

VALIDEA.COM

# 2010 GURU PORTFOLIO PERFORMANCE REPORT

---

REVIEW AND ANALYSIS OF VALIDEA'S  
GURU-BASED MODEL PORTFOLIOS

4 BUCKINGHAM LANE  
WEST HARTFORD, CT 06117

# GURU PORTFOLIO PERFORMANCE REPORT

## REVIEW AND ANALYSIS OF VALIDEA'S GURU-BASED MODEL PORTFOLIOS

---

### 2010 MARKET OVERVIEW

---

Heading into 2010, a myriad of potential problems confronted the economy and stock market -- problems that had many pundits predicting a tough year, and many investors waiting on the sidelines. But despite growing debt woes in Europe, a burgeoning U.S. deficit, and an unemployment rate that remained stubbornly high, both the economy and stock market proved remarkably resilient.

On the economic side, Corporate America continued to recover from the "Great Recession", with manufacturing and industrial growth continuing to spur the rebound. The manufacturing sector expanded in every month of the year, in fact, according to the Institute for Supply Management. While the expansion slowed a bit in the middle of the year, it picked up again in the fall, rolling into 2011 with good momentum.

The American consumer also showed resilience. In December, retail and food service sales, which tumbled more than 11% in 2008, passed their pre-recession highs, according to the Census Department. U.S. consumers, who many pundits had pronounced dead, were back to spending like it was 2007 again, even though they'd decreased their household debt/disposable income ratio by about 15% since the start of the recession, and increased their savings rate from just over 2% of personal income to nearly 6%.<sup>12</sup>

Companies also started to put their big stockpiles of cash to work in 2010. According to Standard & Poor's, 255 of the companies in the S&P 500 upped their dividend payouts in 2010. That's about 100 more than did so in 2009. Firms in the index also have increased their share buybacks for five straight quarters, including a 128% increase in the third quarter of 2010 (vs. the year-ago quarter). And corporate buyouts were up 12% in 2010 vs. 2009, as companies spent nearly \$900 billion buying other companies.<sup>3</sup>

A big factor behind the improvement in Corporate America, and in the economy overall, was the government. With stimulus funding continuing to flow into system and interest rates remaining extremely low, government bodies made it clear that they were going to pull out all the stops in trying to promote growth and stabilize the economy. And they appear ready to continue that support in 2011, if the recent extension of the Bush-era tax cuts is any indication.

The economy's ability to shake off fears of a double-dip recession, the European debt crisis, and other concerns helped stocks post solid gains in 2010. After a mid-year correction, the market bounced back strong in the fall, and the S&P 500 ended the year with a 12.8% gain (not including dividends). Our Validea.com 10-stock portfolios fared even better. They on average returned 19.2%, more than 6 percentage points ahead of the S&P 500, with 10 of the 14 portfolios beating the S&P.

---

<sup>1</sup> *Household Debt Service and Financial Obligations Ratios*, The Federal Reserve Board. Data through Q3 2010.

<sup>2</sup> *Personal Saving Rate*, Bureau of Economic Analysis. Data through Q3 2010.

<sup>3</sup> Krantz, Matt. "Companies Stash More Cash as Profits Increase". *USAToday*, Jan. 4, 2011.

The Joseph Piotroski-inspired model was the top performer, gaining 55.9% and more than quadrupling the S&P's 12.8% return. Our worst performer was the John Neff-based portfolio, which gained 0.1%. (All portfolio figures do not include dividends.)

With 2010 now in the rearview mirror, here's a look at how some of our top-performing monthly rebalanced portfolios were able to find value in the market over the past year.

---

## TOP 2010 VALUE STRATEGIES

---

### The Joseph Piotroski Strategy

While many of the gurus upon whom I base my strategies are world-renowned investors, Piotroski remains unknown to most people. But his impact on the investing world has been significant. Back in 2000, while teaching at the University of Chicago's business school, Piotroski authored a paper entitled "Value Investing: The Use of Historical Financial Statement Information to Separate Winners from Losers". In it, he detailed a step-by-step, accounting-based method to buy and short stocks that produced a 23% annualized back-tested return from 1976-1996 -- more than double the S&P 500's return.

