Learn How to Analyze Stocks Using the Strategies of Buffett, Lynch, and Graham

John P. Reese, Founder and CEO

Equity Research: Validea.com

Asset Management: Validea Capital Management

Investment Blog: TheGuruInvestor.com

validea

VALIDEA | CAPITAL MANAGEMENT

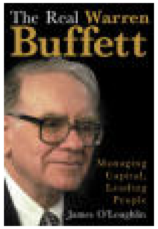
Goal of today's presentation

- Outline three quantitative investment strategies by highly successful gurus – Lynch, Buffett and Graham methods.
- Discuss an investment framework that can help you become a better investor.
- Look at a few investment ideas in real-time using Validea.com and analyze stocks that you're interested in.

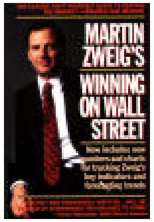
Who: At Validea we follow numerous guru strategies, including:

1. Peter Lynch
2. Ben Graham
3. Warren Buffett
4. Ken Fisher
5. David Dreman
6. Martin Zweig
7. James O'Shaughnessy
8. John Neff
9. William O'Neil
10. Joseph Piotroski
11. Joel Greenblatt









Why these “Gurus”? Three key factors.

- 1) developed a framework to select stocks that has delivered market outperformance
- 2) publicly disclosed these techniques either in books, academic papers or other sources
- 3) created a quantitative methodology that can be leveraged using a computer program

Let's look at the quantitative strategies of:

Peter Lynch

Peter Lynch – The Star "GARP" Manager

STEP 1 - Determining the Classification
1. EPS growth < 10% Slow-grower
2. EPS growth ≥ 10% and < 20% Stalwart
3. EPS growth ≥ 20% Fast-grower

STEP 2 – P/E/G Ratio (i.e. Fast Grower)
1. > 0 and ≤ 0.5 **Pass—Best case**
2. > 0.5 and ≤ 1 **Pass**
3. > 1 **Fail**

Methodology Example, Peter Lynch

STEP 3 – Change in Inventory-to-Sales
1. If a financial or service company Not applicable 2. Change in inventory/sales is negative **Pass—Best case** 3. Change in inventory/sales = 0 **Pass** 4. Change in inventory/sales is positive but ≤ 5% **Pass—Minimum** 5. Change in inventory/sales is positive and > 5 percentage points **Fail**

Methodology Example, Peter Lynch

STEP 4 – Total Debt to Equity
1. If a financial or service company N/A (See tests below for financial firms) 2. D/E < 30% **Pass—Best case** 3. D/E ≥ 30% and < 50% **Pass—Normal** 4. D/E ≥ 50% and < 80% **Pass—Mediocre** 5. D/E ≥ 80%, and firm is a utility **Pass** 6. D/E ≥ 80%, and firm is not a utility firm **Fail**
Note: if financial firm use Equity-to-Assets & ROA

Methodology Example, Peter Lynch

STEP 5 – P/E Ratio (i.e. Fast Grower)
1. Sales > $1 billion and PE ≤ 40 **Pass**
2. Sales > $1 billion and PE > 40 **Fail**
3. Sales ≤ $1 billion **N / A**

STEP 6 – EPS Growth (i.e. Fast Grower)
1. ≥ 20% and ≤ 25% **Pass—Best case**
2. > 25% and ≤ 50% **Pass**
3. > 50% **Fail**

Methodology Example, Peter Lynch

STEP 7 & 8 – Apply Bonus Criteria
1. Free Cash Flow Per Share to Current Price 2. Net Cash per Share-to-Current Price

Real Time Ideas & Analysis:

Lynch Portfolio & Picks

Let's look at the quantitative strategies of:

Warren Buffett

Warren Buffett – The "Greatest" Guru

STEP 1 – Buffett Type Company?
1. Nature of firm's business? 2. Ability to pass on costs? 3. Complexity of product / business model?
Note: this is qualitative analysis vs. quantitative.

Methodology Example, Warren Buffett

STEP 2 – Earning Predictability

1. Y1 ≥ Y2 ≥ Y3 ≥ Y4 ≥ Y5 ≥ Y6 ≥ Y7 ≥ Y8 ≥ Y9 ≥ Y10 (No years with a negative EPS.) **Pass-Best Case**

2. Y1 ≥ Y2 ≥ Y3 ≥ Y4 ≥ Y5 ≥ Y6 ≥ Y7 ≥ Y8 ≥ Y9 ≥ Y10 (except for dips from a prior year's earnings, that total no more than 45 percent). No years with a negative EPS. **Pass**

3. All other combinations **Fail**

Methodology Example, Warren Buffett

STEP 3 – Long Term Debt
1. ≤ 2 times earnings **Pass – Best case**
2. > 2 and ≤ 5 times earnings **Pass**
3. > 5 times earnings **Fail**

STEP 4 – Return on Equity
1. ≥ 15% **Pass**
2. < 15% **Fail**

STEP 5 – Return on Capital
1. ≥ 12% **Pass**
2. < 12% **Fail**

Methodology Example, Warren Buffett

STEP 6 – Capital Expenditures
1. $>$ 0 **Pass** 2. $\leq$ 0 **Fail**

STEP 7 – Utilization of Retained Earnings
1. $\geq$ 15% **Pass—Best case** 2. $\geq$ 12% and $<$ 15% **Pass** 3. $<$ 12% **Fail**

Methodology Example, Warren Buffett

IS THE PRICE RIGHT?

STEPS 8-15 – Calculate Expected Return

1. Calculate expected return w/ROE method.
2. Calculate expected return w/EPS method.
3. Take the average of the ROE and EPS methods to determine if return is in the acceptable range (**likes to see 15%**).

