.8	194
7/15/1957	10/22/1957	49.13	38.98	-20.7	99
8/3/1959	9/28/1960	60.71	52.48	-13.6	422
12/12/1961	6/26/1962	72.64	52.32	-28.0	196
8/22/1962	10/23/1962	59.78	53.49	-10.5	62
2/9/1966	10/7/1966	94.06	73.20	-22.2	240
9/25/1967	3/5/1968	97.59	87.72	-10.1	162
11/29/1968	5/26/1970	108.37	69.29	-36.1	543
4/28/1971	11/23/1971	104.77	90.16	-13.9	209
1/11/1973	10/3/1974	120.24	62.28	-48.2	630
11/7/1974	12/6/1974	75.21	65.01	-13.6	29
7/15/1975	9/16/1975	95.61	82.09	-14.1	63
9/21/1976	3/6/1978	107.83	86.90	-19.4	531
9/12/1978	11/14/1978	106.99	92.49	-13.6	63
10/5/1979	11/7/1979	111.27	99.87	-10.2	33
2/13/1980	3/27/1980	118.44	98.22	-17.1	43
11/28/1980	8/12/1982	140.52	102.42	-27.1	622
10/10/1983	7/24/1984	172.65	147.82	-14.4	288
8/25/1987	12/4/1987	336.77	223.92	-33.5	101
1/2/1990	1/30/1990	359.69	322.98	-10.2	28
7/16/1990	10/11/1990	368.95	295.46	-19.9	87
10/7/1997	10/27/1997	983.12	876.99	-10.8	20
7/17/1998	8/31/1998	1186.75	957.28	-19.3	45
7/16/1999	10/15/1999	1418.78	1247.41	-12.1	91
3/24/2000	10/9/2002	1527.46	776.76	-49.1	929
11/27/2002	3/11/2003	938.87	800.73	-14.7	104
10/9/2007	3/9/2009	1565.15	676.53	-56.8	517
4/23/2010	7/2/2010	1217.28	1022.58	-16.0	70
4/29/2011	10/3/2011	1363.61	1099.23	-19.4	157
5/21/2015	8/25/2015	2130.82	1867.61	-12.4	96
11/3/2015	2/11/2016	2109.79	1829.08	-13.3	100
1/26/2018	2/8/2018	2872.87	2581.00	-10.2	13

* Corrections are declines of 10% or more. Bear markets are declines of 20% or more (highlighted in red).
** Number of days includes weekends and holidays.

But knowing that a bear is laying somewhere in the weeds doesn't help an investor pinpoint when or where it will rear its head. That's not to say that signs of change cannot be identified -- recent research by Morgan Stanley analyzed S&P 500 trends since 1950 to identify patterns that might signal market change in the offing -- but such cues are not foolproof.

Signs that Market Change is Coming

Here are a few of the patterns that emerged from the Morgan Stanley study:

A widening of credit spreads, the research shows, provides a bearish market signal 3-12 months in advance, with government bonds (on average) peaking about 3 months before the S&P 500.

Global equities tend to rise steeply heading into a bear market, with emerging market shares rallying the most dramatically.

Rising bond yields, "largely because of the bull market macroeconomic backdrop that spurs growth and inflation." The research shows that U.S. 10-year Treasury yields have tended to rise by more than 100 basis points in the 12 months before a market peak.

A surge in commodities: The Morgan Stanley report says that crude oil, gold and copper have all historically witnessed double-digit increases in the 12 months before a bear market.

Signals, however, don't offer a crystal ball. There is no sure-fire way to know, or to predict, the coming of a bear market, and trying to guess can end up being a costly exercise. It's very tough to identify a market "top", for instance, and most people end up panicking and selling once stocks have already fallen heavily (when they should be buying). Moreover, even those fortunate enough to get out before a bear market hits are often too frightened to get back in to take advantage of a rebound.

