



# Invest Using the Strategies of Wall Street Legends

Learn to Leverage the Proven Stock Selection Methodologies of Investing Greats

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## How do you pick stocks?

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- Who here has a strategy for stock selection?
- How many of you deviate from that strategy and let your emotion get the best of you?
- How many of you are unsure of what values you should look at (i.e. P/E ratio, EPS Growth or P/B) when evaluating a stock?
- For those who don't have a strategy is it because you don't know what strategy to follow?



# The Story Behind Validea.com & Validea Capital Management

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- MIT and Artificial Intelligence Research & Harvard Business School
- Sold first technology company and proceeded to invest in stocks
- Took computer and stock knowledge and combined them to found Validea
- Awarded two U.S. patents in area of Automated Stock Analysis



## Other Interesting Developments...

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- Authored the book “The Market Gurus: Stock Investing Strategies you can use from Wall Street’s Best”
- Columnist for Forbes.com and TheStreet.com. Former participant in MSN Money’s “Strategy Lab”
- Founded a capital management firm – Validea Capital Management, LLC.



# The Market Gurus

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- **Who** are the gurus...
- **Why** have they been selected...
- **What** do the winning strategies consist of...



## Underperforming is the norm

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- 90% of all professionals fail to outperform the market over long periods of time (10 or 15 years).
- Most professionals underperform by 1-2%, while individuals underperform by 2-3%
- Most experts are only right with their predictions 20% of the time\*

\*Source: "Ditch the Experts",  
Fortune, Feb. 6, 2006



But...

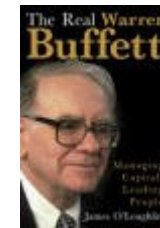
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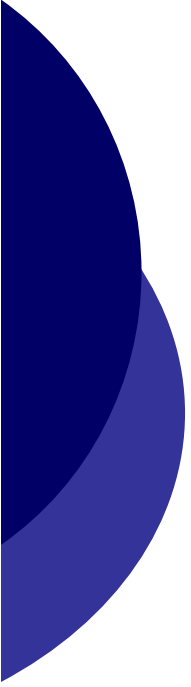
- There are a handful of investors who have proven, either through extensive back testing or real world results, that they can deliver returns that beat the pants off the market.
- What if you knew who these individuals were? Well, we do!

# Who: At Validea we follow numerous guru strategies:

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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





# Why: Most Have Long Term Market Outperformance – Real World or Back Tested

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<u>Guru</u>	<u>Performance</u>
Peter Lynch	29% p.a. for 13 years
Warren Buffett	24% p.a. for 32 years
Martin Zweig	Ranked #1 newsletter by Hulbert on risk-adj. basis for 15 years (15.9% p.a. over 15 years)
James O'Shaughnessy	Backtest Stats of 22% p.a. over 40 years
Joseph Piotroski	Backtest Stats of 23% p.a. over 20 years
David Dreman	16.6% over 11 years



## Why: Each one of these “gurus” has:

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- 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



# What: Multiple Quantitative Investing Strategies

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- Varying Styles - Value, Growth, GARP, Momentum, Small Cap
- Strategies can have anywhere from 5-15 unique criteria
- More than just screens – some of the strategies have aspects of artificial intelligence
- Each strategy selects a different set of securities that score highly based on different measurements



## Methodology Example, David Dreman

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### Key Investing Criteria:

- Look in the universe of the largest cap stocks (1500 largest companies)

### Look for a contrarian indication:

- Look for a low price-earnings (PE), price-cash flow (PCF), price-book (PB) and price-dividends (PD) ratios – bottom 20% of market

### Earnings and Financial Criteria:

- Look for an increasing earnings trend in past 2 quarters
- Look for EPS growth in the immediate past and projected future to beat market



## Dreman Methodology Example Cont...

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### Look at the financial ratios.

