OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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Valuentum Securities Inc.
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Portfolio Return	Benchmark Return	Outperformance
82.7%	56.4%	26.4pts

Our Best Ideas (see page 8): AAPL, MO, BIDU, BWLD, EBAY, XLF, F, GE, GOOG, XLV, INTC, PCP, KBE, RSG, RIO, TEVA, UNP, XLU, V

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Goals of our 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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The Writing Is on the Wall

By Brian Nelson, CFA

"The stock market is a no-called-strike game. You don't have to swing at everything—you can wait for your pitch. The problem when you're a money manager is that your fans keep yelling, 'Swing, you bum!'" – Warren Buffett, 1999

If there is an environment more difficult to hit a pitch out of the park, I don't think I've seen one. Valuations have been shooting to the upside for some time, making it difficult for investors to hit that proverbial home run. The market is climbing a wall of worry—and now, the wall has writing on it. Janet Yellen at the Fed had something to say about valuations in its Monetary Policy Report (1), released July 15:

"…valuation metrics in some sectors do appear substantially stretched—particularly those for smaller firms in the **social media and biotechnology industries**, despite a notable downturn in equity prices for such firms early in the year. Moreover, implied volatility for the overall S&P 500 index, as calculated from option prices, has declined in recent months to low levels last recorded in the mid-1990s and mid-2000s, reflecting improved market sentiment and, perhaps, the influence of **"reach for yield"** behavior by some investors."

It's somewhat unusual for the Fed to make sector valuation calls, which is why we think the Fed wants to say more, but doesn't want to spook investors in doing so. Small cap managers, for example, have been saying for some time that stocks are as "expensive as 'they've' ever seen them" (2). Many pure value investors have already stepped to the sidelines.

We credit the Valuentum methodology—which prefers stocks with strong valuation and pricing support—for letting the portfolio's winners run to keep the outperformance gap moving in the right direction. The Best Ideas portfolio (see page 8) added 70 basis points of outperformance since the last update, and at the time of this writing, Best Ideas portfolio holding Intel (INTC) posted a strong quarter and outlook—it's up a few points in after-hours trading.

Today, you are at the plate. **The crowd is loud.** But you don't have to swing at every (stock) pitch. The Best Ideas portfolio on page 8, for example, is a list of ideas that we think will continue to outperform. Importantly, if you're chasing overpriced social media and biotechs or reaching for *unsupported* dividend yields, you're likely going to strike out. I simply don't want that to happen.

(1) http://www.federalreserve.gov/monetarypolicy/files/20140715_mprfullreport.pdf
(2) http://blogs.wsj.com/moneybeat/2014/07/07/why-cash-is-king-for-this-small-cap-investor/

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KEY CONCEPT: After adding firms to the Best Ideas portfolio, we may tactically trade around these positions when they have VBI ratings between 3 and 8 and 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 typically equivalent to a 'we'd hold'). We tend to remove firms from our Best Ideas portfolio (see page 8) when they register a 1 or 2 (we'd sell) on our process. Importantly, however, firms in our Best Ideas portfolio, which have generally registered a 9 or 10 on our scale when we added them, should be considered our best ideas at any point in time. View FAQ for more details about how the team utilizes the Valuentum Buying Index to run the portfolio.

There's No Space Like Aerospace

By Brian Nelson, CFA

The recovery from the stock-market bottom in March 2009 has been five years in the making, but as the cyclical threat of an eventual global downturn looms, the aerospace industry is one of the few industries that we think will continue to be resilient in the face of such pressures. We expect commercial aircraft build rates to continue to climb at least through 2018.

If the multi-year backlogs of unfulfilled deliveries at the large airframe makers aren't enough, Boeing's updated 20-year outlook for commercial aerospace demand, released June 10, was about as rosy as can be. The reason for such a long-range view has to do with the nature of aircraft building. When airframe makers build next-generation aircraft, they are essentially building a plane for the next two decades, as it may take 5 years or more from the drawing board to first flight and another 10-15 years before hitting maximum production efficiency on the assembly line. Such a long-term forecast is necessary to develop product strategy.