Bear Market Tool Box

Instead of trying to predict when a downturn will happen, why not prepare for it? One of the best ways to do so is to establish an investment strategy aligned with your risk tolerance and financial goals--then stick with it.

Here are some things investors can do to prepare for the next downturn.

Know your risk tolerance. Think carefully about how much risk you can live with. It's easy to say you have thick investor skin when the markets are continuing to climb. The reality is, it's never pleasant to watch your hard-earned savings drop in value. To determine your risk tolerance, it's important to take into account the stage of your investing life, so to speak. For example, a Millennial might be inherently more risk tolerant than a Baby Boomer by virtue of their longer runway to retirement.

Set goals. Map out an investment plan that takes your goals into account, both on a short-term and long-term basis. For example, money you'll need in the short term (and therefore can't afford to lose) should be invested more conservatively. Money you won't be needing in the next five or more years, on the other hand, could be in more volatile assets offering potentially higher returns.

By investing in the mix of assets that best aligns with goals and risk tolerance, investors can increase their chances of ensuring gains in bull markets and enduring any losses that will occur in bear market periods.

Keep emotions out of the investment equation. It's a mistake to focus on market turbulence, news headlines, and the declarations of market pundits. That will only lead to emotionally-driven trades, which can be costly. Once you've established your investment goals and strategy, stick to both. That's the best defense against inevitable ups and downs.

It's been a great 9+ years for most U.S. stock investors, and market trends can continue longer than most people think. This bull market could have years left in it -- no one knows. But, one thing is certain and that is another bear market will come someday and it will be painful, scary and most likely appear out of nowhere. Investors who understand that bear markets come, and

go, and plan in advance and prepare mentally will be the ones who come out ahead in the long run.

Knowing when your investment process has failed

Excerpted from the August 24, 2018 Validea Hot List

There's a paradox in investing where a flawed process can work in the short term but a well-considered process will break down. The trick is in figuring out whether your process is truly flawed or only temporarily held back by fleeting circumstances. And there does come a time when you may have to shift gears because a once successful process is no longer working.

We can look to the sports world for inspiration. Baseball is a game of statistics. Four years ago, the Houston Astros baseball team was a disaster. In 2013 it lost a franchise-record 111 games, the third straight 100-loss year. Veteran players were cut loose so the team could rebuild. Fans stopped going to games, and the ones who did booed the team. For the nicknamed "Lastros," it seemed hopeless.

But the Astros had a plan. In 2014, they managed to break their 100-loss streak going 70-92. The following year they made the playoffs for the first time in a decade and beat the New York Yankees in the wild card game. Last year they won the World Series.

This seemingly random set of events - driven by pure luck, perhaps - was anything but. Exchanging the expensive veterans for unpredictable, but cheap, rookies was not a blind gamble. The team's new management was going off historical evidence to build a process.

It would take an agonizing (for the fans) amount of time to pay off, but the point is they stuck to their conviction even through the tough times, resisting the temptation to abandon the plan when the fans stopped cheering and the criticism mounted.

This is an important lesson for investors. Process is more important than outcome, and we can see this over the long-term. But there is no guarantee that a process will work under all conditions all of the time. While it's wise to find a process you can believe in and stick to it through the normal ups and downs of a market, it's important to take a step back and reexamine whether the process might need some adjustments or whether a new process is needed.

Here are some things to think about when making that decision:

1. Your process should have data that backs it up. This is the proof that shows you have a well-thought out plan that isn't going to be compromised by human emotion. Value and momentum investing are based on factors that don't change over time. Index investing can point to the index itself over time. Picking stocks based on the flavor of the month or what a prominent hedge fund manager is doing doesn't have the data to support it. So, ask yourself if your process makes sense and whether you have the data to prove it.

