OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

December 15, 2016
Volume 6 Issue 12

Valuentum Securities Inc.
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Portfolio Return	Benchmark Return	Outperformance
115.8%	85.8%	30.0pts

The Best Ideas Portfolio (see page 8): AAPL, MO, BWLD, BRK-B, CSCO, FB, XLF, GE, GM, GOOG, GOOGL, XLV, INTC, JNJ, KBE, KMI, KORS, PYPL, PCLN, RSG, SDY, TEVA, UNP, XLE, XLU, V

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Goals of the Best Ideas Newsletter: We want to deliver positive returns to you, our subscriber, year after year, in addition to outperforming the market benchmark. Our Best Ideas portfolio is generally found on page 8 of each edition.

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"At some point, contractionary monetary policy will come home to roost in the form of higher discount rates applied to stock valuations. Right now, stock prices and interest rates are moving in the same direction, which simply doesn't hold water."
- Brian Nelson, CFA

See page 8.

Is It Time or Timing in the Market?

By Brian Nelson, CFA

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Image source: Dimitris Kalogeropoylos

= ALL TIME HIGH

KEY CONCEPT: Stocks in the Best Ideas portfolio (see page 8), which have generally registered a 9 or 10 on the VBI when added, should be considered our best ideas at any point in time. After adding firms to the Best Ideas portfolio, we may tactically trade around these positions when they have VBI ratings between 3 and 8 depending on the size of their weighting in the portfolio or the attractiveness of them relative to other opportunities (a score of 3 through 8 is equivalent to a 'we'd hold'). We tend to remove firms from the Best Ideas portfolio when they register a 1 or 2 ("we'd sell"). Contact us for more details about how the team utilizes the Valuentum Buying Index to run the portfolio.

Since joining the workforce after undergraduate studies, those that will be turning 30 years' old during 2017 will have never witnessed a meaningful bear market, large down year, or even a substantial "correction" in the stock market during their working lives. That's right -- many workers that were born in the mid-1980s when Ronald Reagan was President are probably starting to believe that they've found the secret to investing success and that broader US markets only go up (or down just a little at times, but they always recover and go higher). No matter if this assessment of their opinion of the markets is true or not may not matter.

At the very least, it may be appropriate to say that this group of savers has yet to truly discover their risk tolerances, which in my opinion, can only be tested under adverse market conditions, and it's also quite feasible that they may have unrealistic portfolio return expectations in light of the trajectory of the markets during the past several years. I ponder what might happen if the stock market gives back only a portion of the gains it has reaped in recent years. The S&P 500 (SPY) has more-than-tripled since the March 2009 panic bottom, amounting to a 200%+ cumulative return for the entire S&P 500 in just ~8 years. But what happens if the market starts to disappoint? Will there then be

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a stampede towards the exit? Are the markets today just building up for the next "crash" as investor expectations are reset? Possibly.

But many may say -- markets always go up in the long run, right? Well, so far, but it's not that easy. Indexers often champion their cause when the going is good (right now), as returns during the immediate 8-year look-back period have certainly been fantastic. It's worth noting, however, that at the beginning of 2009, we were just starting to emerge from the worst financial catastrophe since the Great Depression, hardly a fair starting point to measure returns. In my view, the last 8 years reveal more about the benefits of timing the market, than time in the market, the latter many indexers hold dear. By my calculations, S&P 500 index returns haven't been all that great if we look back just a bit further than the recent past. Since July 2000, for example, near the peak of the dot-com bubble, the S&P 500 has notched just a ~2.4% compound annual return since then, during the past 16-17 years (according to YahooFinance data that adjusts for dividends). That's about what the riskless 10-year Treasury yields today, after years and years of expansionary monetary policy that has just begun to reverse. In case you missed it, the Fed plans to tighten three more times during 2017.

How wonderful one must think the stock market is if he or she launched their 401(k) in March 2009. On the other hand, how disappointed investors must be, by comparison, if an indexer had accumulated most of their savings by the dot-com peak. Timing is everything. Please forgive me, but I'm not going to refer to 200-year charts that show how the stock market has provided a mid-single digit annual return over the past two centuries (has it?), as I just don't think this line of thinking is helpful. I used to love reading about historical returns, too (thanks Jeremy Siegel), but we need to get serious because this is your money -- stock market returns prior to the invention of the computer, television, automobile, *prior to the American Civil War*? I think the financial industry is getting a bit ridiculous with their multi-century, backward-looking studies that always seem to somehow support their agenda, to keep your money with them over long periods of time. Don't get me wrong -- of course these studies are interesting and informative, and they may even be accurate (I haven't audited them), but what I do know is that they're not practical -- and what's worse, new regulations appear to be forcing financial advisors to put more and more investors into index funds. Frankly, it has me scared.

Someone said rushing in as an indexer in today's market is like rushing into the elevator with everyone else just to go down. You see--indexing is not investing. Indexing is speculating on a basket of stocks, buying and holding them at any price regardless of what their intrinsic value is. Indexing is like driving a car with your hands off the wheel looking only at the rear-view mirror to gauge your future direction. As an indexer, you're not in control, and you are using the past (what's behind you) to determine what may be ahead, as indexers use historical returns as justification (evidence) behind the "prudence" of a strategy. To me, driving blind will always be a recipe for disaster--and I'm worried investors may be spending more time thinking about how much they pay for groceries, or at the gas pump, or for that new refrigerator than they do reasoning through what they are doing with their savings. To me, indexing, which amounts to buying "everything" in the index at "any price" and holding it "regardless of what happens" is just not prudent. It's just a form of speculation. Maybe the worst kind?

No matter what you may have heard or believe, timing is so important when it comes to investing--and while "everybody" says you can't time the market, I believe that reasonable investors can and have. During the Financial Crisis, it was pretty clear that the stocks of great companies were beaten down unfairly. During the housing bubble, it was pretty clear that with all the "liar loans" everybody knew about, housing prices were way too high. During the dot-com bubble, Internet stock prices were getting way out of whack--and now today, the forward price-to-earnings ratio on the S&P 500 is 17+ times, well in excess of its 10-year average of ~14.4 times. Yet, hordes of pundits will tell you to

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leave your money alone no matter what, for what might be the beginning of another 16-17 year period where returns are ~2.5% like those starting from the dot-com peak? Is this what prudent pundits are now advocating? Without a doubt, how to allocate one's capital is as difficult a decision today as it has ever been.

Complicating matters is that we have a President-elect Donald Trump that may make it his personal agenda to drive the market ever higher in any way he can during his administration. He is a competitive spirit, and he doesn't like losing. His rhetoric is working thus far--and if the incoming administration is successful in cutting the corporate tax rate, the "bubble" that we are currently experiencing could continue to inflate, arguably through much of the Trump administration. If you may recall, Alan Greenspan in a televised speech on December 5, 1996, coined the term "irrational exuberance," but it would be another 3+ years of strong stock market returns before that "bubble" finally burst at the beginning of this century, the starting point of the period of meager ~2.4% compound annual returns (2000-2016).

What I'm trying to say is that the market is overheated today, but it could continue to get even more overheated in coming years--and with political influence and potential changes in tax and accounting treatments on the horizon, it's even becoming more and more difficult for analysts to predict corporate earnings without tying probabilities to them influenced by an assessment of whether political initiatives and changes to the tax code will come to fruition. Stock analysts have become political analysts more so today than perhaps in any other time in history. This can't be a good thing, and I don't think what we're witnessing in terms of valuations across market sectors in the context of contractionary monetary policy is sustainable.

At some point, contractionary monetary policy will come home to roost in the form of higher discount rates applied to stock valuations. Right now, stock prices and interest rates are moving in the same direction, which simply doesn't hold water. I'm also starting to believe that the labor force is getting a bit tapped out in light of some statistics I've come across. I read that more than half of US companies "state that they have few or no qualified applicants for their openings," coincidentally at a 17-year high. It seems very likely that the Trump administration may still help to fuel US GDP growth through infrastructure investments, benefiting "old economy" companies, but he has also thrown out some rather harsh rhetoric toward defense spending, pointing at Boeing's (BA) Air Force One and Lockheed Martin's (LMT) F-35, in particular. Please be sure to examine how sector returns have shaken out during the past few weeks, if only to get a feel for the change in sector leadership, now financials and energy--two sectors that were responsible for a lot of pain during 2008-2009 and 2015, respectively. With now everything having rallied considerably, is this the beginning of the end for this now-7+ year bull market?

You may not believe this, but we really don't care what the answer to that question is, as it neither changes our game plan nor the Best Ideas Newsletter portfolio's path to long-term success. We're going to continue to highlight undervalued, strong companies for consideration, and add the very best to the Best Ideas Newsletter portfolio when we think the time is ripe. The latest additions to the Best Ideas Newsletter portfolio, General Motors (GM), Berkshire Hathaway (BRK.B), and the SPDR S&P Dividend ETF (SDY), have been solid performers, and we plan to continue to add opportunistic ideas, but only at the right price. That being said, we're also letting a lot of our winners run in the spirit of the Valuentum methodology, but we're watching those same companies, too, and view them as a source of cash should their equities get too "extended." These are exuberant times, in my opinion. I hope that you enjoy this December edition of the Best Ideas Newsletter.

Image: Returns Following the Trump Victory

By Brian Nelson, CFA

Text from table duplicated below.

Sector/Theme	Symbol	Return Since Election Day %*	Forward P/E**	10-yr Avg Forward P/E**	Notes
Financials	XLF	18.8%	14.4	12.2	Trump's Treasury Secretary choice Steven Mnuchin wants to repeal most of the burdensome Dodd-Frank legislation. A steepening yield curve is helping banks and may drive improved net interest margins in coming periods. Goldman Sachs is ripping higher, leading the Dow's charge.
Crude Oil	USO	13.3%	-	-	The world is moving to a better balance in supply/demand dynamics in the energy markets. OPEC is talking, has agreed to cuts, and expectations for improved economic growth are helping energy resource pricing. High-beta companies such as Continental Resources are rallying hard.
Energy	XLE	10.5%	NMF (1)	17.7	Capital spending cuts are bolstering free cash flow in the upstream space as energy resource pricing improves. Reduced regulations could help the midstream arena, though concerns over measures of "cash flow" prevail.
Industrials	XLI	9.9%	18.1	14.7	"Old" economy companies, including engineering and construction entities, are rallying on hopes for government-financed infrastructure expansion as a result of initiatives by the Trump administration. Fiscal conservatives may intervene, but large cap industrials are still healthy.
Materials	XLB	9.0%	17.8	15.1	Coal stocks are jumping in light of expectations that Trump's new policies may aid the beaten down space, but natural gas remains a lower-cost alternative. Trump's impact on trade is driving optimism with respect to steel prices. The group remains volatile, and dividends aren't secure.
Telecom	XTL	8.3%	13.5	14.6	Top-weighted Sprint in this representative telecom ETF has been rallying hard since the election. Consolidation is brewing, and Sprint may get scooped up by T-Mobile, another top weighting in this ETF. Potential rollback of regulations could be positive.
Consumer Discretionary	XLY	7.0%	18.7	16.5	Top-weighted Amazon in this representative ETF hasn't done particularly well, but second-largest holding Comcast has surged higher as a result of the election results. Third-largest Home Depot has also done well thanks to both secular and cyclical trends.
Dividend Growth	SDY	6.9%	-	-	New highs again for the dividend growth crowd as this ETF, which includes companies with consecutive annual dividend increases, continues to catch a bid. What we find most intriguing though is that the ETF is rallying in the face of higher interest rates.
S&P 500	SPY	5.8%	17.1	14.4	The stock market is at all-time highs...again. Optimism about what the Trump administration might bring is the main driver, and many are pointing to reduced corporate taxes, translating to higher dividend payments, as reasons to be even more optimistic.
REITs	VNQ	3.2%	17.4	-	The 10-year Treasury yield has surged to nearly 2.5% as investors believe that Trump's fiscal policies will drive government borrowing rates higher. The market has taken the increase in stride, and even REITs have "gone up" since the election.
Biotech	IBB	3.1%	-	-	Drug pricing may not face as much pressure during a Trump administration than what might have happened under Clinton, but recent rhetoric hasn't completely eased, even by Trump himself. Biotechs continue to trade violently, and the election did little to easy overall uncertainty.
Technology	XLK	2.6%	16.6	15.7	Most of Silicon Valley had been against a Trump victory, particularly with the state of California largely driving the popular vote in Hillary Clinton's favor. Trump's rhetoric about China could disrupt tech supply chains, but lower taxes on bringing back foreign cash to the US could help the group.
Energy MLPs	AMLP	2.1%	-	-	Most of the energy MLP space is composed of midstream entities, which continue to benefit from improved credit for themselves and across their customer bases as energy resource pricing improves. A Trump administration may be the catalyst to ease regulatory hurdles on projects.
Health Care	XLV	0.7%	14.2	14.1	Healthcare has faced more uncertainty as a result of the Trump election, and potential modifications to Obamacare could be disruptive. Long-term demographics play into this sector's favor, but the 'drug pricing question' remains a big overhang. Generic pharma under investigation.
Consumer Staples	XLP	-1.3%	19.1	16.7	This steady-eddy sector is retracing a bit, largely as expected. Outlined as one of the priciest sectors in some of our prior work, money is being reallocated to higher-beta areas, namely financials and energy. This usually means pressure on conservative business models.
Utilities	XLU	-2.5%	16.6	14.6	The 10-year Treasury yield is wreaking havoc on the utility sector, which tends to be more fixed-income oriented than the consumer staples and REIT sectors. The group continues to trade above its long-term valuation average, and rising interest rates show no signs of letting up.
Silver	SLV	-8.2%	-	-	Silver had a rough month in November as investors move out of precious metals and into risk assets, namely financials and energy shares. We're not expecting a sharp comeback anytime soon.
Gold	GLD	-9.2%	-	-	November was also a tough month for gold. The near-8% decline in the yellow metal was the largest monthly decline in years. Gold bugs aren't too happy, and declines have continued.