- Strong current ratio ( $>$  industry)
  - Lower payout ratio than its historical average
  - High return on equity (ROE) (top 33%)
- 
- Pretax profit margins ( $>8\%$ )
  - High dividend yield (at least 1% over market)
  - Low debt-equity (DE) ratio ( $<20\%$ )





Do the written strategies of legends  
still work today?

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Yes!

# Validea's Model Portfolios Based On Value Strategies - Large Excess Returns over S&P

Portfolio	Based On	Inception Date	Model Ret p.a.	S&P Ret p.a.	Excess Ret. p.a
Contrarian Investor	David Dreman	7/15/03	33.7%	10.2%	23.5%
Book/Market Investor	Joseph Piotroski	2/27/04	25.5%	7.1%	18.4%
Value Investor	Benjamin Graham	7/15/03	27.9%	10.2%	17.7%
Low PE Investor	John Neff	1/2/04	17.9%	7.9%	10.0%

Historical Beta Coefficient ranges from .90 to 1.13

p.a. = per annum

Source: Validea.com – Portfolio Performance (as of 10/31/2006)



# Validea's Model Portfolios Based On Growth & GARP Strategies - Large Excess Returns over S&P

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Portfolio	Based On	Inception Date	Model Ret p.a.	S&P Ret p.a.	Excess Ret. p.a
Growth Investor	Martin Zweig	7/15/03	33.5%	10.2%	23.3%
P/E Growth	Peter Lynch	7/15/03	28.3%	10.2%	18.1%
G/V Investor	J. O'Shaughnessy	7/15/03	25.5%	10.2%	15.3%

Historical Beta Coefficient ranges from 1.09 to 1.25

p.a. = per annum

Source: Validea.com – Portfolio Performance (as of 10/31/2006)

# Model Portfolios YTD 2006 (10/31/06) Performance – Validea.com

Rebalancing  
Period:

Monthly

Portfolio Size:

10 Stocks

Return Period:

Year To Date

Investing Style:

All

Filter our model portfolios using the drop down boxes to the left. You can filter based on the number of stocks in the portfolio, the rebalancing time frame, and the period over which the return is calculated.



Model Portfolio	Based on Book By/About	Date of Inception	YTD Return	S&P 500 Return	Accuracy
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## Individual Guru Portfolios - Monthly Rebalancing

<a href="#">Price/Sales Investor</a>	<a href="#">Kenneth Fisher</a>	7/15/2003	27.2%	10.4%	67.3%
<a href="#">Contrarian Investor</a>	<a href="#">David Dreman</a>	7/15/2003	24.3%	10.4%	64.5%
<a href="#">Book/Market Investor</a>	<a href="#">Joseph Piotroski</a>	2/27/2004	20.5%	10.4%	58.2%
<a href="#">Growth Investor</a>	<a href="#">Martin Zweig</a>	7/15/2003	20.0%	10.4%	64.5%





## Why Do They Still Work Today?

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- Human emotion prevents many from following these strategies (drawdowns, bubbles and other reasons). Concept of “ever-changing cycles”
- There are certain variables that have proven over time that they show a predictive capability to select outperforming securities on the whole



## Why Do They Still Work Today?

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- The strategies are not worn out --  
Exact strategies are hard to reproduce  
and replicate
- We use a computer program that is  
non-emotional and sorts through the  
entire market of liquid stocks, not just  
the stock of the day



## Why Do They Still Work Today?

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- Validea's Guru Strategies seek out fundamentally sound stocks trading at reasonable valuations.
  - French/Fama Study: 1963-1990:  
Results: high book-to-market stocks outperformed low book-to-market stocks by 2.5x.
  - Takeaway: stocks that are trading at attractive valuations outperform overvalued securities