In 2010, the strategy also produced excellent returns for us. The 10-stock Piotroski-inspired portfolio gained nearly 56%, vs. 12.8% for the S&P 500.

The Piotroski method is a value approach that starts by taking companies in the market's top 20% based on book/market ratio (the same as the lowest 20% of stocks based on price/book ratio). These stocks are trading at a nice discount to the value of their underlying businesses.

Others had used the book/market ratio to find unloved firms, but Piotroski went a crucial step further. He understood that some high book/market companies were solid firms whose shares were unfairly beaten down or flying under the radar, while others were simply dogs. To separate the two, he used his accounting background, employing several balance sheet tests to further examine high book/market firms. For example, he looked for companies with positive returns on assets and cash flows from operations, and more cash from operations than net income (a sign that they weren't simply benefiting from a one-time earnings windfall).

Piotroski also wanted a company's numbers to be improving. He wanted a firm's ROA, current ratio, gross margin, and asset turnover all to be on the rise. And he wanted its long-term debt/assets ratio and number of shares outstanding to be steady or declining (new share offerings may mean a firm can't generate enough cash internally, Piotroski hypothesized).

The Piotroski method usually keys in on small stocks, since those are most likely to fly under the radar of investors. And in 2010, most of its biggest winners came from stocks with market capitalizations below \$2.5 billion. Some were stocks that the portfolio had picked up in 2009, like Petroleum Development Corporation, which it bought for \$11.00 a share on March 20, 2009, and sold for \$22.88 a share on Feb. 19 of this year. Others were stocks it picked up during the year, like Education Management Corp., which it snatched up on Sept. 3 and sold for a 71.0% profit on Nov. 26, and fashion apparel and home furnishing company Dillard's, which gained 49.0% while in the portfolio from July 9-Nov. 26.

The Piotroski-based portfolio offered a great lesson in patience and discipline in 2010. Coming into the year, it had been struggling. After doing very well in 2004, 2005, and 2006, it lagged the S&P by more than 8 percentage points in 2007. In 2008, it slightly outperformed the index, but still lost

more than 37%. And in 2009, it missed out on the big rebound, returning just 6.8% while the S&P gained 23.5%. Most investors probably would have bailed on a strategy that produced those returns. But in 2010, the Piotroski-based portfolio made up all the ground it had lost on the S&P, and then some. Sticking with a good strategy for the long term is something many of the gurus upon whom I base my strategies preached, and in 2010 those who exercised that type of discipline with the Piotroski strategy made out big-time.

### **The Benjamin Graham Strategy**

The Graham approach is based on the oldest strategy of all those that inspired my guru-based models, drawing on the stock-picking advice Graham laid out in his 1949 classic *The Intelligent Investor*. But the strategy once again proved timeless in 2010, with the 10-stock Graham-based portfolio gaining 22.6%. That left the portfolio as our best performer over the long term, having returned 211.6% since its July 15, 2003 inception. That's a 16.4% annualized return during a period in which the S&P 500 returned just 3.1% annualized.

The Graham model reflects the conservative approach that Graham -- called the "Father of Value Investing" -- used. Having lived first through his own family's financial woes and then through the Great Depression, Graham focused as much on preserving capital as he did on generating big gains. He thus used some rigorous balance sheet tests to assess a business in which he was looking to invest. For example, my Graham-based model requires that a company have a current ratio (that is, current assets/current liabilities) of at least 2.0, a sign of strong liquidity. It also requires that a firm's long-term debt be no greater than the value of its net current assets.

Those requirements helped the Graham approach find financially stable companies during the financial crisis, allowing it to minimize losses in what was a dreadful year for stocks. In 2009 and 2010, as fears subsided, the model's strict valuation metrics helped it target the best buys in a rejuvenated market. The strategy looks at a stock's price/earnings ratio using both trailing 12-month earnings and three-year average earnings; neither P/E can be greater than 15. It also requires that the product of a stock's P/E and price/book ratio be no greater than 22.