* Return data, November 8 through December 10
** Source: Factset, December 9 (Earnings Insight)
(1) 41.3

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Silver: Silver had a rough month in November as investors move out of precious metals and into risk assets, namely financials and energy shares. We're not expecting a sharp comeback anytime soon.

Gold: November was also a tough month for gold. The near-8% decline in the yellow metal was the largest monthly decline in years. Gold bugs aren't too happy, and declines have continued.

Utilities and Telecoms to Benefit Most from Corporate Tax Reduction?

By Kris Rosemann and Brian Nelson, CFA

Image source: Michael Vadon

Speculation over which sectors may be the biggest beneficiaries of the incoming Trump administration has been running rampant in recent weeks, and we've received questions from members pertaining to this topic, specifically with respect to the utilities and telecom sectors. In fact, an article in the Financial Times, released mid-November, tabbed the utilities (XLU) and telecom (XTL) spaces as two sectors that may be able to generate outsize earnings improvements thanks to a reduced corporate income tax. But will they truly benefit over the long haul? Let's walk through our take on the impact a potential reduction in corporate tax rates may provide these two areas. It may not all be positive.

Let's start with regulated utilities. Though regulatory environments differ across the world, rate-setters consider a regulated entity's cost structure, including estimated income taxes, when assigning maximum rates that regulated utilities can charge for their services to recapture their investments. The profitability of a regulated utility is tied to a fixed-ROE, or regulated return on equity, that is applied to the rate base, and income taxes are an estimated component of the cost structure (rate base) of most regulated utilities. In simplistic terms, a higher rate base means higher regulated earnings, holding all-else equal (a fixed ROE), so higher estimated income taxes in a higher rate base means higher regulated earnings. On the other hand, lower estimated income taxes would translate into lower earnings as a result of a regulated utility's lower rate base. Regulated utilities are a unique business model in this respect where the more they invest in their rate bases (taxes included), the more earnings they generate, all else equal.

However, it is important to differentiate what may happen to regulated utilities' earnings streams in the near term versus what may happen over the long haul in the event corporate tax rates are reduced during the Trump administration. It is our view that lower corporate tax rates may translate into a short-term shot in the arm for regulated utility earnings as estimated tax expense falls while rates that they can charge temporarily remain at prior levels (prior rates would have considered the higher tax burden in the rate base). Still, we don't think this near-term boost would be a big deal for most utility holding company

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valuations, as most market participants may look past this short-term positive in evaluating the long-term earnings power of a regulated utility to estimate its intrinsic value. Our fair value estimates, for example, consider a utility's normalized earnings, and a long-term view with respect to utility fundamentals has significantly more weight within our valuation process than any near-term bump that might come from an income tax break, or more specifically an impermanent timing mismatch that artificially enhances a regulated utility's ROE.

Where the impact on near-term earnings for regulated utilities may be positive as a result of a tax cut, the long-term implications of a tax cut are less clear. For example, under a scenario where the Trump administration lowers tax levels, we would fully expect regulators to work quickly to reset rates such that outsize ROEs won't last long. We doubt consumers will continue to pay lofty utility bills detached from the cost basis of the regulated utility. They will demand relief, too. Though the magnitude of any impact, whether near-term or long-term, will vary for each regulated utility across our coverage universe, we think the end game is that any tax savings a regulated utility would garner under the new Trump administration would largely be passed to the consumer in the form of lower utility prices as a result of a lower rate base, all else equal.

Looking beyond the near-term boost, it can even be reasonably assumed that the amount of economic profit a regulated utility could create, in aggregate, would be reduced as rate bases are negatively impacted from the lower income taxes themselves, all else equal. The net impact, of course, is much more complicated than just this simple observation, as lower corporate taxes may also enhance the financial flexibility (improve credit) of the utility holding company, and lower implicit tax burdens at the consumer level coupled with increased infrastructure spending initiatives (expected during the incoming Presidential administration) may inevitably help drive rate bases continuously higher even if income taxes act as a short-term rate-base headwind. Utilities that generate a high percentage of unregulated earnings may see a more tangible, sustainable boost from having to pay a reduced amount to the tax man, so the "Trump income-tax question" is certainly a firm-specific one.

Let's now talk the telecom sector. Some have pegged the sector as one that will benefit the most from corporate tax reform in terms of after-tax income, and in the second quarter of 2016, for example, the sector had the highest average tax rate of any sector, so the group could use some relief from a tax-rate cut. However, a potentially bigger impact on telecom companies' earnings more so than other sectors may come more from changes in the tax code itself as Trump's call to expense capital investments and disallow net interest deductions could have profound implications on the group's reported profitability. Utilities will also be impacted disproportionately relative to other capital-light, cash-rich sectors given utilities' hefty capital spending and debt-heavy balance sheets, too.

Changes to expense capital investments would be beneficial to telecom and utility companies since they require large amounts of capital spending to build and maintain the infrastructure necessary to operate their businesses. Expensing would bring forward tax deductions today that otherwise wouldn't be realized for years and years into the future. However, doing away with net interest expense deductions would have a negative impact on the debt-heavy telecoms and utilities, as interest is itself a tax shied. The net impact of these tradeoffs will vary from company to company from sector to sector, depending on the level of annual capital expenditures and the service costs of debt loads. In fact, we won't know the net positive of each entity until all the details are hammered out, but we think the telecom and utility spaces will be disproportionately impacted by these specific accounting-related considerations.

The telecom industry also expects to benefit from a relaxed regulatory environment, as Trump has promised to, "formulate a rule which says that for every one new regulation, two old regulations must be eliminated." Industry participants anticipate the Trump administration to be more open to consolidation within the sector, which bodes well for AT&T (T) and its acquisition agreement with Time Warner (TWX). Such expectations are welcome news to industry heavyweights after the Obama

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= ALL TIME HIGH

The Best Ideas Portfolio

By Valuentum Analysts

Portfolio Return	Benchmark Return	Outperformance
115.8%	85.8%	30.0pts

Below we outline the constituents of the portfolio and their respective weightings and returns thus far (please note that many stocks have been removed since inception). Each subsequent issue discusses Valuentum's latest changes to the portfolio and analysis and trends impacting companies in our Best Ideas portfolio.

We currently have ~15% of the portfolio in cash, a level we're looking to bring down in coming months. Tactically, we like to have the most cash when the market is making new highs and fully invested when the market is putting in short-term lows.

Our investment process is completely transparent and easy to implement in your own portfolio. The goal of our Best Ideas portfolio is to outperform the S&P 500 Index and to generate positive returns each year regardless of the market environment. Firms added to our Best Ideas portfolio are the cream of the crop based on our stock-selection methodology, the Valuentum Buying Index.

THE BEST IDEAS PORTFOLIO -- as of December 15, 2016 — **Best Ideas Portfolio Inception Date: May 17, 2011**

Portfolio Holdings	Symbol	Initial VBI*	Current VBI**	Fair Value	P/FV	First Purchase	Cost/Shr ($)	# Shares	Total Cost ($)	Price/Shr ($)	Current Value ($)	Cumulative Div's Rec'd	% of Portfolio	% Return
Bullish														
Apple Corp.	AAPL	10	7	$147.00	0.79	17-Jun-11	51.92	107	5,569.33	115.82	12,392.74	1,150.82	5.7%	143.2%
Altria Group	MO	8	6	$58.00	1.14	28-Jun-11	28.39	157	4,471.86	66.27	10,404.39	2,379.79	4.8%	185.9%
Berkshire Hathaway	BRK-B	6	5	$160.00	1.04	20-Apr-16	146.13	69	10,089.97	165.65	11,429.85		5.3%	13.3%
Buffalo Wild Wings	BWLD	6	6	$190.00	0.87	27-Aug-15	179.81	16	2,876.90	165.50	2,648.00		1.2%	-8.0%
Cisco	CSCO	9	7	$39.00	0.79	14-Nov-14	26.33	221	5,831.87	30.63	6,769.23	275.38	3.1%	20.8%
Energy Select SPDR	XLE	NR	NR	NA	NMF	6-Oct-15	67.14	143	9,608.02	76.42	10,928.06	263.26	5.1%	16.5%
Facebook	FB	6	6	$142.00	0.85	29-Jan-16	112.10	50	5,612.00	120.57	6,028.50		2.8%	7.4%
Financial Select SPDR	XLF	NA	6	NA	NMF	9-Jan-11	13.46	178	2,405.83	23.70	4,223.79	271.05	2.0%	86.8%
General Electric	GE	7	6	$32.00	0.98	21-Oct-13	25.99	375	9,761.75	31.26	11,722.50	987.00	5.4%	30.2%
General Motors	GM	6	6	$43.00	0.84	26-Aug-16	31.65	132	4,184.80	36.24	4,783.68	100.32	2.2%	16.7%
Google - Class C	GOOG	10	7	$855.00	0.93	23-Oct-12	450.92	7	3,170.42	797.85	5,584.95	10.35	2.6%	76.5%
Google - Class A	GOOGL	10	7	$855.00	0.93	4-Apr-14	Split	7	Split	815.65	5,709.55		2.6%	+++
Health Care ETF	XLV	9	6	NA	NMF	22-May-12	36.60	125	4,582.00	69.83	8,728.75	491.44	4.0%	101.2%
Intel	INTC	6	6	$42.00	0.88	12-Sep-11	20.48	150	3,086.50	36.79	5,518.50	634.50	2.6%	99.4%
Johnson & Johnson	JNJ	6	7	$121.00	0.96	29-Jan-16	104.18	54	5,632.72	115.89	6,258.06	170.10	2.9%	14.1%
SPDR S&P Bank ETF	KBE	NR	NR	NA	NMF	9-Jan-12	21.07	100	2,114.00	43.83	4,383.00	247.76	2.0%	119.1%
Kinder Morgan	KMI	5	6	$20.00	1.05	17-Feb-16	17.29	157	2,721.53	21.02	3,300.14	58.88	1.5%	23.4%
Michael Kors	KORS	8	3	$66.00	0.70	27-Aug-15	43.44	68	2,953.80	46.02	3,129.36		1.5%	5.9%
PayPal	PYPL	UR	4	UR	UR	17-Jul-15	Spin-off	100	Split	39.54	3,954.00		1.8%	+++
Priceline	PCLN	10	6	$1551.00	0.97	26-Feb-15	1239.49	6	7,450.91	1501.20	9,007.20		4.2%	20.9%
Republic Services	RSG	8	6	$44.00	1.29	19-May-11	31.42	201	6,329.42	56.65	11,386.65	1,223.10	5.3%	99.2%
SPDR S&P Dividend ETF	SDY	NR	NR	NA	NMF	20-Apr-16	81.33	124	10,091.92	87.03	10,791.72	123.77	5.0%	8.2%
Teva Pharma	TEVA	6	6	$58.00	0.63	24-Jul-13	41.22	77	3,180.94	36.72	2,827.44	364.09	1.3%	0.3%
Union Pacific	UNP	6	6	$87.00	1.20	24-Jul-13	79.67	40	3,193.80	104.68	4,187.20	264.20	1.9%	39.4%
Utilities Select SPDR	XLU	NR	NR	NA	NMF	18-Mar-14	41.12	83	3,419.96	48.27	4,006.41	328.41	1.9%	26.8%
Visa	V	7	6	$82.00	0.97	30-Nov-11	26.86	188	5,064.39	79.50	14,946.00	362.69	6.9%	202.3%
Latest changes: XLF stock dividend adjustment (9/19). 132 shares of GM purchased (8/26).														
Cash -- changes in monthly cash balance reflects dividends received and trading gains/losses, where applicable.											30,728.00		14.2%	0.0%
Bearish														
For investors seeking 'short' or 'put option' exposure, please consider firms with VBI ratings with 1 and 2 as ideas.														
Best Ideas Portfolio Value								Original -->	100,000.00	Current -->	**215,777.67**			**115.8%**
S&P 500 Index (SPY)						17-May-11	132.69	754	100,000.00	226.76	170,894.57	14,868.87	92.0%	
Cash											14,868.87		8.0%	
Benchmark Portfolio Value											**185,763.44**			**85.8%**
Relative Outperformance														**30 pts**

Data as of December 15, 2016. Cost basis includes commissions. Results include dividends, but not interest received on cash balance.

* VBI score at the time we added the firm to the portfolio.

** See our methodology regarding the Valuentum Buying Index (VBI). Best Ideas portfolio is not a real money portfolio.

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*Utilities and Telecoms...*from page 7

administration nixed two wireless telecom deals in recent years but may not appeal to smaller players, who fear of pro-establishment, anti-competition behavior from federal policy makers. In fact, among the largest deals axed by the DOJ have been in the telecom space, and a Trump administration may mark the beginning of the end for their deal-making blues. Chasing trends in M&A, however, isn't really a sound investment strategy for long-term investors, in our view, even if the Trump administration turns out to be less of a headache than those of prior Presidents.

Corporate tax reform may be more likely than any other time in recent history due to a Republican-controlled Congress and White House, but potential income-tax rate cuts, changes in the tax code regarding the expensing of certain items, and regulatory rollbacks certainly cannot be guaranteed by any President-elect, even if the market is starting to price in probabilities associated with them. This article specifically addresses implications on the utilities and telecom sectors from changes in corporate tax-related considerations, but we continue to be wary of these sectors, in general, particularly in light of the rising interest rate environment, which has sent the 10-year Treasury yield to ~2.5% at the time of this writing. As is well-known, both sectors satisfy yield-hungry investors, but as risk-free rates continue to rise, dividend yields may become less and less attractive within these groups. It is a theme we've been emphasizing for the past many months as a cautionary tale to dividend growth investors.