The best data goes back for decades. Some trends can last half a decade or longer, so data that only goes back 3 or 5 years wouldn't necessarily screen them out. Value investing has been out of favor for the last decade, and people who developed a strategy based only on that time frame would miss out on the relative outperformance of value investing going back nearly a century. Relying on the short term data would lead to an incorrect conclusion and a flawed process. This is why understanding the strategy is important. It should be designed with sound economic and

financial principals that affect a company's value and performance. Otherwise it's more likely luck that determined the outcome.

2. Is the outcome within the expected parameters? We know markets go through ups and downs. Strategies flow in and out of favor, and for some, the out-of-favor periods can last a painfully long time. But that doesn't mean they aren't sound strategies. We can look and see that value investing has waxed and waned over the decades and come out on top. You would expect this going in. If your expectations aren't met, it is worth it to reevaluate your investment process.

3. Are Things Really Different This Time? It has been said that the belief that things are different this time is one of the most dangerous things in investing. But the belief that things are never different can be equally as dangerous. Sometime things change. Sometimes what has worked historically doesn't anymore. Identifying those situations is incredibly tricky.

The price/book ratio has been a reliable indicator of value supported by copious amounts of long-term data. And it goes in and out of favor. So it meets the first two of our criteria set forth above. But we have transformed from an economy dominated by old-line companies that make things with equipment to high-tech companies that have few tangible assets and a lot of intangibles. Intangible assets are not reflected in the price/book ratio. It could be time to rethink using the ratio or replacing it with other measures of value.

The more important point is that sometimes things do change and those changes warrant a thoughtful review of your investment strategy. The fact that your process is supported by long-term data is not a guarantee it will continue to work.

In the end, there is no magic bullet that identifies when an investment process has failed. There is also no way to say whether other teams who adopt a similar process to the Astros will achieve the same result. Statistically speaking, the amount of time it would take to say for sure that a process no longer works is often longer than the period we have to evaluate it. As a result, there will always be a large element of judgement that goes into the decision.

Like most decisions, though, it is important to have a framework to analyze the relevant results. That will provide the greatest chance to achieve the long-term outcome you desire.

A good process will be evidence-based, make sense, enforce discipline and be repeatable. At Validea we have developed a system that is fundamentally based and systematic, based on the approaches outlined by some of history's best investors. Using these techniques in a disciplined, unemotional manner can lead to long-term market outperformance, the ultimate goal for any investor.

Stay Skeptical About Sure-Thing Indicators

Excerpted from the November 2, 2018 Validea Hot List

If the last couple of weeks didn't make this obvious, headlines can cause investors to panic. Blips in the market can attract outsized coverage, and sustained declines or sharp reversals are often described in catastrophic terms. No one really pays attention when the market goes up 400 points. But when it falls by that much or more, and over successive days, it's almost certain the nightly news will cover it.

While the headlines and the stories may be important from a news perspective, they can be hazardous for investors, who are constantly searching for the next clue that will tell them what to do. If only there were a sure-fire way to know when to sell.

Enter the binary sell indicator. It's that magic tool that offers hope. It can help investors avoid corrections and bear markets and it can tell them precisely the moment to jump back in. Investing was never easier!

The problem, of course, is it doesn't exist.

In case you were wondering, here are a few indicators commonly discussed in the markets and why they don't really deliver what they promise:

1. Valuation

It's not lost on most investors that the markets have been on a tear for the last couple of years. Yale University's Robert Shiller, a Nobel prize winner, came up with a way of measuring the market's value, called the cyclically adjusted price to earnings ratio, or CAPE. It's generally used to see if stocks are over or under valued but its utility in predicting future returns is in question.

Valuations can be very good predictors of returns over the next decade, but they are useless for predicting short-term returns. To illustrate that, just think about the bull market of the late 90s and the one we are currently in. In both cases, valuations got very high, and stayed there for a long time. Investors trying to use those valuations to time the market missed substantial gains.