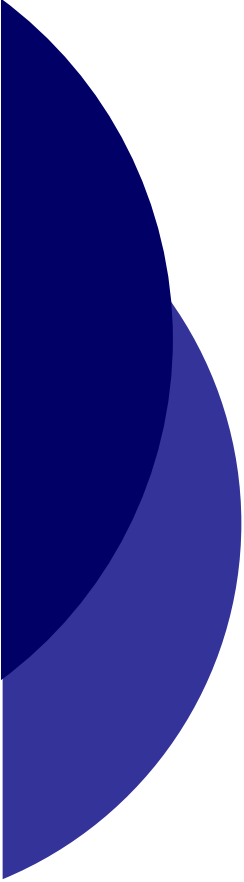
Source: French/Fama Study  
Eugene Fama, Kenneth French



## Do they work in a Bear Market?

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- Each strategy has proven, either through back test or real world performance, to have great returns over long term (through Bull & Bear Markets)
- Select fundamentally sound stocks: companies need to be profitable - avoided the highly speculative type stocks in late 1990s and Internet boom



Can you blend these strategies  
together for better risk adjusted  
performance?

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Yes!



## Blending these strategies produces better risk adjusted performance

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- Value + Growth Strategies = reduces volatility
- Consensus, or blended approaches, hold both value, growth, high dividend and international stocks
- Selects both large and small caps and not tied to specific industry or sectors
- Strategies perform well when varying styles are in and out of favor with investors





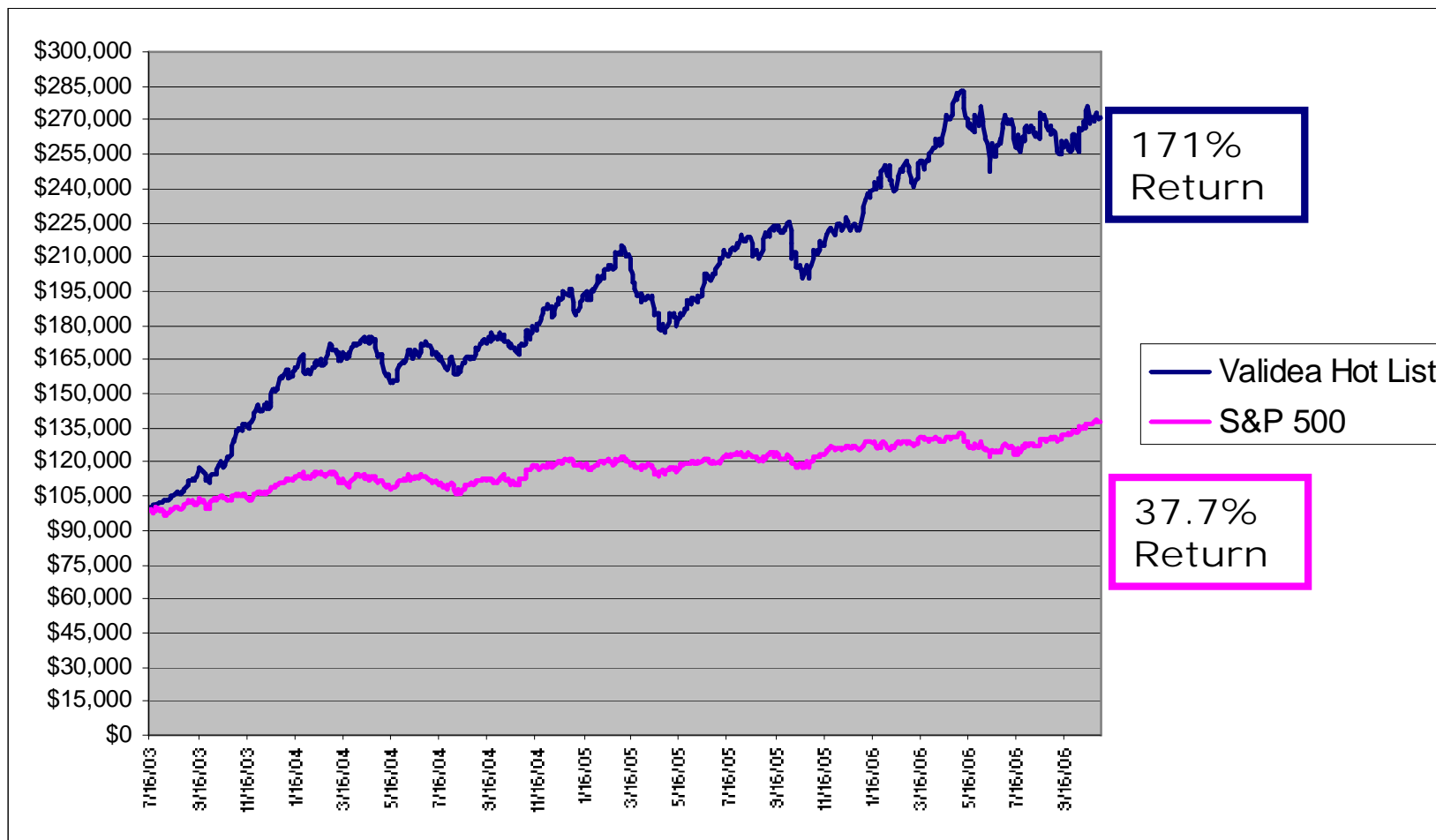
# Benefit of Blending Value + Growth Strategies