Valuentum has long-favored aerospace exposure in the Best Ideas portfolio, and we continue to think the industry weighting makes sense—even this far into the economic recovery. Please note that when we say aerospace exposure, we mostly mean the aerospace supply chain, which includes firms such as Precision Castparts (PCP) and United Technologies (UTX), not the airline industry, which includes firms such as American Airlines Group (AAL) and JetBlue (JBLU). Though both the commercial aerospace and commercial airline industries are levered to air travel demand, their respective economics are *completely* different. Where one benefits from increased aircraft build rates, the other suffers from what we believe are the worst structural characteristics of any industry in our coverage.

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Boeing's 20-year outlook takes the following shape:

> The aviation industry continually adapts to market forces. Key among these are fuel prices, economic growth and development, environmental regulations, infrastructure, market liberalization, airplane capabilities, other modes of transport, business models, and emerging markets. Fuel is now the largest component of airline cost structure. This fact has spurred manufacturers to produce more efficient airplanes, such as the 787 and the 737 MAX, and encouraged airlines to optimize other cost and revenue centers to maintain profitability in the face of high fuel prices.
>
> Our long-term forecast incorporates the effects of market forces on the development of the aviation industry. Economic growth, as measured by gross domestic product (GDP), is a primary contributor to aviation industry growth. GDP is forecast to rise 3.2 percent over the next 20 years, which will drive passenger traffic to grow 5.0 percent annually and cargo traffic (which also depends on global trade) to grow 4.7 percent annually.

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> We forecast long-term demand for 36,770 new airplanes, valued at $5.2 trillion. We project that 15,500 of these airplanes (42 percent of all new deliveries) will replace older, less efficient airplanes. The remaining 21,270 airplanes will be for fleet growth, which stimulates expansion in emerging markets and development of innovative airline business models. Single-aisle airplanes continue to command the largest share of the market. Approximately 25,680 new single-aisle airplanes will be needed over the next 20 years. Fast-growing low-cost carriers and network carriers pressed to replace aging airplanes drive single-aisle demand. The widebody fleet will need 8,600 new airplanes. The new generation of efficient widebody airplanes is helping airlines open new markets that would not have been economically viable in the past.

Airplane Deliveries - units (2014-2033)	
Regional Jets	2,490
Single-aisle	25,680
Small wide-body	4,520
Medium wide-body	3,460
Large wide-body	620
Airplane Market Value - $ bil (2014-2033)	
Regional Jets	100
Single-aisle	2,560
Small wide-body	1,140
Medium wide-body	1,160
Large wide-body	240
Airplane Deliveries by Region (2014-2033)	
Asia Pacific	13,460
Europe	7,450
North America	7,550
Middle East	2,950
Latin America	2,950
C.I.S.	1,330
Africa	1,080
Airplane Market Value by Region - $ bil (2014-2033)	
Asia Pacific	2,020
Europe	1,040
North America	870
Middle East	640
Latin America	340
C.I.S.	150
Africa	140

Source: Boeing

Though such a forecast may seem optimistic, we note that Boeing's 20-year outlooks, which are provided annually, have traditionally been proven conservative—the 1994 outlook, for example, is the most recent version to have been bested by actual numbers. Though commercial aircraft orders will always be cyclical, the commercial aerospace industry has proven to be quite resilient. Since 1980, the industry has bounced back from 4 recessions, 2 financial crises, 2 Gulf wars, 1 oil shock, 1 near pandemic (SARS) and 9/11. There's not much more that can try to knock commercial aerospace expansion off its long-term upward trajectory.