The Graham-based model found some big winners in a variety of areas in 2010. National-Oilwell Varco, which it had actually picked up in late October 2009, gained about 40% from the start of the year until the portfolio sold it in late November 2010. Aerospace & defense firm Triumph Group, which joined the portfolio in September 2009, gained nearly 50% from the start of 2010 until being sold in mid-April. It also made a 32.3% profit on retailer The Buckle, which it held for just one month, and a 42% profit on oil services firm Atwood Oceanics, which it bought in early September and held through the end of the year.

### **The David Dreman Strategy**

Most of the investors upon whom I base my strategies have a contrarian streak. But if you could say that one is the "most" contrarian, it may well be Dreman, who made a very successful career out of finding hidden gems among the market's dregs.

In 2010, the Dreman-based portfolio continued to build on its solid long-term performance, and it did so by picking up some strong stocks from unloved industries. It scored big gains on investment firm American Capital Ltd (+33.9%), and two pharmaceutical companies -- AstraZeneca PLC (+24.4%), and OSI Pharmaceuticals, which soared 78% while in the portfolio from Nov. 27 of 2009 to March 19 of 2010, as the company became the subject of takeover reports. (It was later acquired

by Japanese drugmaker Astellas Pharma.) Those picks helped the portfolio gain 23.1% for the year, tying it with the O'Shaughnessy-based portfolio for the #2 spot among my individual guru-based portfolios.

From its July 2003 inception through the end of 2010, the Dreman portfolio returned 89.6%. That's just shy of 9% annualized, nearly tripling the S&P 500's meager 3.1% annualized return over that period.

The portfolio has posted those returns with a two-part strategy. The first part identifies the market's most unloved stocks by comparing share price to earnings, cash flow, dividend payout, and book value.

Of course, sometimes a stock is unloved for good reason -- everyone knows it's a dog. Because of that, the second part of the Dreman-based approach involves applying a variety of financial and fundamental tests to contrarian stocks, looking at returns on equity, profit margins, recent earnings results, and the debt/equity ratio. By using these tests, the strategy separates good stocks that are being unfairly beaten down (usually because of overwrought fears, or, in some cases, apathy) from those that are being shunned for good reason.

---

## TOP 2010 GROWTH STRATEGIES

---

### The James O'Shaughnessy Strategy

Based on O'Shaughnessy's *What Works on Wall Street*, this portfolio actually employs two strategies, one growth-focused and the other value-focused. Depending on the market environment, the portfolio can thus be heavily weighted to the growth side, or heavily tilted to the value side.

In 2010, it was the growth strategy that drove the portfolio's returns. The combined 10-stock portfolio returned 23.1%; a separate 10-stock portfolio of only growth stocks picked using the model gained 23.6%, while another 10-stock portfolio of only value stocks picked with the strategy gained just 4.7%. Interestingly, that wide spread occurred despite the value portfolio being accurate -- i.e., making money -- on a higher percentage of its picks than the growth model, 63.8% to 58.5%.)

Growth stocks were, not surprisingly, the hybrid portfolio's biggest winners in 2010. Among them: Jos. A. Bank Clothiers (+34.6%) and Medicare benefits firm HealthSpring (+66.6%).

The O'Shaughnessy-based growth model looks for stocks with market caps of at least \$250 million, to screen out those that are too illiquid for most investors. Rather than looking at magnitude of earnings growth, it looks for persistence -- earnings per share must have increased in each year of the most recent five-year period, without regard to magnitude.

While the approach is a growth model, it also includes a key value component: the price/sales ratio. O'Shaughnessy found that this metric was a better predictor of future success than the more popular price/earnings ratio. He teamed it with another key variable, relative strength (my model uses a stock's relative strength over the past 12 months). By keying on stocks with low P/S ratios and high RS scores, the strategy thus find stocks that are being embraced by the market, but which haven't gotten too pricey.

The O'Shaughnessy-based value model, meanwhile, looks for larger stocks -- sales must be at least 1.5 times the market mean, and the number of shares outstanding must be greater than the market average. It also wants firms that have cash flows per share greater than the market mean, and which have high dividend yields.

### **The Motley Fool Strategy**

Based on the writings of brothers Tom and David Gardner, creators of The Motley Fool investment newsletters and web site, the Fool-based strategy continued a rather remarkable run in 2010. While no strategy will beat the market every year, the 10-stock Fool-inspired portfolio has done so in each year so far since its mid-2003 inception -- and it's done so by at least 6 percentage points. In 2010, it turned in another stellar year, returning 19.2%.