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- O'Shaughnessy 40+ year back test
- Highest Sharpe Ratio on United Cornerstone Strategies
  - Large Stocks = Sharpe Ratio of 45
  - Cornerstone Growth = Sharpe Ratio of 63
  - Cornerstone Value = Sharpe Ratio of 64
  
  - United Strategies = Sharpe Ratio of 68

Source: "What Works on Wall Street", James O'Shaughnessy

# Validea Hot List vs. S&P 500 – Top Performer

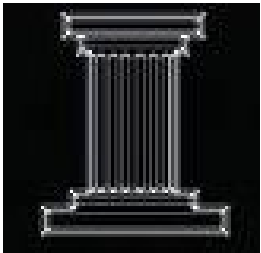


Source: Validea.com – Portfolio Performance (10/31/06)

# Other Key Pillars In Strategy

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- 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



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Construction

# “Rebalancing” in Action – Growth Investor Model (10/06/06 Rebalancing)

Table View: Performance

Rebalancing Period: Monthly Portfolio

Portfolio Size: 10 Stocks

The **Growth Investor** model portfolio contains the top 10 ranked stocks according to our strategy based on the published writings of [Martin Zweig](#).  
See Disclaimer

[Latest Changes](#) [Full Portfolio History](#)

Portfolio Stats		
Time Period	Portfolio	S&P 500
Since Inception	163.8%	34.9%
2004	54.8%	9.0%
2005	5.8%	3.0%
2006 YTD	22.0%	8.1%
Accuracy	66.3%	N/A
Beta	1.25	1.0

Symbol	Company	Date Added	Interest When Added / Strong / Some	Current Interest / Strong / Some	Score When Added	Current Score	Buy Price	Current Price	Return
<a href="#">PTR</a>	<a href="#">PETROCHINA COMPANY LIMITED (ADR)</a>	3/24/2006	2 / 2	3 / 3	92%	85%	\$104.19	\$105.50	1.3%
<a href="#">TWGP</a>	<a href="#">TOWER GROUP, INC.</a>	4/21/2006	2 / 2	3 / 1	92%	92%	\$26.38	\$34.78	31.8%
<a href="#">GRMN</a>	<a href="#">GARMIN LTD.</a>	5/19/2006	2 / 1	1 / 2	100%	92%	\$44.62	\$50.20	12.5%
<a href="#">HITT</a>	<a href="#">HITTITE MICROWAVE CORPORATION</a>	7/14/2006	1 / 1	1 / 2	92%	85%	\$33.92	\$47.41	39.8%
<a href="#">ODFL</a>	<a href="#">OLD DOMINION FREIGHT LINE</a>	8/11/2006	2 / 1	2 / 1	85%	85%	\$29.83	\$32.77	9.9%
<a href="#">WIT</a>	<a href="#">WIPRO LIMITED (ADR)</a>	8/11/2006	1 / 1	1 / 1	92%	92%	\$12.28	\$14.08	14.7%
<a href="#">WLP</a>	<a href="#">WELLPOINT, INC.</a>	8/11/2006	2 / 0	2 / 0	92%	92%	\$74.83	\$76.20	1.8%
<a href="#">PDC</a>	<a href="#">PIONEER DRILLING COMPANY</a>	9/8/2006	1 / 1	1 / 1	92%	92%	\$13.29	\$12.19	-8.3%
<a href="#">THO</a>	<a href="#">THOR INDUSTRIES, INC.</a>	10/6/2006	4 / 0	4 / 0	92%	92%	\$44.49	\$45.07	1.3%
<a href="#">SAY</a>	<a href="#">SATYAM COMPUTER (ADR)</a>	10/6/2006	1 / 3	1 / 3	85%	85%	\$39.66	\$41.12	3.7%