That said, in light of the capital-intensive nature and debt-heavy positions of both the utilities and telecom sectors, they haven't fit well with our focus on identifying companies that have indisputable financial strength and cash cushions to withstand pretty much anything that is thrown at them or their dividends. We're still comfortable holding PP&L (PPL) for diversification purposes in the Dividend Growth Newsletter portfolio and the Utilities Select SPDR (XLU) in the Best Ideas Newsletter portfolio, but Trump's move into the Oval Office won't do much to alter our opinion on these two sectors, a fundamental view that remains grounded in financial statement analysis. The capital intensity and leverage positions of these two sectors simply won't go away under a Trump administration, unfortunately.

FAQ: Does a 'Very Poor' score on Valuentum's assessment of a company's dividend safety mean the firm will cut its dividend in future periods?

Not necessarily. In many cases, a 'Very Poor' dividend safety score will predict a cut, as this is what the Valuentum Dividend Cushion ratio has been designed to do.

However, in other cases, the Valuentum Dividend Cushion may highlight significant risk related to future dividend payments (but not necessarily suggest that a cut is on the horizon). For one, the assessment of a firm's dividend safety is based on the excess cash-flow capacity the firm has for future dividend raises after considering its balance sheet structure. By extension, there will be a positive correlation between the safety of a firm's dividend and its future potential for growth.

In other words, the larger the capacity the firm has to raise its dividend based on our Valuentum Dividend Cushion ratio, the more secure existing dividend payments are. However, just because a firm has a 'Very Poor' dividend safety score doesn't necessarily mean it will cut its dividend anytime soon. What a low safety score does mean, however, is that the board has effectively maxed out the company's annual payout and has little room for operating error.

In fact, a lot of steady-eddy utilities firms receive a 'Very Poor' safety rating. However, based on the stability of their business models (and sometimes fixed rate of returns), we're not expecting them to cut their respective dividends anytime soon. However, should an exogenous event happen, the board hasn't left much excess cash-flow capacity to absorb the impact and the dividend may be exposed to significant risk (think of the most recent examples of Exelon and First Energy).

Around Retail: Aspirational Brands Battle Consumer Perception

By Kris Rosemann

Summary

· After positive data reads in the months of October and November, things may finally be looking up for retail spending, but the impact of discounting looms large for many in the space. There are pockets of weakness and strength.

· Aspirational and luxury goods manufacturers and retailers are not only subject to the pressures of the promotional retail environment, but also are subject to additional outside forces such as tourism and brand perception. While not dead, mall traffic has been challenging.

· Whether it is next-generation wearable technology, a refined online presence, a reduction in markdown allowances, or an enhanced shopping experience, luxury goods companies continue to invest for sustainable growth. Fossil and Richemont have been caught by surprise, however.

· Though certainly not the strongest companies with respect to brand equity, Coach and Michael Kors remain opportunistic valuation considerations in an aspirational and luxury goods space that continues to face myriad challenges.

Our top two speculative ideas in the luxury goods industry, Coach (COH) and Michael Kors (KORS) have provided us with plenty of ups and downs since their additions to the Dividend Growth Newsletter portfolio and Best Ideas Newsletter portfolio, respectively. The aggressive and competitive discounting environment we've seen in the retail space as of late has not been conducive to maintaining aspirational brand equity, and these two ideas have not been spared the pain and may continue to ebb and flow as they work to rebuild the elite-status branding both once enjoyed. Let's have a look at pockets of weakness and strength in retail sales, and identify important trends that are impacting the aspirational and luxury space, in particular.

The department-store retail space, particularly J.C. Penney (JCP) and Sears Holdings (SHLD), remains under considerable pressure as consumer spending patterns shift away from big box clothing retail. Millennials (MILN) appear to be more fixated on spending their disposable income on memorable experiences than material possessions, and wearable technology has become the new fashion statement. For example, while overall electronic-store sales remain under pressure, according to recent Census data, Best Buy's (BBY) third-quarter earnings report, released November 17, revealed strength in sales of mobile phones and wearables, propelling the stock to nearly $50 per share, almost a decade-long high. Mall traffic, however, continues to be under pressure, and while gross margins performed well at Best Buy in its third quarter ended October 29, many retailers have been pursuing aggressive discounting. According to a December 14 article by the Wall Street Journal, "the number of receipts that included promotions jumped 79% in November from the same period a year ago." The price discounting has continued into December, which could have profound implications on the broader retail group's levels of profitability during the fourth quarter of 2016.

That said, retail store sales have been in positive territory during the months of October and November, a welcome change from recent performance. According to estimated monthly retail sales by the US Census Bureau, released December 14, while general merchandise (department) stores and electronics and appliance stores continue to struggle during the holiday season, clothing and clothing accessories store sales have been largely a mixed bag, advancing during November but declining in October on a year-over-year basis. Aside from trends toward e-commerce spending (non-store retail), a good portion of the strength in year-over-year retail sales has been coming from the auto parts and building material industries, perhaps a positive sign for Advanced Auto Parts (AAP) and AutoZone (AZO) and Lowe's (LOW)

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and Home Depot (HD), respectively. Food services and drinking places continue to do well, too, according to the Census data.

To a large extent, retail sales remain a mixed bag with both pockets of weakness and strength, and we'll be watching just how much the level of discounting impacts the group's profitability levels during the fourth quarter of 2016. Nevertheless, traditional consumer spending seems to be returning to healthier levels in the US. US third quarter GDP growth, for example, was revised higher November 29 to 3.2% (the fastest rate in two years) from 2.9% on the back of better-than-expected household spending. The upward GDP revision was largely due to incremental data from the Alcohol and Tobacco Tax and Trade Bureau, monthly retail sales figures, motor vehicle registrations, and improved household utility data. Consumer spending power continues to grow as well, as the gain in wages and salaries in the third quarter of 2016 was also recently revised higher. Retailers may also experience a benefit from a reduction in consumers' tax burden. President-elect Donald Trump's choice for Treasury Secretary Steven Mnuchin has stated that his first priority will be tax reform, specifically in the areas of the middle-class and corporate tax rates. Any increase in disposable income for consumers bodes well for retailers.

Let's now dig into the aspirational and luxury brands, in particular. These entities not only are subject to the typical pressures of the broader retail space, but they also draw a portion of sales from their flagship locations in major cities, the traffic of which is driven in part by tourism. Currency movements, namely the recent appreciation of the US dollar against most currencies, have negatively impacted tourism spending in many such American cities. Though Macy's (M) recently reported strong traffic at its New York City flagship store on Black Friday, others including Michael Kors have noted weakened trends in tourism from Europe and South America as reasons for a slower pace of sales in the US. While international tourists at Coach's stores increased in its fiscal first quarter of 2017, it experienced declines in tourist traffic from China. Tiffany's (TIF) flagship store has been negatively impacted by the hoopla of the Presidential election given its proximity to Trump Tower, but the company posted a better-than-expected report on the top- and bottom-lines November 29.

We've made mention in the recent past of how many aspirational and luxury brands are attempting to regain or maintain the luster of their products, "Brand Image Taking Center Stage in Aspirational Goods." Coach is among the companies that are working hard to maintain the aspirational perception of its current product portfolio. In addition to closing ~250 of its locations in the department-store channel and issuing a reduction in markdown allowances, the company is looking to improve its brand image via differentiating its store environment and emotional marketing. It is also hoping to bring its Coach 1941 brand into a higher focus in its outreach efforts, and a marketing revamp has helped the firm reign in operating costs. Also, on its fiscal first-quarter 2017 conference call, November 1, the company said it was limiting its promotional efforts online, which management says has a greater negative impact on the long-term health of the brand than the positive impact such promotional activity may have on near-term results.

> Generally, our coach.com retail site demand is similar to our retail stores. For most of the category, the dotcom channel is overwhelmingly a promotional one, with most of our competitors having perpetual sale shops available. As you're aware, we have a clear strategic direction to limit our promotional stance online, given the negative impact on long-term brand health. – *Andre Cohen, President North America and Global Marketing*

Coach isn't the only luxury brand limiting its online presence. LVMH (LVMHF), for example, plans to keep its products off of Amazon (AMZN), since the massive online marketplace does not fit with the perception its brands aspire to hold. Concerns over pricing and counterfeits have reduced the attractiveness of online marketplaces for many luxury brands, which are based on aspirational exclusivity and not affordable prices for the mainstream population. However, Chinese Internet-giant Alibaba (BABA) continues to vigorously fight against counterfeit products on its platforms, and recent

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sales trends remain robust for the e-commerce behemoth. For example, on widely-followed Singles' Day (November 11), gross merchandise volume and mobile sales advanced considerably, with brands like Nike (NKE), Adidas (ADDYY), and Phillips (PHG) fan-favorites.

As with Coach, Michael Kors is also accepting short-term pain for long-term brand health as it works to rebuild and maintain the aspirational perception of its products by consumers. Specifically, the company is reducing the sell-in of inventory in its US wholesale channel in hopes of doing away with the brand-damaging aggressive discounting taking place across most of the retail industry. The rebalancing of its business is expected to result in an increase in average transaction value in both its retail and wholesale businesses, but will reduce the number of units it sells in the luxury goods marketplace in North America. This should help gross margin, and Michael Kors' store growth continues to be a driver mitigating same-store sales pressure. During its second quarter of fiscal 2016 (ends October 1, 2016), for example, new store openings totaled nearly 200 on a net basis.

Ralph Lauren (RL) is a prime example of a luxury brand that may have gone "too mainstream." According to recent Investor Day presentation, the company has not a sufficient focus on core brand strength, and its operating model has at times led to excess inventory, which in turn has created an unhealthy environment of overly-aggressive discounting. The retailer's three core brands--Ralph Lauren, Polo, and Lauren--account for the vast majority of its brand strength and performance, and marketing initiatives focused on these core brands coupled with a renewed shopping experience can be expected moving forward. The company's sales remain under intense pressure at the moment, however, falling 8% on a constant-currency basis during the fiscal second-quarter of 2017. Fiscal 2017 guidance also calls for a decline in revenue at an even-worse, low-double digit rate.

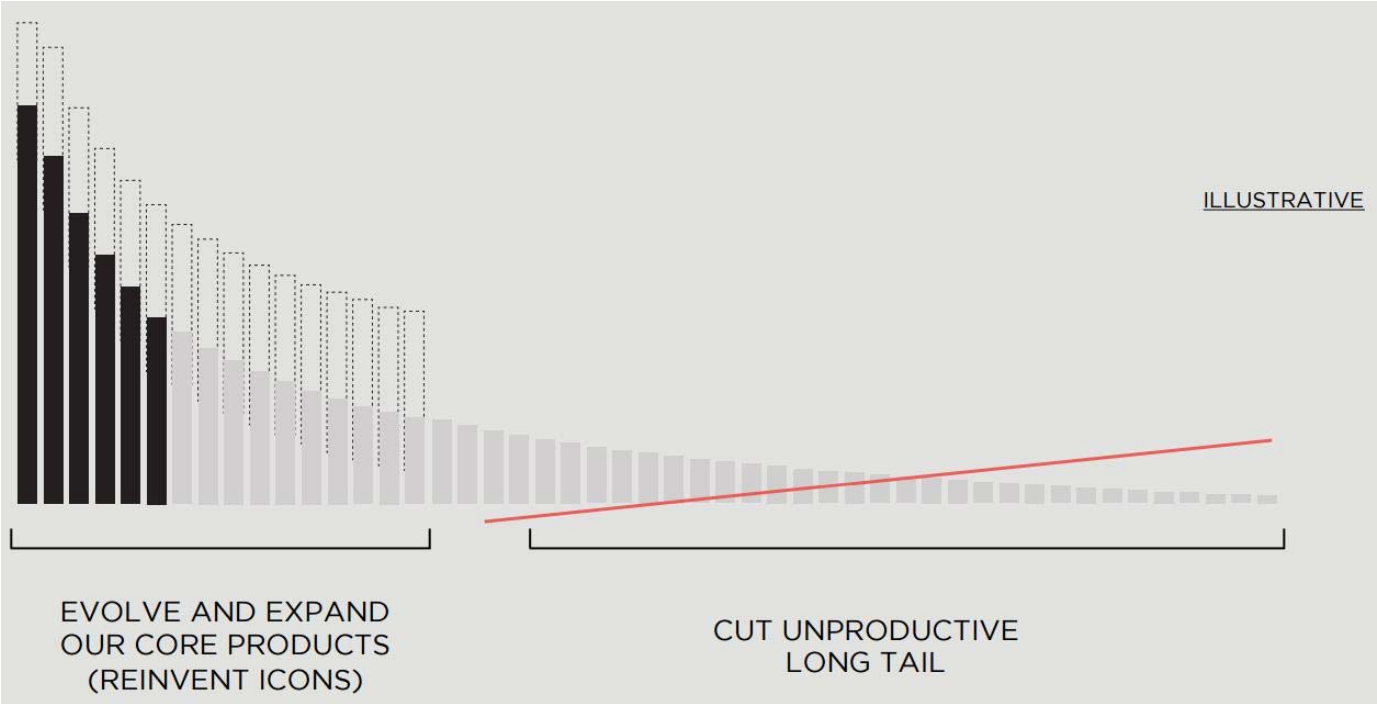

Image source: Ralph Lauren investor presentation

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Another trend working against aspirational and luxury brand companies is falling demand for traditional watches as the adaptation of wearable technology becomes more commonplace. Such a trend has impacted the likes of Fossil (FOSL), Michael Kors, and Richemont (CFRUY), among others. Fossil is particularly dependent on watch sales, as roughly three-quarters of its revenue is generated by it watch business. Meanwhile, Swiss watch maker Richemont plans to cut 200 jobs in its high-end watch business, a sign that it is not expecting a material rebound in demand in the space in the near term. The traditional fashion watch may very well be on its way out for good.