Real Time Ideas & Analysis:

Buffett Portfolio & Picks

Let's look at the quantitative strategies of:

Benjamin Graham

Ben Graham – The "Granddaddy" of the Gurus

STEP 1 – Sector & Sales Limis
1. All stocks (including public utilities) besides technology firms **Pass**
2. Technology stocks Fail
1. ≥ $340 million **Pass**
2. < $340 million **Fail**

STEP 2 – Current Ratio
1. Current ratio ≥ 2 **Pass**
2. Current ratio < 2, and company is a utility or telecom **Pass**
3. Current ratio < 2, and company is not utility or telecom **Fail**

Methodology Example, Ben Graham

STEP 3 – LT Debt in rel. to Net Cur. Assets
1. Long-term debt ≤ Net current assets **Pass** 2. Long-term debt > Net current assets **Fail**

STEP 4 – Long Term EPS Growth
1. ≥ 30%, and no negative annual EPS in last five years **Pass** 2. < 30% **Fail** 3. ≥ 30%, with negative annual EPS in any of last five years **Fail**

Methodology Example, Ben Graham

STEP 5 – Price-Earnings Ratio
1. $P/E \leq 15$ **Pass**
2. $P/E > 15$ **Fail**

STEP 6 – Price-Book Ratio
1. $P/B \times P/E \leq 22$ **Pass**
2. $P/B \times P/E > 22$ **Fail**

Methodology Example, Ben Graham

STEP 7 – Total Debt-Equity Ratio
1. Industrial companies—D/E ≤ 100% **Pass**
2. Utilities, phone companies, railroads—LTD/E ≤ 230% **Pass**
3. Industrial companies—D/E > 100% **Fail**
4. Utilities, phone companies, railroads—LTD/E > 230% **Fail**

Real Time Ideas & Analysis:

Graham Portfolio & Picks

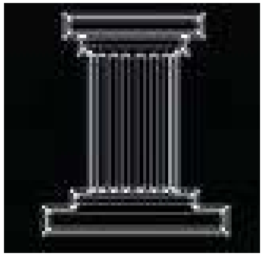
A look inside Validea and Validea Capital's Key Investment Pillars

Other Key Pillars In Strategy

- Monthly Rebalancing (opportunity cost of not selling & best performance)
- You need to stick to strategy for the long term
- Look for opportunities across all market segments
- Remove emotion from the equation
- Hold baskets of 10, 20 or 50 stocks
- Equally weighted portfolio – i.e. with a 20 stock model each holding accounts for 5% of portfolio

Rebalance
Long Term
All Cap
Emotion
Portfolio Construction

Redefining Long Term Investing



Rebalance
Long Term
All Cap
Emotion
Portfolio Construction

- Don’t have to hold onto stocks for the long term to be a long term investor – goes against conventional wisdom
- Hold onto the strategies for the long term not the stocks
- Buy and Hold strategies, in our testing, fail to produce the best returns

To Be Successful You Need To Stick To The Strategy, Even After Down Years

- Seminal Study by Joel Greenblatt in “The Little Book That Beats the Market”. Greenblattt is the founder of Gotham Capital

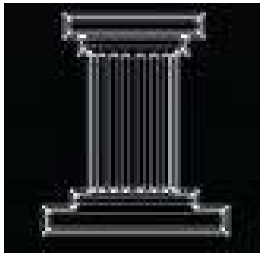
1 Year Period	**2 Year Period**	**3 Year Period**
Under-performed 25% of the time	**Under-performed 17% of the time**	**Outperformed 95% of the time**

Rebalance
Long Term
All Cap
Emotion
Portfolio Construction

Source: Joel Greenblatt, “The Little Book That Beats the Market” (John Wiley & Sons, Inc., 2006)

Behavioral Finance: Investor Biases

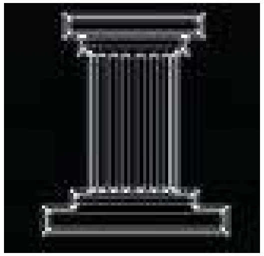
- **Over Optimism**: We are overoptimistic with our estimate of how we can do and to find good stocks.
- **Overconfidence**: Overconfident that your judgment is always right and creates and illusion of control and knowledge.
- **Recency** : Peoples tendency to give too much credence to their most recent, short term experience.
- **Loss Aversion**: Fear of losing money and subsequent inability to withstand short term events and maintain a long term perspective.



Rebalance
Long Term
All Cap
Emotion
Portfolio Construction

Portfolio Construction – equally weighted holdings and diversification

- 10, 20 or 50 Stocks depending on multiple factors like portfolio investment size and risk tolerance
- You can't beat the market by owning it
- Equally weighted shows optimal historical performance in the Validea system. Studies have shown equal weighting can generate outperformance over market cap weighted approaches.



Rebalance
Long Term
All Cap
Emotion
Portfolio Construction

Buffett Quote on Emotions & Discipline

"Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ…Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

"To invest successfully does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding the framework."

Warren Buffett, Chairman Berkshire Hathaway

- Rebalance
- Long Term
- All Cap
- **Emotion**
- Portfolio Construction

Key Lessons We have Learned that will help maximize Long Term Performance

- Understand the variables in the strategy. These have proven to be successful and predictive;
- Stick to the strategy through the ups and downs and over the long term;
- Examine and scan entire equity universe. Avoid looking at a few stocks at a time;
- Rebalance periodically (monthly, quarterly or annually) to ensure you are always holding the highest scoring stocks;
- Adhere to the strategy with the utmost discipline and remove emotion.

Contact Us

John Reese, Founder and CEO

Equity Research: www.validea.com

Asset Management: www.valideacapital.com

johnreese@validea.com

(800) 730.3457