## Deletions

### Deletions

INFOSYS TECHNOLOGIES LIMITED (ADR)	INFY
THE BEAR STEARNS COMPANIES INC.	BSC

## Additions

### Additions

SATYAM COMPUTER (ADR)	SAY
THOR INDUSTRIES, INC.	THO

- 30-40% turnover
- Opportunity Cost



# Redefining Long Term Investing with Frequent Rebalancing

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- Monthly Rebalancing (opportunity cost of not selling & best performance).
- Annualized Performance since 7/15/03



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Rebalancing Period	10 Stock Model (avg.)
Annually	16.6%
Quarterly	21.1%
Monthly	24.7%

Source: Validea.com 10/31/2006

# Model Portfolio Example – Frequent Rebalancing and After Tax Returns

G/V Investor (O'Shaughnessy )	Total Return	Tax Rate	Total Return After Tax
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S&P  
500

10.2%

15%

**8.9%**

Annual  
Rebalancing

12.9%

15%

**11.0%**

Monthly  
Rebalancing

28.3%

35%

**18.4%**



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Source: Validea.com – Portfolio Performance (as of 10/31/06)

# Redefining Long Term Investing

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- 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

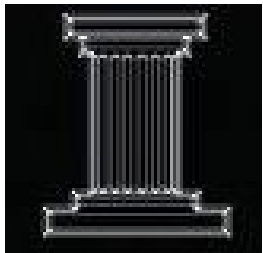


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# Performance - Unpredictable Over The Short Term - Predictable In The Long Term

- Over the last 79 years if you would have bought the S&P 500 and...

Held it for (# of years)	Sold it after (# of years)	# of losses (%)
1	1	23 times (29%)
5	5	10 times (13%)
15	15	0 times
Variability in returns <u>go down</u> as the <u>holding period gets longer</u> .		