Fossil and Michael Kors are taking the wearable technology challenge head-on by developing their own smartwatches. Though Michael Kors' smartwatch products, which are a result of a partnership with Fossil and Google (GOOG, GOOGL), have not been able to fully replace the lost demand for its traditional fashion watches, they helped to mitigate the declines to a degree. In one of the most interesting recent developments in the luxury space, Luxottica (LUX) has partnered with Intel (INTC) to develop a smart eyewear product, Radar Pace, which was launched in early October 2016. Though its capabilities are currently limited to running and cycling training support, its ability to collect and interpret real-time data leaves the imagination open to a wealth of possibilities.

Whether it is next-generation wearable technology, a refined online presence, a reduction in markdown allowances, or an enhanced shopping experience, it is clear that luxury goods firms are well aware of the relationship of the perception of their brands and their long-term success. Trading near-term sales pressures for long-term brand equity looks to have become a common theme in the space, more so now than ever, and we think the stage may be set for a rebound in consumer sentiment via potential tax cuts for consumers, facilitating more discretionary spending on aspirational and luxury goods. Any step-change increase in consumer spending will likely fall into the hands of those dominating next-generation digital and wearable technology, but execution risk remains. One doesn't have to look much further than GoPro (GPRO) to see a company that dropped the ball this holiday season.

Given that Michael Kors is a rather small weighting and is included more for speculative, opportunistic reasons in the Best Ideas Newsletter portfolio, we're not rushing to make any changes to its weighting there. Michael Kors is certainly struggling to overcome the current operating environment, which has pressured its same-store sales considerably, we believe its brand still has room to grow, and its valuation opportunity remains enticing. Shares are currently changing hands at less than 11x next fiscal year's (ending March 2018) earnings, and below the lower bound of our fair value estimate range. Perhaps growing disposable income among the US consumer will be the catalyst shares need for price-to-fair value convergence to take place.

As for Coach, we're holding on to shares for now, too, despite being disappointed by reports that it made multiple takeover offers for UK luxury goods retailer Burberry (BURBY). Similar to the situation that unfolded with the recent acquisition of the Stuart Weitzman brand, we think management may be willing to stretch a bit too far in looking for incremental brand strength to offset core business weakness. At this point, however, our position in the company has largely been capital-appreciation neutral since the addition of shares to the Dividend Growth Newsletter portfolio in 2014, but we remain fond of its dividend growth profile in the event it does not pursue a large acquisition; shares currently yield ~3.6%. Coach's Dividend Cushion ratio of 1.9 remains solid, but the December dividend may very well end up being the last one collected by the Dividend Growth Newsletter portfolio.

GE Hikes Payout; Digital Transformation to Benefit Income Investors

By Kris Rosemann

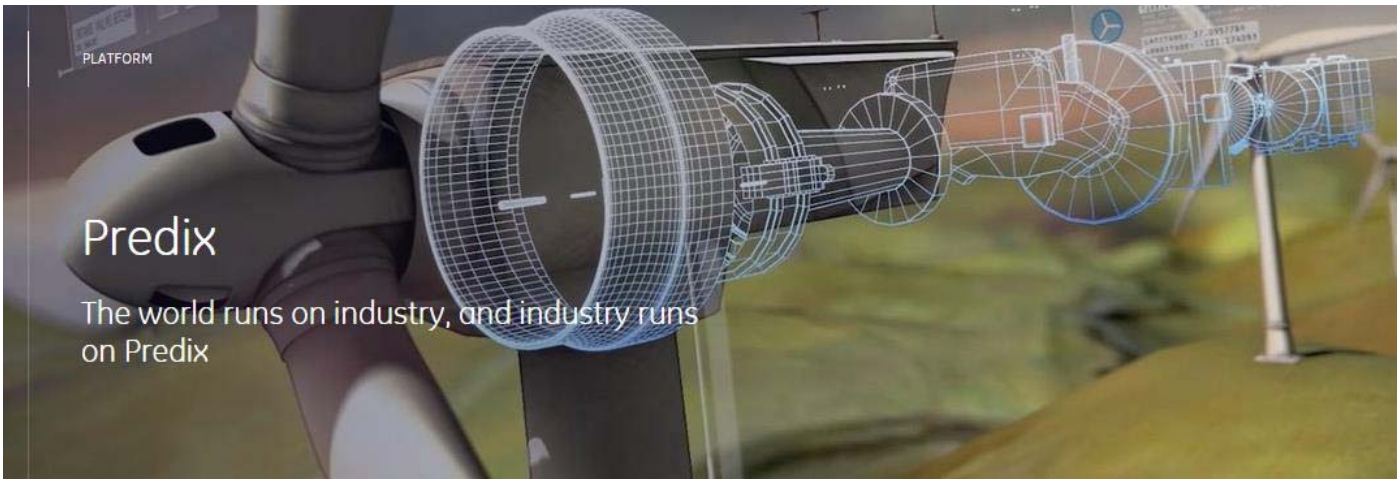

Image source: GE website

Income investors cheered as Best Ideas and Dividend Growth Newsletter portfolios holding General Electric (GE) raised its quarterly per share dividend $0.01, or 4%, to $0.24 per share December 9. The move is consistent with its multi-year capital allocation strategy to have a dividend payout ratio of 45%-50% and then grow the payout in line with earnings once the targeted dividend payout ratio is hit. The increase, however, reflects a payout ratio above the upper bound of management's target ratio based on consensus estimates for 2017. We like what the payout growth signals for income-minded investors, and management looks to be set in continuing its shareholder-friendly ways beyond its planned return of $30 billion in cash to shareholders in 2016 via dividends and share buybacks.

GE's dividend hike comes near the end of a year in which the firm made material progress in its strategy to become a simpler, digital-based company with a more narrow focus on revolutionizing its industrial businesses. It now dubs itself the world's 'Digital Industrial Company,' and a large portion of its transformation rests in the potential of the GE Store, where each business with which it partners is able to access the same technology, markets, structure, and intellect. We view the GE Store, and its potential, similar to that of Apple's (AAPL) App Store, but instead of making the products in its store perceived necessities in the lives of consumers, as Apple has done, GE is looking to make the products in its store necessities for industrial and other companies to maximize the efficiency of the next generation of businesses.

With such lofty potential in mind, GE continues to invest in its future. Acquisitions of smaller firms in the avenues of digital, additive manufacturing, and renewable energy have become commonplace as of late. Two of the most recent examples of such behavior come in the form of Internet of Things startup Bit Stew Systems (purchased for ~$150 million) and cloud-based field service management firm ServiceMax (purchased for $915 million).

Though smaller acquisitions have become a core part of GE's digital transformation, the industrial giant made a splash recently with its merger agreement with Baker Hughes (BHI), "GE Positioning for Long-term Crude Oil Price Recovery." As the crude oil market begins to show early signs of rebalancing, the deal is looking more and more prudent. Not only have OPEC-member nations agreed to cut production levels, but non-OPEC producers, led by Russia, have signed their first production cut agreement since 2001.

Despite the improved prospects for a recovery in energy resource pricing, volatility appears to have become a part of the new normal for oil and gas producers. Productivity initiatives across the space have

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improved the efficiency of the vast majority of operators, but recovery rates and well efficiencies have room for improvement. GE believes its deal with Baker Hughes will make it the leader in driving oil and gas productivity, which will help keep breakeven prices lower for longer. The aforementioned minor acquisitions are also helping to push GE closer to realizing its potential as a productivity leader. Additive manufacturing is expected to result in material cost savings across most end markets, including oil and gas, and automated drilling systems are beginning to look like a real possibility by 2020, according to management.

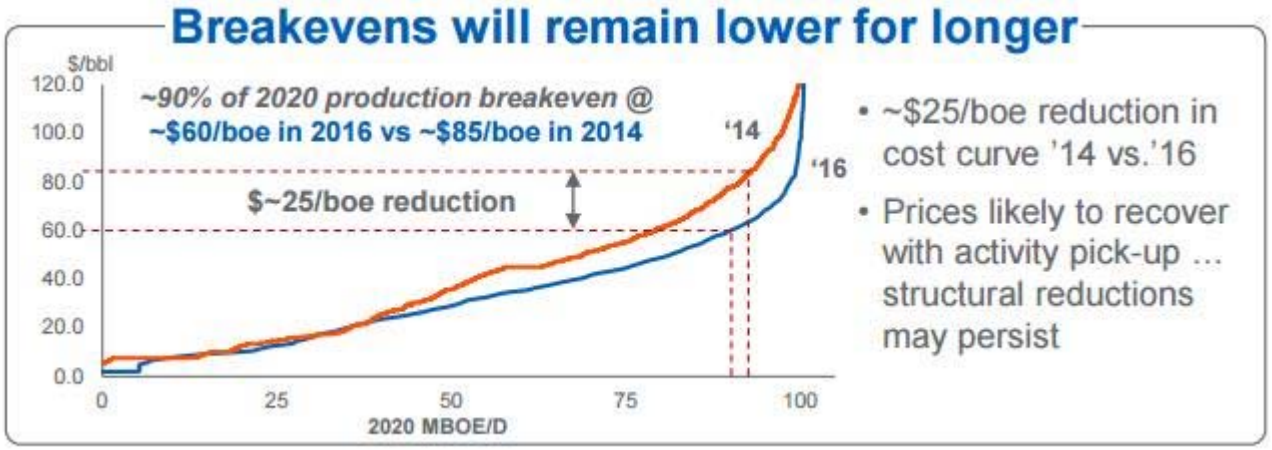


Image source: GE presentation

As GE touts its potential as a productivity leader in the oil and gas industry and continues to highlight its evolving digital capabilities, one thing is clear: the GE Store will have to become a key advantage for the firm to realize its potential. GE's first class industrial products are taken to the next level by the technology available in the GE store, which was evident in the firm's recent deal with Exelon (EXC). Exelon signed a five-year agreement to use GE's full software set in managing its 91 US powerplants in addition to software used to analyze the firm's overall performance and profitability. Though the value of the deal was not disclosed, it was reported to be the one of the three largest sales of GE's Predix industrial operating system--Predix is a cloud-based platform that connects industrial equipment, analyzes data, and delivers real-time insights. According to GE brass, its power plant technology has resulted in a 3% increase in efficiency, 5% reliability improvement, and operating and maintenance cost reduction of 25%.

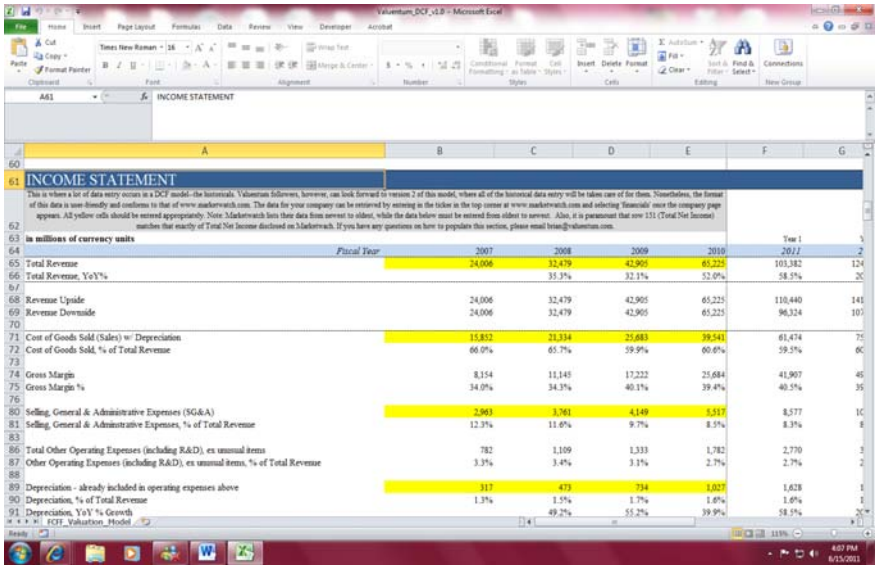
GE's focus remains on creating value for its customers throughout its digital transformation, but as it continues to work to increase the productivity of its customers, it is inherently improving the productivity of its own operations. We love what such a focus means for its presence in its vast number of end markets served, but we are also fond of what it can do for GE's own financial performance. The recent dividend increase reaffirmed management's commitment to returning cash to shareholders, and as the company's efficiency and productivity initiatives take stronger hold, so will its dividend.

Management appears to have a disciplined capital-allocation strategy in place, and its target to return less than half of earnings to shareholders via dividends over the long-run should help ensure sufficient cash flow coverage of the payout. GE's free cash flow generation should only benefit from its moving to a digital-based industrial company, as cost reductions and lower capex requirements are key benefits expected from technological advancements in manufacturing.

We're holding on to shares of GE in both newsletter portfolios. In addition to resilient income generating potential--the firm's unadjusted Dividend Cushion ratio sat above 1.6 at last check--we think shares have the potential to reach the upper bound of our fair value range, and rising energy resource prices may very well be one of the catalysts that helps facilitate strong performance in light of GE's addition of exposure to the space.

What Causes Fair Value Estimates to Change?

By Brian Nelson, CFA



If you've been a member of Valuentum for a while, you'll notice that when we update a stock report, our estimate of a company's fair value and the firm's Valuentum Buying Index ratings can change. This is completely normal and should be expected (over time, companies generate cash). But sometimes the changes can be confusing, particularly if they are material (i.e. 10% or more). In this piece, let's talk about why changes are standard operating procedure for investment research publishers.

But first, a bird's eye view of the topic. Our estimate of a company's fair value is driven by myriad factors. To derive a company's fair value estimate, we use a detailed cash flow model that considers future expectations of revenue, earnings and cash flows, among other financials (i.e. the balance sheet). You can download the individual-investor-friendly version here (we charge a token price for the template -- hope that is okay). When important drivers change or when new information comes to light, fair value estimates change. Though there are perhaps an infinite number of reasons why a fair value estimate can change, there are two primary reasons that account for the vast majority of revisions.