My Fool-based strategy is based on the Gardners' *Motley Fool Investment Guide: How the Fools Beat Wall Street's Wise Men and How You Can Too*. The approach centers on finding the stocks of small, fast-growing companies that have solid fundamentals. Healthy profit margins, low debt, strong cash flows, and good research and development budgets are all important to the strategy, which also uses the P/E/Growth ratio to help avoid fast-growing but overpriced stocks.

In 2010, the Fool-based portfolio found some big-time winners among smaller stocks. Among its best finds: Canadian yoga and athletic apparel company lululemon athletica, which it actually picked up in late 2009. Lululemon remained in the portfolio for all of 2010, surging about 130% for the year.

Another big winner was MIPS Technologies, which makes processor architectures and cores used in home entertainment, communications, networking and portable multimedia products. The portfolio picked up MIPS on Oct. 1, and through the end of the year it had jumped about 55% on the strength of new earnings and revenue guidance figures that topped expectations.

The Fool-based strategy also found big winners in emerging market stocks, including China MediaExpress Holdings, which jumped 57% during a three-month stint in the portfolio; Argentina's Banco Macro, which gained 58% from July 9 through the end of the year; and Mercadolibre, another Argentinian firm, which gained 35% from mid-May through year-end.

While the portfolio has no doubt been helped by the relative outperformance of smaller stocks over the past decade, its rigorous fundamental and financial tests have really helped it find the sort of picks that have left the broader market in the dust. As of year-end, the Fool portfolio was our second-best performing individual guru portfolio over the long term. From its July 15, 2003 inception through year-end, it was up 199.8%, or 15.8% annualized. The S&P 500 returned just 3.1% annualized over the same period.

### **The Martin Zweig Strategy**

After two years of underperformance, the Zweig-inspired portfolio bounced back nicely in 2010. It gained 19.7% for the year, easily beating the S&P 500's 12.8% return.

The Zweig strategy targets stocks whose Price/Earnings ratios aren't too high or too low (Zweig believed a very low P/E wasn't necessarily a sign of a bargain, but potentially a sign of a weak company). It is heavily focused on earnings, looking for companies that have posted several years of strong profits that have been accelerating of late. In addition, it looks for companies that are generating profit growth without excessive use of leverage, targeting firms with debt/equity ratios

that are lower than their industry average. The strategy is thus something of a "conservative growth investor" approach.

In 2010, the strategy found winners in a number of areas -- in fact, it made money on 63.8% of its picks, the third-highest of any of our 10-stock portfolios. Among the biggest winners: Medicare-focused healthcare firm HealthSpring, which jumped more than 60% during a six-and-a-half month stint in the portfolio, and footwear and apparel maker Deckers Outdoor Corporation, which gained about 59% in the same period. The Zweig portfolio also found a big winner in lululemon athletica, whose shares surged more than 33% from Aug. 6 to Nov. 26.

The strong 2010 performance built on the Zweig-inspired portfolio's solid long-term track record. Since its July 2003 inception, the portfolio has gained 88.4%, or 8.9% annualized. That nearly triples the S&P 500's 3.1% annualized return over the same period.

---

## 2010 CONSENSUS STRATEGIES

---

### **The Top 5 Gurus Strategy**

Our second-best performer in 2010, the Top 5 Gurus Portfolio gained 31.0% for the year. It was the second straight year the portfolio more than doubled the S&P 500's return (it jumped 55.3% in 2009), and the seventh time in eight years (including the partial 2003 year) that it beat the benchmark index.

The Top 5 Gurus approach takes the five strategies that have the best historical risk-adjusted performance and selects each of those models' two highest-rated stocks. In 2010, it found some stocks that made big gains while in the portfolio for relatively short periods. VirnetX Holding Corp., which makes software that secures real-time communications over the Internet, gained 71.4% from Sept. 3-Oct. 1, for example, while Education Management Corp. jumped 71.0% from Sept. 3-Nov. 26. China Yuchai International gained almost 70% from Oct. 1 through year-end.