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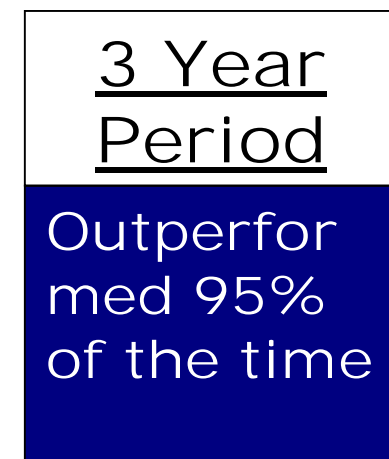
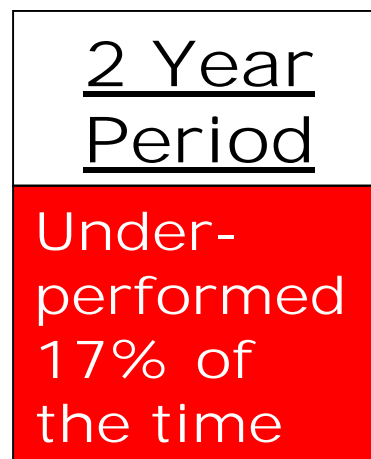
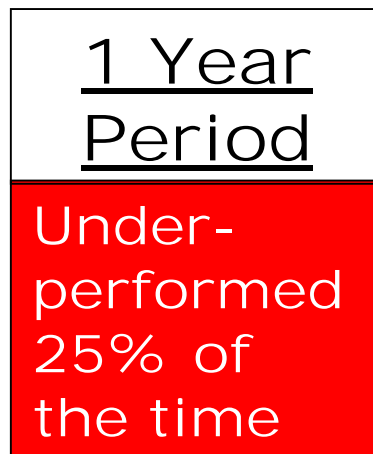
Source: Roger G. Ibbotson and Rex A. Sinquefield, "Stocks, Bonds, Bills and Inflation," 1982 ed., Institute of Chartered Financial Analysts, Charlottesville, Va.; updated by Ibbotson Associates, "Stocks, Bonds, Bills and Inflation 2005 Yearbook," Chicago.

# 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".  
Greenblatt is the founder of Gotham Capital



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



# Use Strategies To Find Opportunities Across All Market Segments

- Different styles work over different time periods

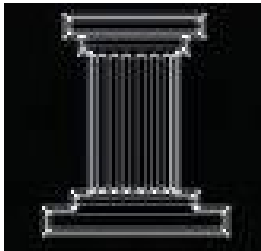
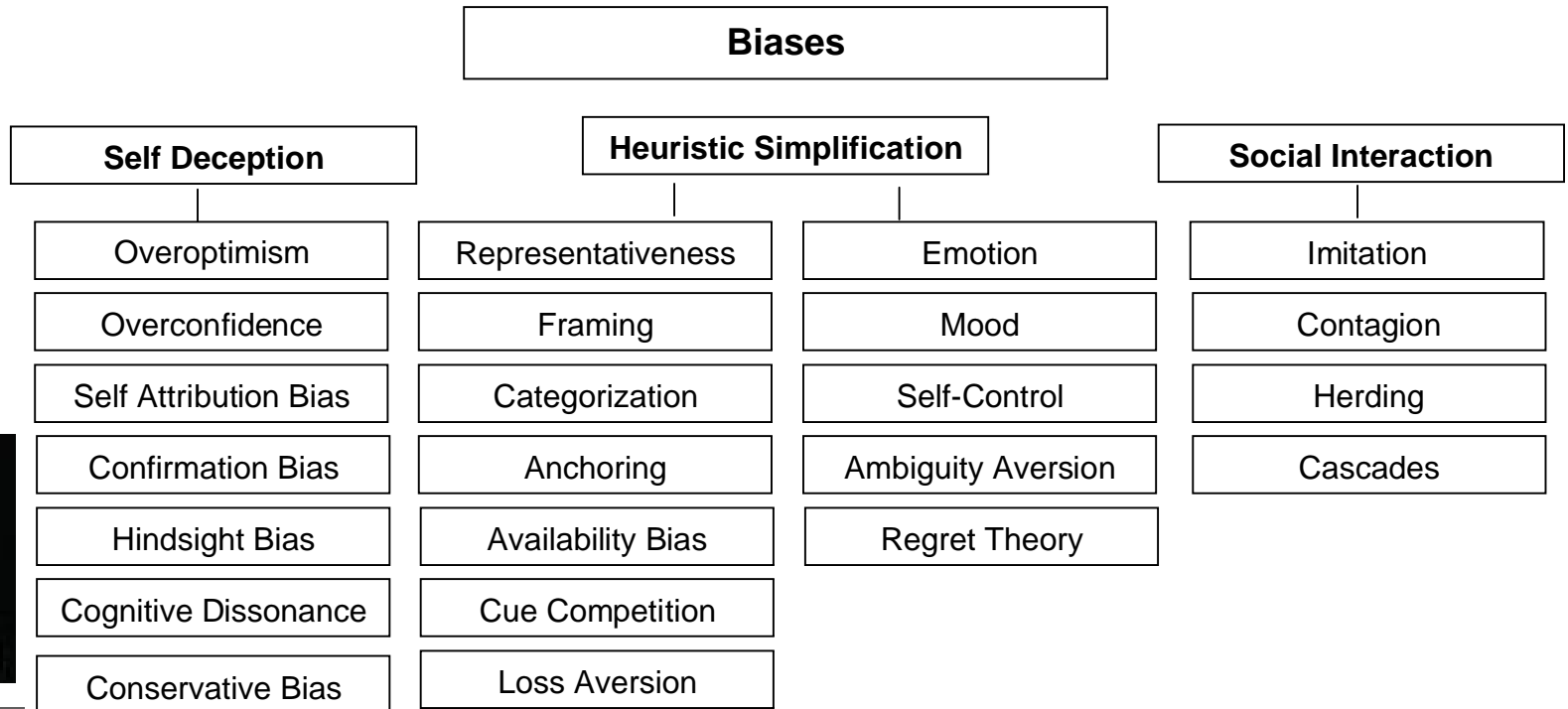