2. Trends

You may have heard the term "200-day moving average" in the last week or so as pundits talked about this indicator signaling something about the market after the indexes broke below it. Trend following can be successful. It calls for selling stocks when they fall below an average and buying them back when it moves back up. The idea is to avoid major market declines. But along the way you get a lot of false signals. When the S&P 500 breaks below its 200-day moving average, it produces gains more often than it produces losses. The strategy makes up for that fact through huge loss savings in bear markets. So a series of small incorrect signals are offset by a few very large correct ones.

3. Sentiment

When sentiment gets too positive it's a bad long-term sign for the market, much like when valuations get too rich. But that doesn't mean sentiment predicts the short-term. This has been explained by Nick Maggiulli of Ritholtz Wealth Management, who looked at investors' average allocation to equities over time and developed a strategy that moved into bonds when sentiment was too positive (investors had more than 70% of their portfolios in equities) and invested in stocks when sentiment was too negative (investors had less than 50% of their portfolios in equities). He found that strategy outperformed buy and hold by a wide margin. He also found that the portfolio would have been essentially impossible to follow for most investors. The model would have moved investors into bonds in September 1996, avoiding the dotcom bubble, but also missing years of gains. It wouldn't have moved back into stocks until October 2002, already well into the market's recovery. Maggiulli also notes that this indicator can stay negative for a long time before the market moves in a significant negative direction.

4. Yield curve

This one has been talked about relentlessly this year as the sure fire signal a recession is on the way. The yield curve simply describes the difference between the rates on long and short term government bonds. Ideally, long term bonds should have higher yields than short term ones. It makes lending profitable for banks among other benefits. But occasionally the short term rate will go higher than the long-term rate, and that's what's called an inverted yield curve. When this has happened in the past, recession has followed about a year to two years later.

But it's important to note it's a very different time now than in the past. The Federal Reserve is moving rates to normalized levels after a decade of being near zero to help the financial system lift itself out of the crisis. The yield curve might not have the relevance it once had as a recession prediction tool. A BMO study found that the stock market tends to do better than average when the yield curve is flattening. And even if the yield curve does invert, it doesn't give you much information about if and when the market will decline.

The stock market is going to have a significant decline at some point. We could be at the start of it now or it could still be years in the future. It is tempting to try to time when that decline will come, and simple indicators are often used to do it. Investing is far from simple, though, and short-term market timing is not a winning strategy. Some of the biggest mistakes investors make occur in trying to predict when the market will fall. Accepting that isn't possible may be one of the best things you can do for your portfolio.

Views on Behavior and Investing

Excerpted from the December 28, 2018 Validea Hot List

Humans approach investing with their own biases and behaviors than can hinder their success. The study of behavioral finance has blossomed in recent years as experts try to find ways to help investors overcome this natural tendency. What the discipline has discovered is that human behavior hurts investor returns more than other outside factors. People chase returns, they sell when they should buy and buy when they should sell, they follow the crowd without examining whether the crowd is right.

Validea's Jack Forehand recently interviewed the psychologist Daniel Crosby, who is the author of three books including The Behavioral Investor. Dr. Crosby recently became Brinker Capital's Chief Behavior Officer.

One of the difficult aspects of behavioral finance is measuring just how much an effect human behavior has on individual portfolios. The research varies on the subject, with some suggesting it cuts into returns by less than 1% a year and others suggesting it cuts 4% to 5% a year off performance. The way this is measured has also been the topic of considerable debate, simply because there are a variety of reasons investors act the way they do at any given time. Investors add money or withdraw from mutual funds for other than bad behavior, for example.