The Top 5 Gurus Portfolio's impressive 2010 performance helped make it our third-best performer over the long haul. From its July 15, 2003 inception through year-end, the portfolio gained 199.3%, or 15.8% annualized. The S&P 500 gained a total of 25.7%, or 3.1% annualized, over that span.

### **The Validea Hot List**

Our flagship portfolio followed up its stellar 2009 with a respectable performance in 2010, though it slightly lagged the S&P 500. The portfolio gained 12.0% for the year, trailing the index by 0.8 percentage points.

The Hot List is a consensus approach that identifies the top stocks in the market using a blend of all my individual Guru Strategies, giving more weight to those models that have had the best risk-adjusted historical results. By looking for overlap among these proven, diverse individual strategies, the Hot List limits the amount of risk that it's susceptible to should one particular approach go out of style for a period. And, by using a varied group of models that focus on a wide array of fundamentals, it is designed to pick only the most fundamentally sound stocks in the market.

A number of strong performers boosted returns this year, including HealthSpring Inc., a Medicare-focused health benefits company. The portfolio picked up the stock on May 14, when the market was in the early stages of its mid-year rough patch, and when concerns were still lingering about the impact of the healthcare bill on Medicare providers. Over the next six-and-a-half months, HealthSpring surged more than 60%, thanks in part to the firm increasing its 2010 guidance, and its acquisition of another Medicare-focused firm, Bravo Health.

Another big winner was Triumph Group, Inc., an aerospace and defense company whose shares surged 38% while in the portfolio from Feb. 19 to April 16. Triumph made two acquisitions while in the portfolio, purchasing Fabritech, Inc., which makes and repairs critical military rotary-wing platforms, and Vought Aircraft Industries, Inc.

Teen clothing retailer Aeropostale, meanwhile, gained 26% from the start of the year up until the portfolio sold it on July 9. (The portfolio picked up the stock again in late November, and it didn't fare as well, falling 8.4% through the end of the year.)

Other big winners in 2010 included pharma giant AstraZeneca PLC, which gained 24.4% from May 14-Aug. 6; discount store Dollar Tree, which gained 21.8% after the portfolio snatched it up on Sept. 3; and videogame giant GameStop, also picked up on Sept. 3, which jumped 20.4% through year-end.

Over the long term, the Hot List portfolio has left the market far behind. From its July 15, 2003 inception through year-end, the portfolio returned 169.9%, or 14.2% annualized. It has posted those strong numbers while the S&P 500 has returned just 3.1% annualized.

### **Looking Ahead**

As we move into 2011, there are a number of tailwinds pushing stocks forward. Despite fears that we'd fall into a double-dip recession, the economy has continued to rebound and enters the year with a good deal of momentum. The federal government's stimulus efforts, quantitative easing plans, and willingness to keep interest rates extremely low are a big part of that momentum, and the support should continue in some shape or form in 2011. Corporate America has also gotten leaner since the recession, and recent data has shown that hiring may, at long last, really be picking up.

There are, of course, some headwinds. The federal deficit must be dealt with at some point, as must state and municipal budgets, many of which are under great strain. And the housing market remains in a sort of limbo. None of those problems should come as a surprise, however, and they thus to a large degree should be baked into the stock market's current prices. Overall, the picture looks fairly bright as we head into the New Year.

Perhaps more importantly, there are signs that individual stock-picking will be critical in 2011. Stocks have moved with very high levels of correlation in the past few years, as investors moved in and out of the market based on the huge macroeconomic issues that dominated the financial world. But this fall, single stock correlations fell sharply, according to Barclays, dropping below their 10-year average, while correlation among sectors was about half what it was mid-year.<sup>4</sup>

The decline in correlations isn't surprising. The financial crisis was a landmark event, and the sweeping nature of it and its aftershocks caused investors to focus less on stock-specific data and

---

<sup>4</sup> Flood, Chris. "BarCap Predicts a Return to Stock Picking". *Financial Times*, Nov. 5, 2010.

more on stocks as an overall asset class. But as we get further and further from the crisis' epicenter and the macro climate stabilizes, it's likely that more and more investors will continue to shift their focus back to stock-specific fundamentals. While our guru-inspired portfolios have more than held their own over the past few macro-dominated years, that means they could be in for even better times in the coming year and over the long term.