Rolling the Model Forward

The biggest fair value revision occurs when "we roll a company's model" forward one year. This is analyst speak for when Year 1 of the model changes from, say, 2015 to 2016, or in the case of what will happen next year, from 2016 to 2017. The timing of this revision occurs after a firm issues its fiscal annual report (form 10-K or form 20-F). For most companies, this occurs late in the first quarter, and our updating proceeds through the second calendar quarter. Once we receive the audited new information for the last fiscal year (which is released in the form 10-K or form 20-F), the new data is entered into the model.

This is why you may see last year's data still listed as Year 1 through most of the first quarter of any year. we're still waiting for the clean, audited numbers.

Generally speaking, a company's fair value estimate will increase by its discount rate less the dividend yield each year, all else equal. However, this increase almost never happens in practice, as the trajectory of the firm's future free cash flow stream and its capital structure are refined with the new information in the 10-K or 20-F. For example, if a company has engaged in value-destructive activities during the previous year (e.g. it has overpaid for acquisitions and bought back its own stock at egregious prices), this will show up in the new fair value estimate. On the other hand, if a firm is a wise capital allocator, the firm's balance sheet and future cash flow trajectory will have been enhanced from the previous year, and this would cause an upward revision in the fair value estimate (sometimes by 10% or more), all else equal.

When "rolling the model forward," there are a near-infinite number of drivers that could influence the fair value estimate, though we point to changes in the balance sheet (specifically the net cash/debt position) and changes in the future free cash flow stream (revenue, EBI, capital spending, working capital and other

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components) as being the two biggest factors. Most of the drivers behind a change in a fair value estimate, resulting from when "we roll the model," will be operational (e.g. updating the cash flow trajectory and accounting for cash generated during the previous year as reflected in the updated balance sheet and/or lower share count). We tend not to adjust a firm's cost of equity, nor do we adjust the risk-free rate frequently, though this may happen in some cases.

Note: Our model does not account for cash generated in interim model updates during the year. For simplicity, we account for cash generated during the previous year once, at the time we "roll the model"-- not continuously.

Significant Changes in Expectations or Transformative Acquisitions

Valuentum's fair value estimates, and by extension, the Valuentum Buying Index rating are forward looking. That means when expectations of a company's future free cash flow stream are revised as a result of forward guidance revisions (or incremental insight from our analyst team), or when a company pursues a transformative acquisition that will materially change its capital structure in the future, the fair value estimate changes accordingly.

The variables that cause the biggest changes in the fair value estimate on an operating level are our forecasts of a company's mid-cycle operating margin (Year 5) expectations, mid-cycle (Year 5) revenue growth rate, and capital spending over the 5-year discrete forecast period (or phase I of the model). If firm XYZ, for example, comes out with substantially lower revenue and earnings guidance for Year 1 than what we and the Street had been modeling, there may be a downward revision in the company's fair value estimate, all else equal.

Though Year 1 (or even Year 2) in the model does not impact the fair value estimate materially in most cases, the information behind the revised guidance could influence the intermediate-term and even the long-term forecasts of the model (think ripple effect), and this would cause an even larger fair value estimate revision (in some cases). Whenever the trajectory of the future free cash flow stream changes, the fair value estimate, which is based on the future free cash flows, changes. This is a fact of value calculation.

How to Think About All of This

First of all, we are not a quant firm. What you see in our reports is in-depth fundamental financial analysis. Analysts from investment bankers to sell-side brokerage firms use a discounted cash-flow model. Their results may be presented in the form of a multiple, but every merger or business transaction is backed by a pro-forma discounted cash flow model that justifies the transaction multiple. Conversely, the multiple implicitly considers all of the information in a discounted cash-flow model. Even a PE multiple applied to this year's earnings has an implied growth rate for earnings 10, 15, 30 years…into the future. Thinking about the long-term in valuation is inescapable, and the discounted cash-flow model is the best way to think about the long-term.

Second, we don't just hit a button and the published fair value estimate pops out of the model. Though we understand that being roughly right is better than being precisely wrong (think in the context of Warren Buffett's margin of safety), we spend a tremendous amount of time modeling companies. We don't play the near-term earnings estimate game, however. For one, we're fairly certain we can't do better than the 40 or so sell-side analysts that cover the average S&P 500 company these days, so our near-term forecasts don't differ much from management's guidance. On average, our revenue and earnings estimates for the next two years won't be but a couple percentage points away from consensus estimates. You can read more about this topic here >> http://www.valuentum.com/articles/20140627

*What Causes...*continued on next page

*What Causes...*from previous page

So If We're Not Playing The Earnings Game, What's Our Advantage?

Our advantage rests in our modeling expertise and synthesizing the framework down to a few key drivers within the detailed free cash flow model that we think the Street often gets wrong (namely mid-cycle operating margins and mid-cycle revenue growth). Whereas the Street spends most of its time playing the quarterly earnings game, we're instead focused on nailing our mid-cycle forecasts and getting the company's fair value estimate correct. Most of a company's intrinsic value is based on the structure of its balance sheet and its future expected normalized free cash flow stream (earnings before interest less net new investment), not on next quarter's earnings.

We understand that there may be a 10%-20% revision or more in a company's fair value estimate at times, but this is normal in the world of value estimation (expectations of the future are always changing and sometimes materially). You can always view the 'Valuation' page in a company's report to see exactly what forecasts have changed from the previous report (page 5 gives you a very nice summary of the three stages of the model). In almost all cases, the updated fair value estimate will fall within the previous report's fair value range.

We embrace the concept of Benjamin Graham's margin of safety, and we consider firms to be undervalued or overvalued when its share price is trading below or above the fair value range, respectively (though, at times, we may add firms trading at less of a discount that we may desire -- good companies sometimes never trade at bargain-basement prices). In the 16-page valuation reports, the percentage difference from the company's share price to the low end of the fair value range is considered the 'percentage undervalued,' and the percentage difference from the company's share price to the high end of the fair value range is considered the 'percentage overvalued.'

The very best way to get a feel for all the moving parts of valuation is to take our valuation model for a test spin. You don't have to become an expert on this process to do well -- just thinking about the key variables behind a discounted cash-flow model will make you a better investor, in our view. We hope you've found this article informative, and if you have any questions about any aspect of our research, please don't hesitate to reach out to our team.

FAQ: How frequently are the (stock and dividend) reports refreshed and what triggers an update?

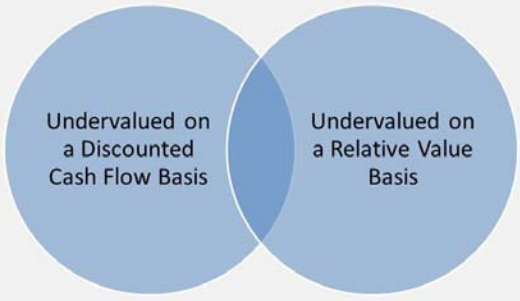
A: Our reports are updated at least every 3-4 months or when material news alters our estimate of a company's fair value. This update cycle is typical for investment research firms. Fair value estimates do not change much over short periods of time, especially if our estimate of a company's intrinsic value is spot on. Although the date, data, or text on our reports may not change daily for each company, you can assume that if the reports are live on the site, the conclusions of the company in the report are still representative of our view on the stock or its dividend.

Importantly, by using our 'Symbol' search box in the website header, you can gain access to some of the most advanced charting features to augment our Valuentum Buying Index's technical/momentum assessment. The charts are equipped with real-time data. The 'Symbol' search box in our website header is also the best way to find our recent articles and analysis (as well as the 16-page equity and dividend reports) on companies.

The Watch List

By Valuentum Analysts

The Valuentum Buying Index (VBI), which places a considerable emphasis on a firm's valuation, is the primary driver behind companies included in our Best Ideas portfolio (see page 8). However, the size of our coverage universe lends itself to a plethora of new ideas beyond the ones we seek to capitalize on. Below, we provide a unique screen that sorts companies we feel are undervalued on both a DCF and relative value basis (the first two pillars of our VBI; the third is a technical assessment).



"By overlaying a relative valuation process on a robust forward-looking discounted cash flow valuation methodology, "pure" value investors add an extra degree of conviction to their undervalued ideas. For the ideas in this screen to register the highest rating on the Valuentum Buying Index, however, the market would also have to agree that shares are undervalued, as evidenced by an advancing stock price, one that has good momentum." – Valuentum's Brian Nelson, CFA

We update this screen monthly and deliver it to you in our newsletter (for your added convenience, we also post it on our site). You'll see we often hold a number of these firms in our portfolio, and we continue to monitor the remainder for the most opportune time to add them. The names on this list are the cream of the crop for the value investor and can supplement your "shopping list" of new ideas.

Company Name	Symbol	DCF Valuation	Relative Valuation	P/FV	Fair Value Estimate
Supervalu	SVU	UNDERVALUED	ATTRACTIVE	0.48	$10.00
Virtu Financial	VIRT	UNDERVALUED	ATTRACTIVE	0.56	$29.00
Omega Healthcare	OHI	UNDERVALUED	ATTRACTIVE	0.60	$48.00
Xerox	XRX	UNDERVALUED	ATTRACTIVE	0.64	$16.00
Prudential Financial	PRU	UNDERVALUED	ATTRACTIVE	0.67	$116.00
Viacom	VIA	UNDERVALUED	ATTRACTIVE	0.67	$66.00
CNO Financial	CNO	UNDERVALUED	ATTRACTIVE	0.69	$23.00
Synaptics	SYNA	UNDERVALUED	ATTRACTIVE	0.69	$76.00
Celgene	CELG	UNDERVALUED	ATTRACTIVE	0.70	$141.00
Korn/Ferry	KFY	UNDERVALUED	ATTRACTIVE	0.71	$33.00
Mylan	MYL	UNDERVALUED	ATTRACTIVE	0.72	$53.00
Corporate Executive Board	CEB	UNDERVALUED	ATTRACTIVE	0.72	$72.00
Jabil Circuit	JBL	UNDERVALUED	ATTRACTIVE	0.73	$30.00
Juniper Networks	JNPR	UNDERVALUED	ATTRACTIVE	0.73	$31.00
Buffalo Wild Wings	BWLD	UNDERVALUED	ATTRACTIVE	0.74	$190.00
Super Micro	SMCI	UNDERVALUED	ATTRACTIVE	0.74	$29.00
Express Scripts	ESRX	UNDERVALUED	ATTRACTIVE	0.75	$91.00
MetLife	MET	UNDERVALUED	ATTRACTIVE	0.75	$56.00
Regal Beloit	RBC	UNDERVALUED	ATTRACTIVE	0.75	$76.00
CVS Caremark	CVS	UNDERVALUED	ATTRACTIVE	0.75	$103.00
CA Tech	CA	UNDERVALUED	ATTRACTIVE	0.75	$42.00
AIG	AIG	UNDERVALUED	ATTRACTIVE	0.76	$78.00
Red Robin	RRGB	UNDERVALUED	ATTRACTIVE	0.76	$60.00
VMware	VMW	UNDERVALUED	ATTRACTIVE	0.77	$81.00
Interface	TILE	UNDERVALUED	ATTRACTIVE	0.79	$21.00
Vitamin Shoppe	VSI	UNDERVALUED	ATTRACTIVE	0.79	$32.00
Cracker Barrel	CBRL	UNDERVALUED	ATTRACTIVE	0.79	$171.00

Ideas...from previous page

The initial table below showcases firms that fit the bill of the Valuentum investor, with each posting a 9 or a 10 on our index. These are names that we may swap into our portfolio on the long side (if not already held) should their upside potential become greater than our current holdings.

We also show firms that register a 1 or 2 on our VBI. These names represent put-option candidates. We provide the respective lists below, and each firm's report can be found on our website.

Company Name	Symbol	Sector	Industry	VBI
Jabil Circuit	JBL	Information Technology	Electronic Suppliers	9
VMware	VMW	Information Technology	Business Services	9
Xerox	XRX	Industrials	Commercial Services	9
AIG	AIG	Financials	Insurance - Property & Casualty	8
CVS Caremark	CVS	Consumer Staples	Food Retailers	8
Prudential Financial	PRU	Financials	Insurance - Life	8