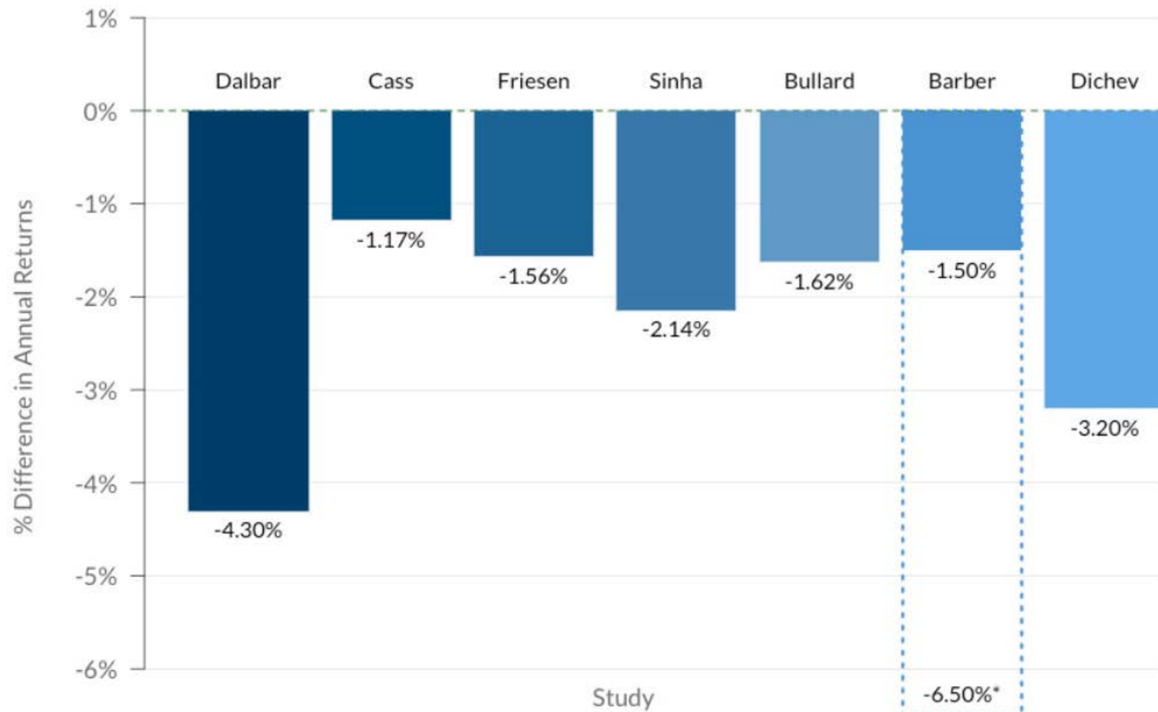
"Whether you think it's 1% or 4% (and I tend to think it's somewhere in the middle), we can all agree that fees, poor timing and improper product selection are at the heart of investor performance," Dr. Crosby told Validea.

His advice is to pay close attention to fees, diversify within and between asset classes, and perhaps most importantly, do less than you think you should do.

He notes that Morningstar found the best predictor of performance is fees. That may seem a little obvious. Paying too much to the fund for management eats into returns. An unwitting investor could easily give up 1% a year in fees and that would get us to the conservative end of the performance gap measures discussed above.

Diversification is another fail-safe for investors because it makes the risk of any one position less of a contributor to overall performance. When one investment is going bad, chances are other investments are balancing it out with good performance.

Dr. Crosby also noted the work of Meir Statman and others, who found that performance decreases with increased account activity, which underscores the importance of getting investors to stop trying to day trade their portfolios. This is the idea behind the so-called robo advisors, which are online brokerage accounts that encourage investors to put money into a mix of ETFs at regular intervals and then let the portfolios do all the work. One such firm, Betterment, recently estimated the behavior gap in the following chart:



Source: https://www.betterment.com/resources/betterments-quest-behavior-gap-zero/

All of the data and analysis in the field of behavioral finance hasn't put a stop to investors behaving against their best interests, though. Validea asked Dr. Crosby if he thought the problem was getting better or whether humans will always be limited in their ability to prevent this.