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Style	Return, 1993-1999	Return, 1993-2002
Small value	13.90%	<b>15.23%</b>
Small growth	16.92%	8.20%
Large value	17.72%	10.43%
Large growth	<b>21.64%</b>	11.08%
Wilshire 5000	20.47%	11.69%

Source: John Mauldin, "Bull's Eye Investing" (John Wiley & Sons, Inc., 2004)

# Behavioral Finance: Removing Emotional Barriers



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Source: David Hirshleifer, "Investor Psychology and Asset Pricing," Journal Of Finance 56 (2001), Dresdner, Kleinwort Wasserstein Research

# Behavioral Finance: Investor Biases

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- 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 an illusion of control and knowledge.
- Anchoring: Peoples tendency to give too much credence to their most recent experience and to show reluctance to adjust to their current beliefs.
- Loss Aversion: Fear of losing money and subsequent inability to withstand short term events and maintain a long term perspective



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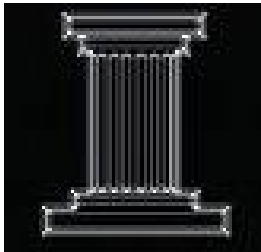
# Buffett Quote on Emotions & Discipline

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"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



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# Portfolio Construction – equally weighted holdings and diversification

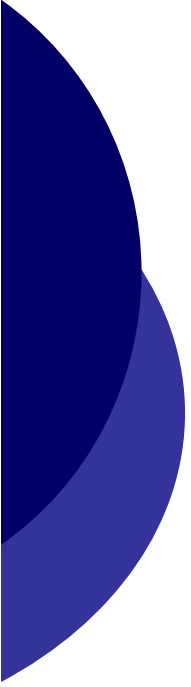
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- 10, 20 or 50 Stocks depending on multiple factors like portfolio investment size and risk tolerance
- You can't beat the market by owning it
- Equally weighted shows optimal historical performance in the Validea system. Studies have shown equal weighting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



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# Review: How you can leverage the stock selection strategies of Wall Street Greats to produce outperformance

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- 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.



## Final Thoughts and Takeaways

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- No one best strategy -- Several strategies are successful long term in the market
- They don't just work by themselves – scanning 7000 stocks, monthly rebalancing, not cherry picking, blending strategies to improve risk adjusted return
- Based on what these gurus have done, they have returned 15% - 29% average per year
- By following the implemented strategies, you give yourself a very good chance of long term market outperformance
- A resource, Validea, exists to help you select stocks using those strategies.



# Q&A & Book Payment Page & Contact Info & More...

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“The Market Gurus” Payment Page:  
[www.validea.com/book](http://www.validea.com/book)

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**Thank You!**