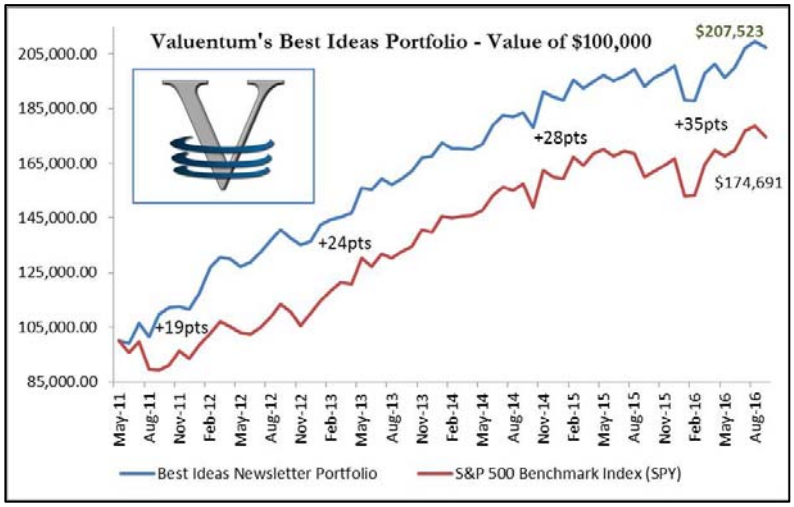
Amphenol Corp	APH	Information Technology	Electronic Suppliers	2
AO Smith Corp	AOS	Industrials	Electrical Equipment - industrial	2
Arch Capital	ACGL	Financials	Insurance - Property & Casualty	2
Drew Indust	DW	Industrials	Recreational Vehicles	2
Infinity	IPCC	Financials	Insurance - Property & Casualty	2
Johnson Outdoors Inc	JOUT	Consumer Discretionary	Sporting Goods	2
Lancaster Colony	LANC	Consumer Staples	Food Products	2
Manhattan Associates Inc	MANH	Information Technology	Software	2
MGM Resorts	MGM	Consumer Discretionary	Gaming	2
Natural Resource Partners	NRP	Energy	Industrial Minerals	2
New Oriental Education	EDU	Consumer Discretionary	Education Services	2
Nordson	NDSN	Industrials	Machinery & Tools	2
Northern Trust	NTRS	Financials	Banks & Money Centers	2
Nu Skin	NUS	Consumer Discretionary	Luxury - Established Brands	2
NuVasive	NUVA	Health Care	Medical Instruments	2
Quad/Graphics Inc	QUAD	Consumer Discretionary	Book Publishing	2
South Jersey	SJI	Energy	Utilities	2
State Auto	STFC	Financials	Insurance - Property & Casualty	2
Amazon.com	AMZN	Consumer Discretionary	Internet & Catalog Retail	1
American Electric	AEP	Energy	Utilities - Large	1
Badger Meter	BMI	Industrials	Electrical Equipment	1
Brown-Forman	BF.B	Consumer Staples	Beverages - alcoholic	1
Church & Dwight	CHD	Consumer Staples	Household Products	1
Federal Realty	FRT	Financials	REIT - Retail	1
General Mills	GIS	Consumer Staples	Food Products - Large	1
Hyatt	H	Consumer Discretionary	Hotels	1
IDEX	IEX	Industrials	Machinery & Tools	1
IDEXX	IDXX	Health Care	Diagnostic Substances	1
Illinois Tool Works	ITW	Industrials	Machinery & Tools	1
Jack in the Box	JACK	Consumer Discretionary	Restaurants - Fast Food & Coffee	1
Kraft Heinz	KHC	Consumer Staples	Food Products - Large	1
Lockheed Martin	LMT	Industrials	A&D Prime	1
McDonald's	MCD	Consumer Discretionary	Restaurants - Fast Food & Coffee	1
MSCI	MSCI	Information Technology	Software	1
Neogen	NEOG	Health Care	Diagnostic Substances	1
Northrop Grumman	NOC	Industrials	A&D Prime	1
Rayonier	RYN	Industrials	Building Materials	1
Toro Co	TTC	Industrials	Machinery & Tools	1
Ulta Salon	ULTA	Consumer Discretionary	Personal Services	1

Ideas...continued on next page

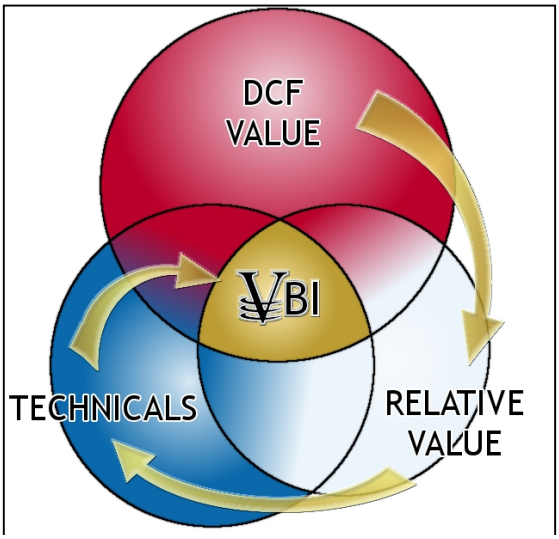
Our Methodology – The Valuentum Buying Index (VBI)

By Valuentum Analysts

At Valuentum, we think the best opportunities arise from a complete understanding of all investing disciplines in order to identify the most attractive stocks at any given time. Valuentum therefore analyzes each stock across a wide spectrum of philosophies, from deep value through momentum investing. We think companies that are attractive from a number of investment perspectives--whether it be growth, value, income, momentum, etc.--have the greatest probability of capital appreciation and relative outperformance. The more deep-pocketed institutional investors that are interested in the stock for reasons based on their respective investment mandates, the more likely it will be bought and the more likely the price will move higher to converge to its true intrinsic value (buying a stock pushes its price higher). On the other hand, we think the worst stocks will be shunned by most investment disciplines and display expensive valuations, poor technicals and deteriorating momentum indicators.



Stocks that meet our demanding criteria fall in the center of the Venn diagram below, displaying attractive characteristics from a discounted cash-flow basis, a relative value basis, and with respect to a technical and momentum assessment. The size of the circles reveals the relative emphasis we place on each investment consideration, while the arrows display the order of our process -- value first then technicals and momentum last. We may like firms that are undervalued both on a DCF basis and relative value basis, but we won't like firms just because they're currently exhibiting attractive technical or momentum indicators. We're not traders or speculators. We're long-term investors and want to have complete confirmation and conviction in the best ideas we deliver to our subscribers.



Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

The center of the Venn diagram on the previous page, the Valuentum Buying Index (VBI) combines rigorous financial and valuation analysis with an evaluation of a firm's technicals and momentum indicators to derive a score between 1 and 10 for each company (10=best). Because our process factors in a technical and momentum assessment after we evaluate a firm's investment merits via our rigorous DCF and relative-value process, we're better able to pinpoint the best entry and exit points on the most undervalued stocks.

Research firms that just focus on valuation may encourage investors to buy a stock all the way down (a falling knife), while those that just use technical and momentum indicators may expose portfolios to significantly overpriced stocks at their peaks. Only when both sides of the investment spectrum are combined can investors get the best stocks on the market today at the best prices, in our view.

Let's examine the chart below, which showcases how the Valuentum process has the greatest profit potential of any investing strategy. The Valuentum process targets adding stocks to actively-managed portfolios when both value and momentum characteristics are "good" and removing them when both value and momentum characteristics are "bad" (blue circles: Buy --> Sell). The Valuentum strategy captures the entire equity pricing cycle, while the value and momentum strategies individually truncate profits.

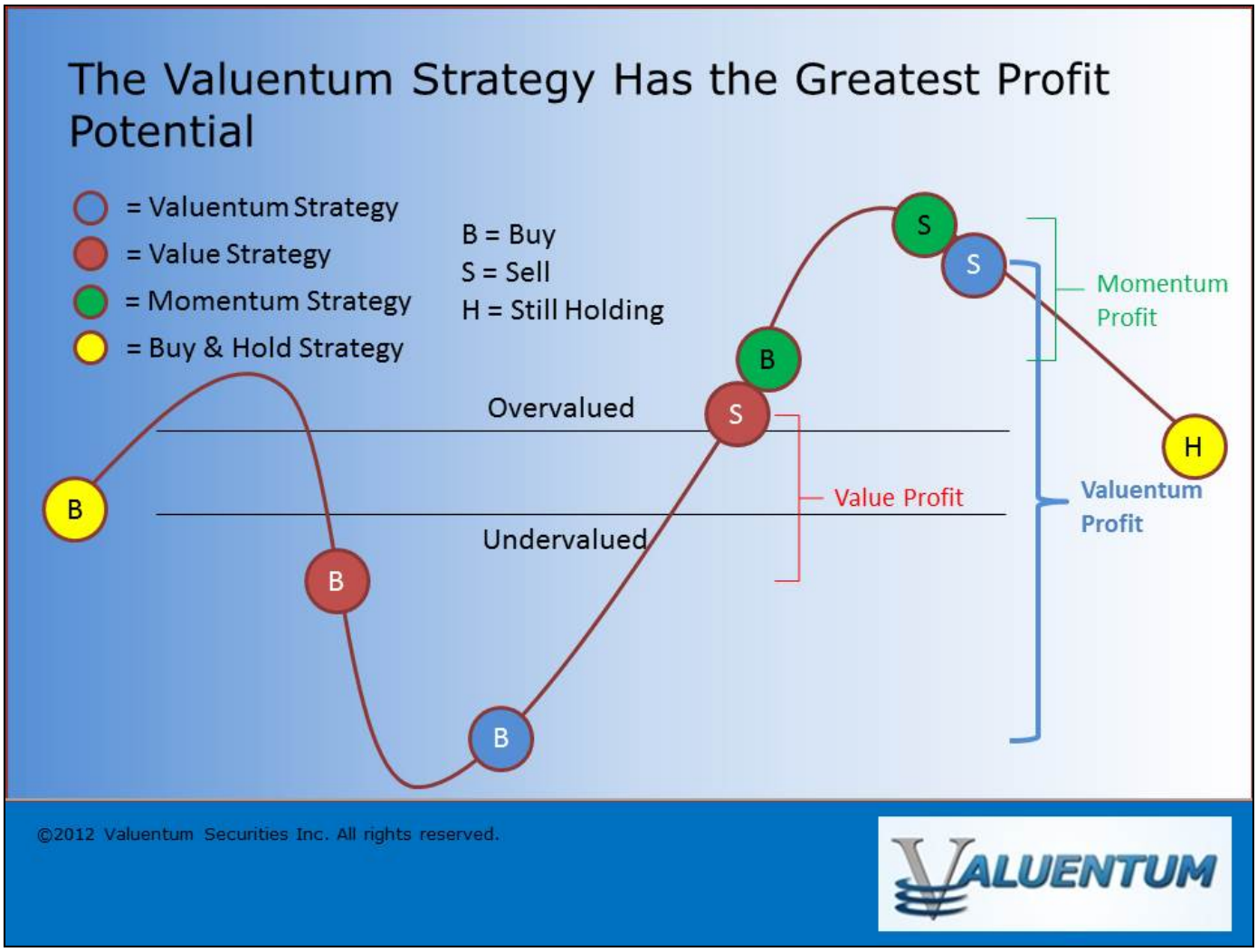


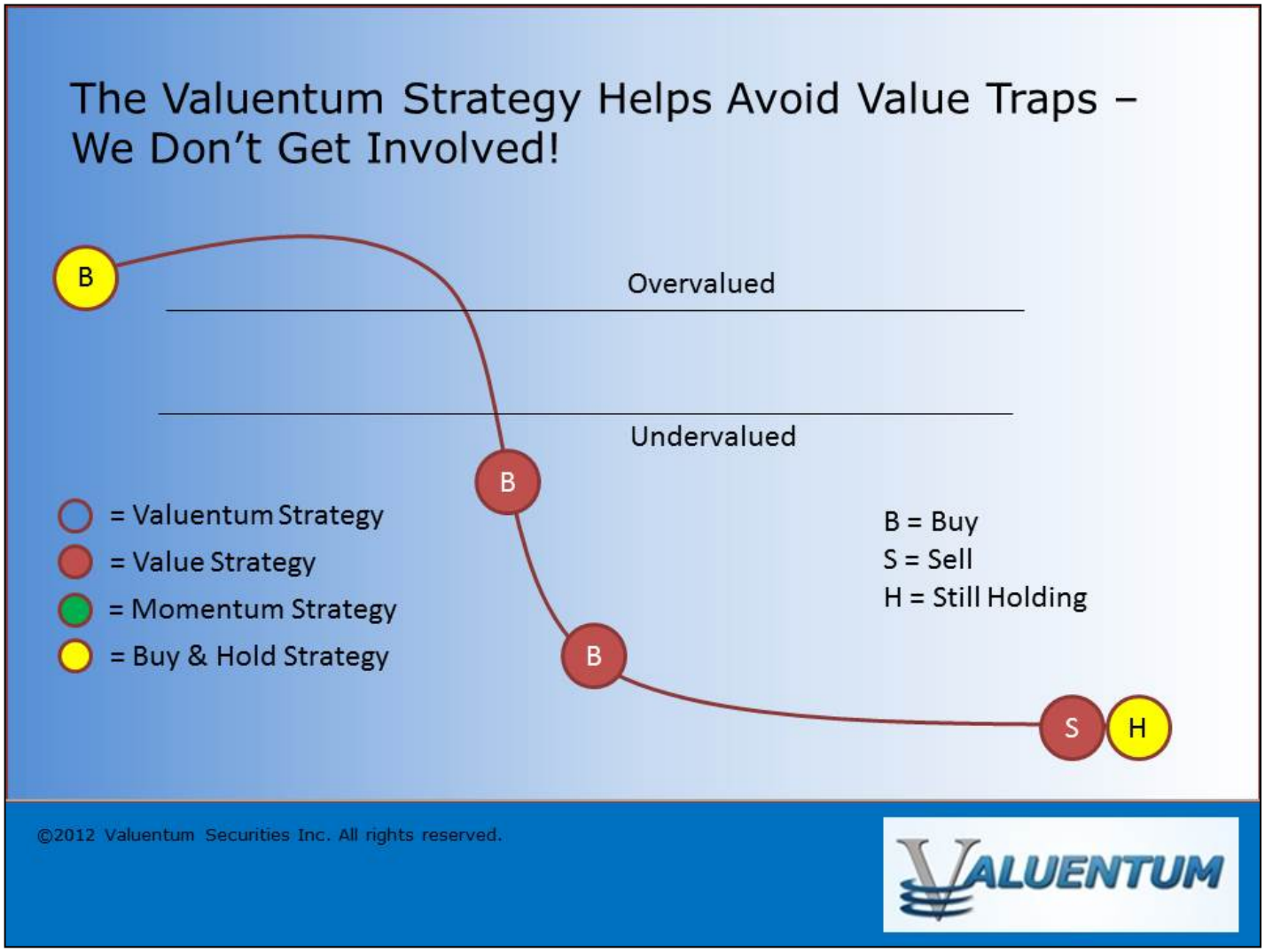
Illustration for educational purposes only.

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

Furthermore, Valuentum subscribers are less likely to be involved in value traps because we demand material revenue and earnings growth for firms to earn a 10 on our Valuentum Buying Index. Value traps often occur as a result of secular declines in a firm's products or services, resulting in deteriorating revenue and earnings trends (and a falling stock price). Valuentum subscribers are less likely to be exposed to these "falling knives" since our process requires firms to not only be undervalued but also be exhibiting bullish technical and momentum indicators before we would consider adding them to our actively-managed portfolios.