(For the historical performance of all of Validea's models, please see the accompanying table on the next page.)

## VALIDEA'S MODEL PERFORMANCE CHART

10-Stock, Monthly Rebalanced Model Portfolios		Annual Portfolio Return (excluding dividends)								Risk
Portfolio	Based on Book by or About	2003	2004	2005	2006	2007	2008	2009	2010	Beta
<b>Value Investor</b>	Benjamin Graham	45.1%	21.5%	10.4%	26.0%	-8.1%	-14.1%	31.4%	22.6%	1.20
<b>Price/Sales Investor</b>	Kenneth Fisher	30.7%	26.0%	-2.7%	40.0%	19.1%	-36.9%	30.2%	20.2%	1.21
<b>Small-Cap Growth Investor</b>	Motley Fool	19.8%	22.5%	9.6%	22.2%	23.3%	-25.0%	38.5%	19.2%	1.10
<b>Growth Investor</b>	Martin Zweig	32.1%	54.8%	5.8%	17.3%	5.2%	-48.5%	14.3%	19.7%	1.06
<b>Contrarian Investor</b>	David Dreman	36.2%	30.0%	18.4%	34.3%	-12.0%	-54.9%	37.6%	23.1%	1.24
<b>Growth/Value Investor</b>	James P. O'Shaughnessy	51.6%	1.0%	22.4%	24.0%	-3.9%	-46.8%	32.0%	23.1%	1.00
<b>P/E/Growth Investor</b>	Peter Lynch	39.6%	34.7%	8.4%	23.3%	-13.5%	-43.4%	45.7%	14.1%	0.99
<b>Patient Investor</b>	Warren Buffett	2.0%	37.3%	-4.6%	16.5%	-12.2%	-39.8%	50.3%	6.3%	1.06
<b>Momentum Investor</b>	Validea	31.6%	5.9%	13.7%	-15.2%	37.0%	-45.0%	12.5%	9.1%	0.98
<b>Book/Market Investor</b>	Joseph Piotroski	N/A	39.9%	9.0%	17.9%	-4.9%	-37.3%	6.8%	55.9%	1.36
<b>Low PE Investor</b>	John Neff	N/A	21.2%	15.1%	22.3%	-1.9%	-48.4%	45.4%	0.1%	1.17
<b>Earnings Yield Investor</b>	Joel Greenblatt	N/A	N/A	-2.8%	14.4%	9.1%	-26.3%	63.1%	13.0%	1.02
<b>Validea Hot List</b>	Validea/Consensus Model	56.9%	23.5%	14.5%	28.5%	-11.6%	-35.0%	47.0%	12.0%	1.19
<b>Top Five Gurus</b>	Validea/Consensus Model	46.4%	29.5%	8.8%	-2.1%	5.5%	-31.0%	55.3%	31.0%	1.07
<b>S&amp;P 500</b>	N/A	11.1%	9.0%	3.0%	13.6%	3.5%	-38.5%	23.5%	12.8%	1.00

- All Models except for and Earnings Yield Investor, Book/Market Investor, Low PE Investor, Patient Investor portfolios began on July 15th, 2003. Inception Dates for: Earnings Yield Investor (12/2/2005), Book/Market Investor (2/27/2004), Low PE Investor (1/2/2004) and Patient Investor (12/5/2003)
- All Models based on 10-stock portfolios that are rebalanced monthly. Rebalancing occurs every 28 days and constructs an equally weighted portfolio.
- Validea Hot List and Top Five Guru Models are based on a blend of individual guru models.
- Returns do not include dividends or transaction costs.

The names of individual investment advisors (i.e., the 'gurus') appearing in this list and on Validea.com are for identification purposes of his methodology only, as derived by Validea.com from published sources, and are not intended to suggest or imply any affiliation with or endorsement or even agreement with our reports personally by such gurus, or any knowledge or approval by such persons of the content of our site. As with any investment strategy, there is potential for profit as well as the possibility of loss and investors may incur a loss despite a past history of gains. Results will vary with economic and market conditions. The information contained within this report and throughout Validea.com is not investment advice. Please consult a financial professional before investing.