Dr. Crosby acknowledged that we might never fully eliminate the tendency of investors to make poor decisions. He calls it the "knowing-doing gap," the problem of accepting things that are difficult even if we know it's for the best. Smoking is an example of this. People know it's bad for health, and yet they don't quit. "Likewise, as investors get more and more information about the impact of their behavior, many will make better decisions, but there will always be a significant minority of the population that makes ill-advised decisions about their wealth, simply because it's emotionally expedient," he explained.

Advisors often have a rough time with this because clients refuse to stay the course and panic during rough times. It's not always easy to spot this behavior in new clients, either, despite questionnaires and other ways to measure a new client's risk tolerance. Many advisors focus on what clients would do in worst-case scenarios and at dollar terms instead of percentages. Validea

asked Dr. Crosby if he had seen any better methods used by advisors to assess this client risk before it presents itself.

One of the things behavioral finance experts know is that humans tend to project the recent past into the present. A client who has recently lived through 5 years of 15% annualized gains is likely to expect that in the near future, as well. Obviously the reality would leave that client somewhat disappointed. Advisors who spend a lot of time managing realistic expectations are the ones with the most success at client relations during bad times. Some experience with market downturns also helps advance an advisor's understanding of how to relate to clients. "Advisors need to work with their clients to give them as visceral an understanding as possible of just how much bear markets can hurt," Dr. Crosby said.

Role playing using dollar figures can help gauge client reactions, he adds. It gives clients a feel for how volatile markets can be if they run through actual scenarios from the past.

Advisors can also be there to talk clients out of making bad decisions in the heat of the moment. "Education remains a weak predictor of good behavior and sometimes the only thing that will work is someone to reassure you that you're making the right choice in a moment of intense emotion," he said.

The aforementioned robo advisors may have a hand in reshaping investor behavior, particularly for the millennial generation they court. When Betterment started showing clients the tax ramifications of their decisions, it helped alter some behavior such as selling during down markets. But of course technology can't replace good old fashioned hand-holding in the event of a crisis. Validea asked Dr. Crosby what he thought about the ability of robo-advisors to change behavior.

Robo advisors have lowered fees in the industry, as have the ETF products they rely on to build their portfolios. What is still untested, because most of the robo advisors came to prominence in steadily upward moving markets, is what happens in a sustained downturn. There isn't any evidence yet of whether investors will continue to embrace the set-it-and-forget-it philosophy that made robo investing popular.

"I think that robo-advisors are wholly capable of figuring out who needs help and even providing them with research, nudges and advice around how best to proceed. What remains to be seen, since no robo has lived through a true bear market, is whether or not these nudges are as powerful as the personal admonition to stay the course from a trusted advisor," Dr. Crosby said.

That brings us to this idea of loss aversion. It's said that investors are more worried about losing money than they are about making money. That helps to explain why people panic at even the most temporary downturn, even if it's preceded by unprecedented gains. Nassim Taleb recently challenged the idea that loss aversion is irrational. He argued that since investors can't recover from losing all their money, it's perfectly rational to fear losses more than celebrating gains. Validea asked Dr. Crosby whether he thought this made sense.

In his recent book, The Behavioral Investor, Dr. Crosby wrote that one of the reasons homo sapiens flourished is we were more loss averse that some of the other species of humans. We were more scared of losing and quicker to up and leave at the sign of a threat. We were also more apt to prepare. But there are both rational and irrational ways this can manifest itself.

People, fearing a bad patch ahead, save for a rainy day and that's a good thing. But others, fearing any sort of loss, steer clear of the stock market in favor of "safer" alternatives. This group may fail to keep up with inflation and eventually be unable to reach retirement savings goals. "The trick thing about loss aversion is that our worst fears can materialize as a direct consequence of trying not to lose."

In volatile markets such as we've seen recently, it can be tempting to pull money out and sit on the sidelines or flee altogether. But at Validea we have designed a disciplined, systemic approach to investing that tries to remove as much human bias as possible and take the fear out of investing. Times like now require rational-minded, cool-headed analysis of the risks and opportunities that will come with the new year.