Since the stock market is a forward-looking mechanism, price usually leads fundamentals. Without a turnaround in price, the risk that the fundamentals of an undervalued stock have not turned for the positive is higher. Where value strategies may encourage the buying of a stock all the way down regardless of whether fundamentals ever turn (red circles: Buy --> Sell), the Valuentum strategy simply steers clear of these situations. We wait for technical improvement in the equity, which often precedes fundamental changes at the company.

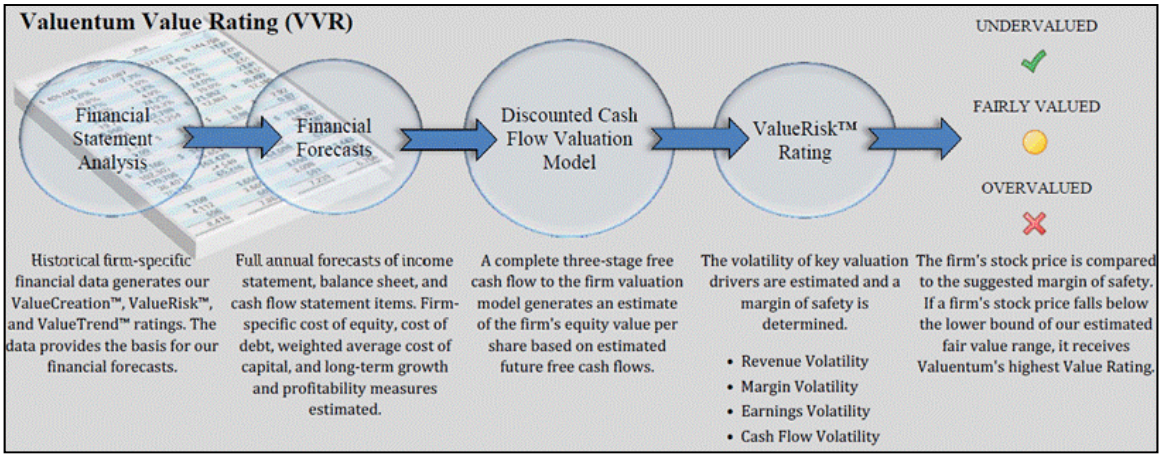


Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

I. We Use a Rigorous Discounted Cash Flow Valuation Process

Our methodology starts with in-depth financial statement analysis, where we derive our ValueCreation, ValueRisk, and ValueTrend ratings, which together provide a quantitative assessment of the strength of a firm's competitive advantages. We compare a company's return on invested capital (ROIC) to our estimate of its weighted average cost of capital (WACC) to assess whether it is creating economic profit for shareholders (ROIC less WACC equals economic profit). Firms that have improving economic profit spreads over their respective cost of capital score high on our ValueCreation and ValueTrend measures, while firms that have relatively stable returns score well with respect to our ValueRisk evaluation, which impacts our margin-of-safety assessment.



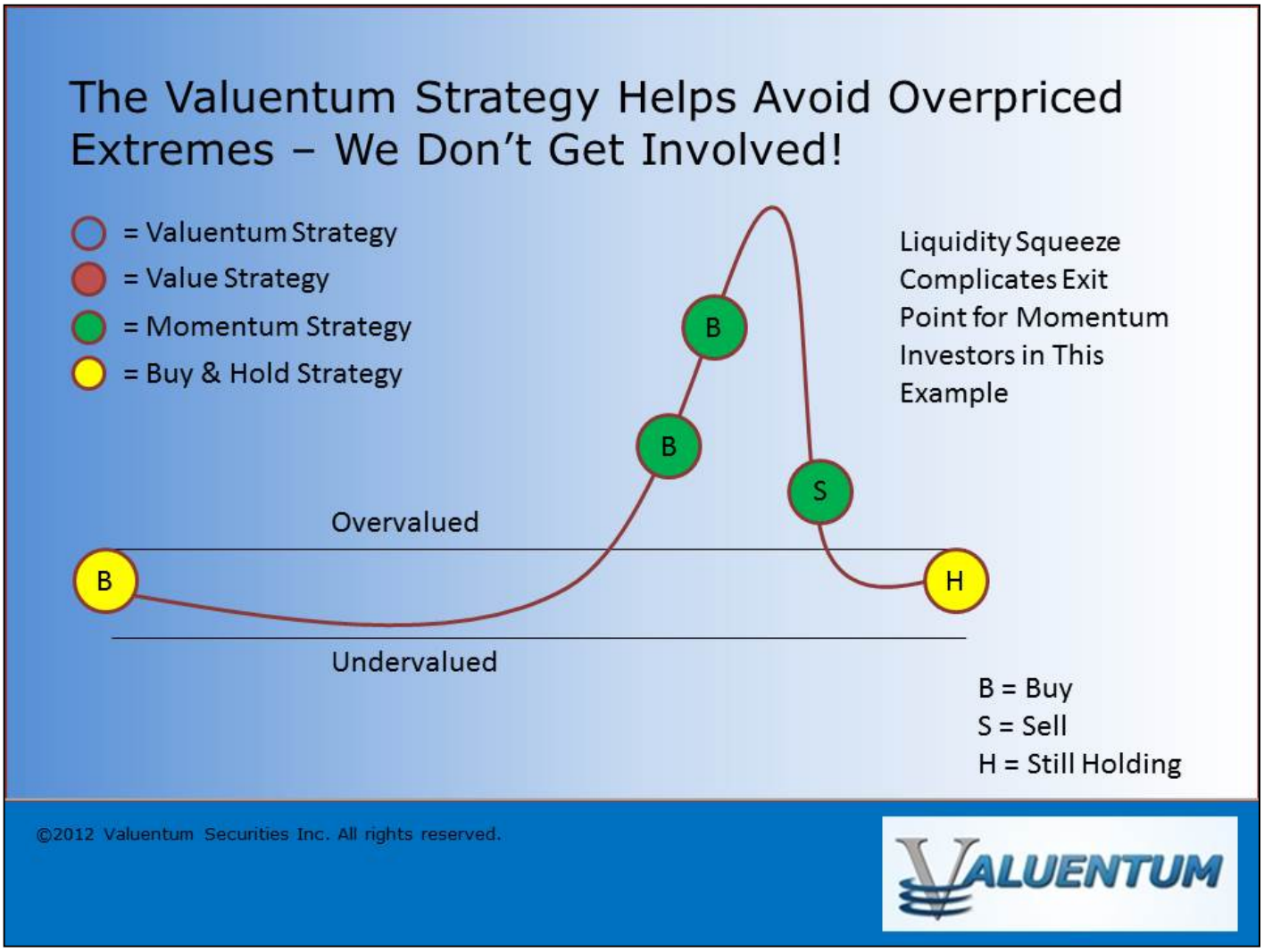
After evaluating historical trends, we then make full annual forecasts for each item on a company's income statement and balance sheet to arrive at a firm's future free cash flows. We derive a company-specific cost of equity (using a fundamental beta based on the expected uncertainty of key valuation drivers) and a cost of debt (considering the firm's capital structure and synthetic credit spread over the risk-free rate), culminating in our estimate of a company's weighted average cost of capital (WACC). We don't use a market price-derived beta, as we embrace market volatility, which provides investors with opportunities to buy attractive stocks at bargain-basement levels.

We then assess each company within our complete three-stage free cash flow to the firm (enterprise cash flow) valuation model, which generates an estimate of a company's equity value per share based on its discounted future free cash flows and the company's net balance sheet impact, including other adjustments to equity value (namely pension and OPEB adjustments). Our ValueRisk rating, which considers the underlying uncertainty of the capacity of the firm to continue to generate value for shareholders, sets the margin of safety bands around this fair value estimate. For firms that are trading below the lower bound of our margin of safety band, we consider these companies undervalued based on our DCF process. For firms that are trading above the higher bound of our margin of safety band, we consider these companies overvalued based on our DCF process.

We think a focus on discounted cash-flow valuation prevents investors from exposing their portfolios to significantly overpriced stocks at their peaks. The chart below reveals how pure momentum investors may expose their portfolios to pricing extremes and dramatic falls (green circles: Buy --> Sell). We stay away from these situations.

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page



II. We Perform a Forward-Looking Relative Value Assessment

Our discounted cash-flow process allows us to arrive at an absolute view of the firm's intrinsic value. However, we also understand the critical importance of assessing firms on a relative value basis, versus both their industry and peers. Many institutional money-managers--those that drive stock prices--pay attention to a company's price-to-earnings (PE) ratio and price-earning-to-growth (PEG) ratio in making buy/sell decisions. With this in mind, we have included a forward-looking relative value assessment in our process to further augment our rigorous discounted cash-flow process. If a company is undervalued on both a price-to-earnings ratio and a price-earnings-to-growth (PEG) ratio versus industry peers, we would consider the firm to be attractive from a relative value standpoint.

III. We Seek to Avoid Value Traps, Falling Knives and Opportunity Cost

Once we have estimated a firm's intrinsic value on the basis of our discounted cash-flow process, determined if it is undervalued according to its firm-specific margin of safety bands, and assessed whether it has relative value versus industry peers, we then evaluate the company's technical and momentum indicators to pin-point the best entry and exit points on the stock (but only after it meets our stringent

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

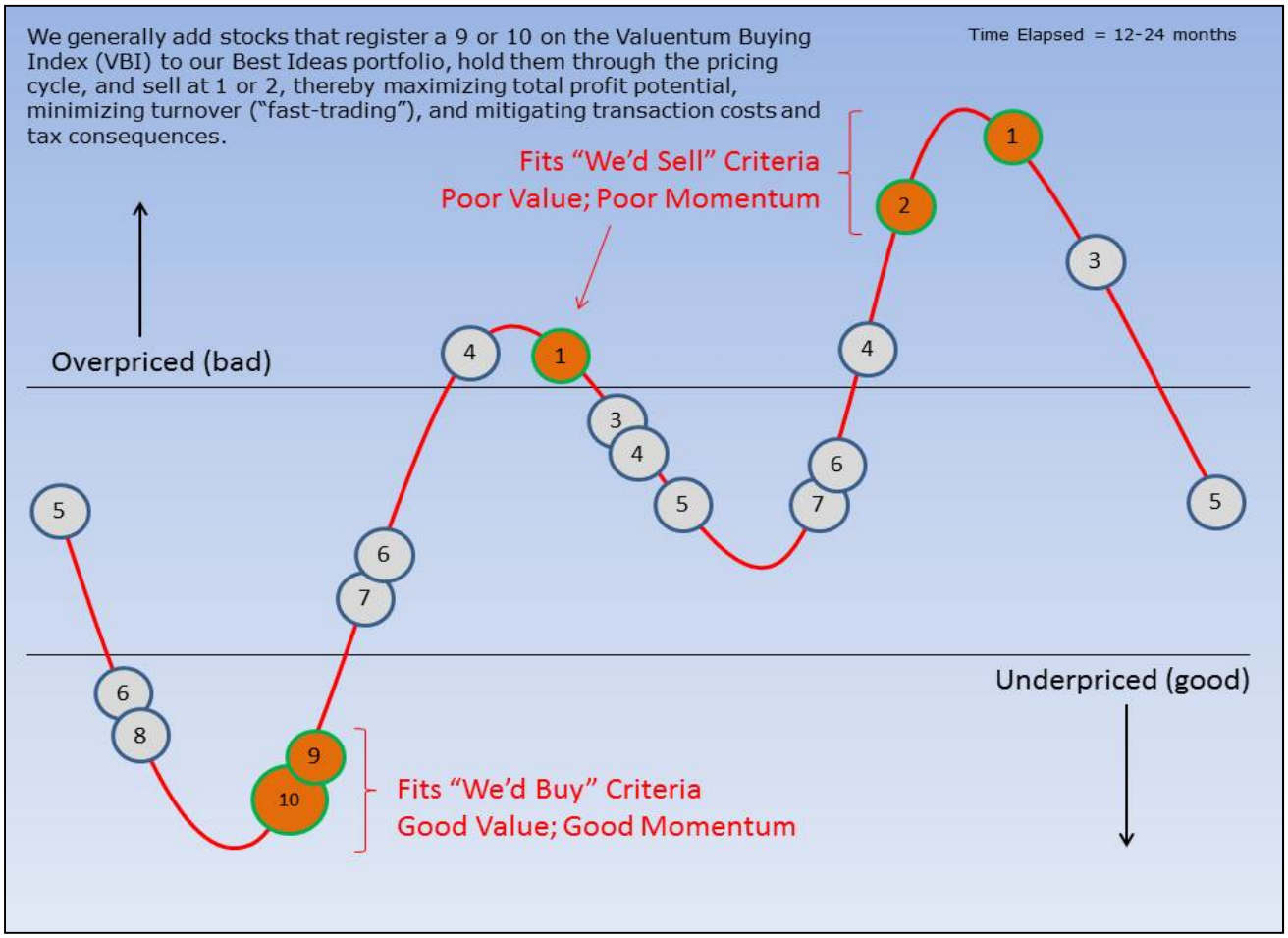
valuation criteria). Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster returns. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we look at with respect to our technical and momentum assessment of a company's stock.

We embrace the idea that the future is inherently unpredictable and that not all fundamental factors can be included in a valuation model. By extension, we use technical and momentum analysis to help safeguard us against value traps, falling knives, and the opportunity cost of holding an undervalued equity for years before it converges to fair value. Other research firms do not consider opportunity cost as a legitimate expense for investors.

Putting It All Together - the Valuentum Buying Index

Though the time frame varies depending on each idea, we expect our best ideas to work out over a 12-24 month time horizon (on average) -- any shorter than that is mostly luck, in our view. We tend to add firms to our Best Ideas portfolio when they register a 9 or 10 on our Valuentum Buying Index (VBI) and tend to remove firms from our Best Ideas portfolio when they register a 1 or 2 on our VBI.

We like to maximize profits on every idea, with the understanding that momentum does exist and that prices over and under shoot intrinsic value all of the time. A value strategy (10 --> 5) truncates potential profits, while a momentum strategy (4 --> 1) ignores profits generated via value assessments. We're after the entire profit potential, as shown below.



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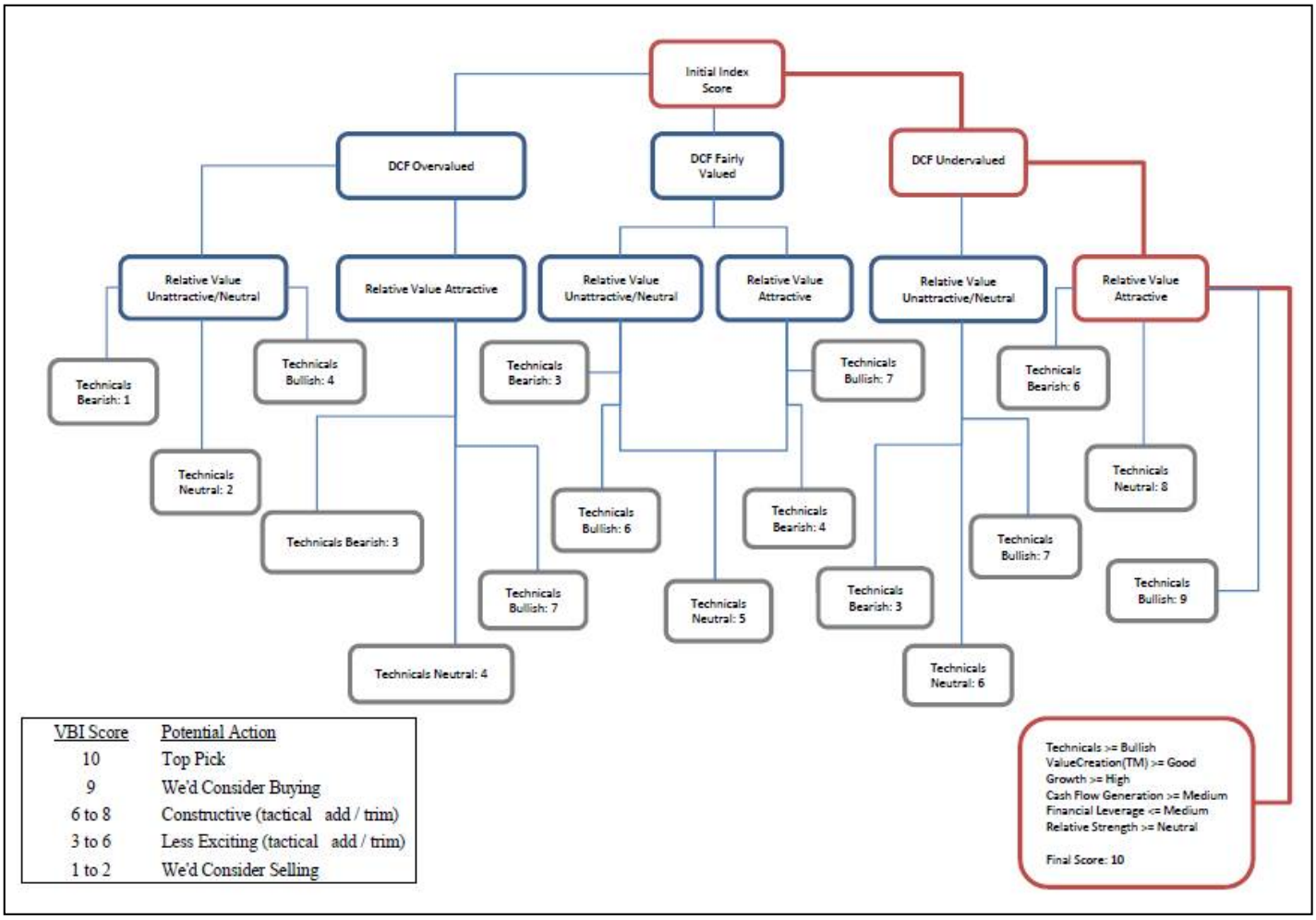
Our Methodology – The Valuentum Buying Index continued from previous page

Let's follow the red line on the flow chart below to see how a firm can score a 10, the best mark on our index (a "Top Pick"). Please click here to view an enlarged pdf version. First, the company would need to be 'UNDERVALUED' on a DCF basis and 'ATTRACTIVE' on a relative value basis. The stock would also have to be exhibiting 'BULLISH' technicals. The firm would need a ValueCreation rating of 'GOOD' or 'EXCELLENT', exhibit 'HIGH' or 'AGGRESSIVE' growth prospects, and generate at least a 'MEDIUM' or 'NEUTRAL' assessment for cash flow generation, financial leverage, and relative price strength.

This is a tall order for any company, but we're looking to deliver the very best of ideas to our clients and subscribers. Firms that don't make the cut for a 10 are ranked accordingly, with the least attractive stocks garnering a score of 1 ("We'd sell"). Most of our coverage universe falls between 3 and 7, but at any given time there could be large number of companies garnering either high or low scores, especially at market lows or tops, respectively.



Our Methodology – The Valuentum Buying Index continued on next page

About the Fair Value Range

By Valuentum Analysts

Understanding the Fair Value Range and Why It's Important

FAQ: Why do you use such a wide fair value range for certain companies?

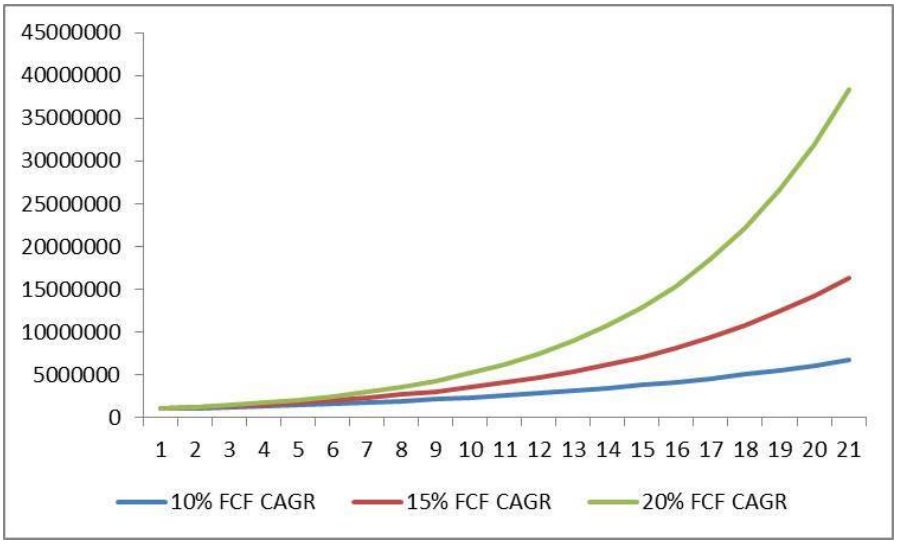
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth exactly $25 or a firm's stock is worth exactly $100. The reality is that, in the first case, the company's shares are probably worth somewhere between $20 and $30, and in the latter case, the stock is worth somewhere between $75 and $125.

Why? Because all of the value of a company is generated in the future (future earnings and free cash flow), and the future is inherently unpredictable (unknowable). If the future could be predicted with absolute certainly (knowable), then a stock analyst could say a company's shares are worth precisely this, or that a firm's stock is worth precisely that. Not *because he or she would know where the stock would be trading at*, but because he or she would know precisely what future free cash flows would be (and all other modeling facts-not assumptions in this case) and arrive at the exact and **non-debatable** value of the firm.

But the truth of the matter is that nobody knows the future, and analysts can only estimate what a company's future free cash flow stream will look like. Certain unexpected factors will hurt that free cash flow stream relative to forecasts, while other unexpected factors will boost performance. That's how a downside fair value estimate and an upside fair value estimate is generated, or in the words of Warren Buffett and Benjamin Graham how a "margin of safety" is generated. Only the most likely scenario represents the point fair value estimate. Any stock analyst that says a company is worth a precise figure--whether it's $1 or $100--falls short of understanding one of the most important factors behind valuation.

But why the large range in many cases?

Well, there are many firms in our coverage universe that have a very large range of outcomes in their future free cash flow growth. And because discounting free cash flows is an integral part of calculating the fair value estimate of a company, the range of fair values will also be large. To illustrate this point, let's take a look at the difference between the levels of free cash flows in Year 20 under three different future growth rates: 10%, 15%, and 20%. Though the growth rate between each scenario is but 5 percentage points, the magnitude of the free cash flow difference is astounding many years into the future, and our discounted cash-flow process considers the long-term intrinsic value of firms.



About the Fair Value Range continued on next page

About the Fair Value Range continued from previous page

Under these future free-cash-flow scenarios, if we assume an 8% discount rate and 100,000 shares outstanding (and no debt), the difference in the fair value estimate between the upside case (green line) and downside case (blue line) would be an incredible $68 per share ($82 per share less $14 per share). That's a huge fair value range (80%+), and all because of just a 10 percentage point difference in a future free cash flow growth assumption. For firms that are growing cash flows at 200% or 300% per annum, a large range of fair value outcomes is not only inevitable but also very reasonable. In other words, the Valuentum framework provides an avenue to quantify the upside and downside risks investors are taking in high uncertainty and fast-growing enterprises.

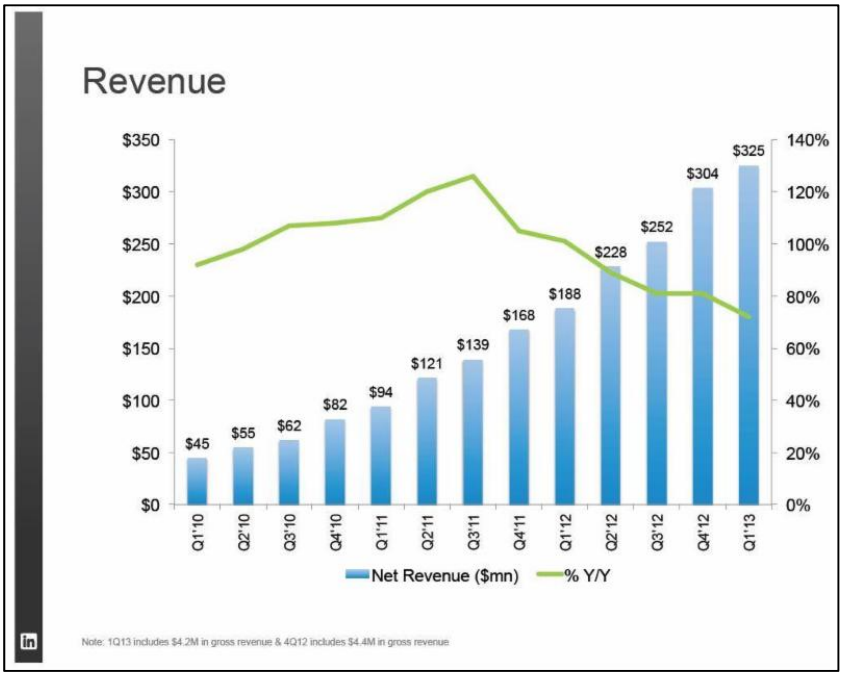


Image Source: LinkedIn

To really hit this point home, shown above is a slide of LinkedIn's (LNKD) revenue from the first quarter of 2010 through the first quarter of 2013. The green line (mapped to the right axis) shows LinkedIn's revenue growth rate. Let's assume revenue expansion translates into similar free cash flow growth expectations (not exactly a precise assumption, given the leverage in LinkedIn's business model), but bear with us for simplistic illustrative purposes. Will LinkedIn's revenue/cash flows expand at a 20% rate, a 40% rate, or a 60% rate (or an even greater pace) through year 20?

It's a very, very difficult question to answer. Remember how significant that 10 percentage point spread was in the hypothetical example above? Well, it's even more significant for LinkedIn. We know LinkedIn's free cash flows will expand, and expand fast, but just how fast is certainly debatable. To a very large extent, that's why LinkedIn's range of probable outcomes (fair value range) is so large. Understanding the cone of fair value outcomes of a company is helpful because the size of the range tends to be positively correlated to the equity's volatility. If you recall, look at what happened to LinkedIn's stock recently when investors ratcheted down their long-term growth assumptions (and by extension, the company's intrinsic value).

Shares collapsed in a huge way.

About the Fair Value Range continued on next page

About the Fair Value Range **continued from previous page**

But it was largely because of that same weakness in equity pricing that drove Microsoft (MSFT) to take the leap to buy LinkedIn's equity outright just a few months later. Over just a very short period of time, LinkedIn's shares effectively collapsed and then surged as the chart below shows (its intrinsic value range didn't change much, however). Having a fair value range that adequately captures both the upside and downside cases for a company's shares remains an integral part of stock investing. Not only does it help hone in on the potential risk-reward profile of an equity at any given time, it also helps reveal the attractiveness of various "entry" or "exit" points using a robust free-cash-flow based and fundamentally-sound intrinsic value estimate as the anchor.

We're scouring our coverage universe for firms that are trading outside of their respective fair value ranges. A firm trading below the low end of its fair value range, for example, is undervalued, while a firm trading above its fair value range is overvalued. The fair value range for each company captures the inherent uncertainty of the trajectory of that firm's unique future free cash flow stream. For the 1,400+ companies we include in our coverage universe, we provide a discounted cash flow derived fair value estimate and a corresponding fair value range -- and a robust discounted cash-flow process is only one aspect of our service.

Valuentum Best Ideas Newsletter: Volume 6, Issue 12

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