Boeing's backlog of unfulfilled deliveries at the end of the first quarter of 2014 was $374 billion, up from $319 billion at the end of 2012 and $295 billion at the end of 2011. This implies that, in the event of an economic downturn, Boeing has the flexibility to move customer deliveries forward to still hit targeted numbers (without having to make costly adjustments to its supply chain). Because many delivery slots aren't available for years, cancellations from customers have typically been a non-issue, especially for the workhorse 737 family and revolutionary 787 Dreamliner.

Airbus' backlog is equally impressive. The aerospace giant's overall backlog, as of June 30, was 5,546 jetliners, composed of 4,372 A320 aircraft, 243 A330s, 742 A350s and 189 A380s. Regional jet operators such as Bombardier (BBD.B) and Embraer (ERJ) will also contribute to growing aerospace build rates in coming years. We think build rates will continue to advance through 2018, regardless of what the economic environment throws at commercial airline travel.

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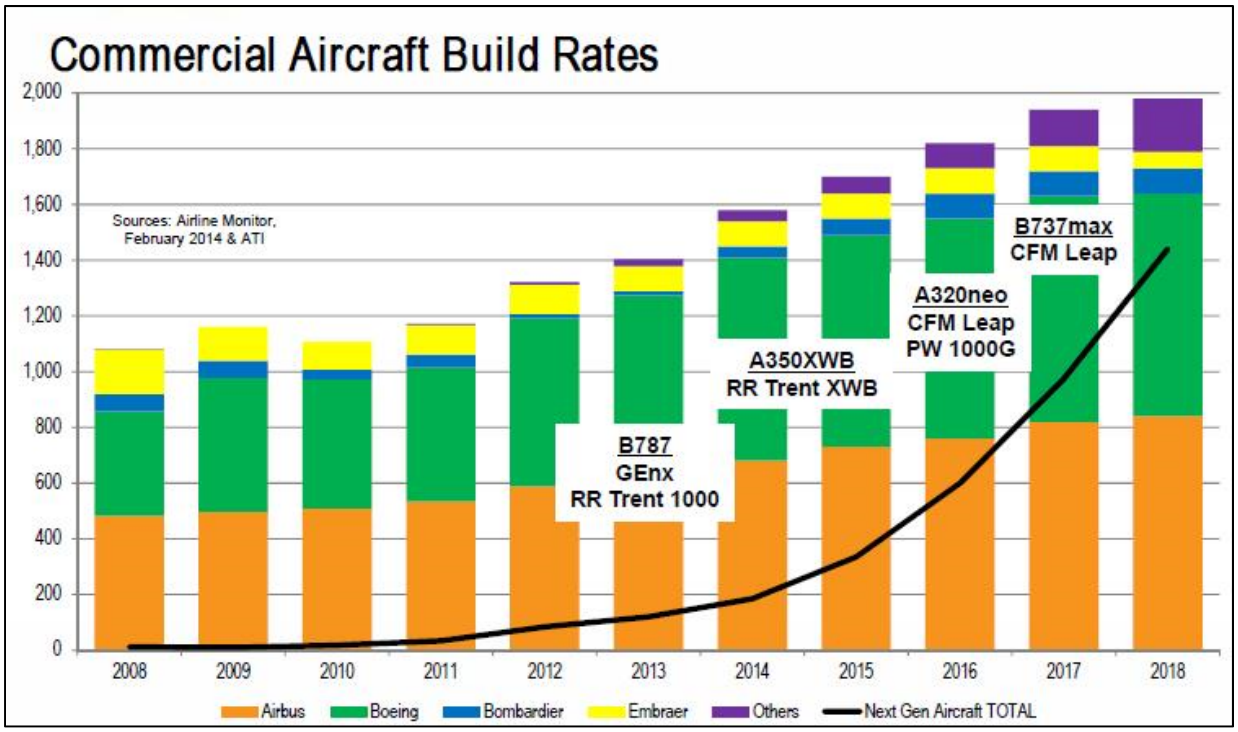


Image Source: Allegheny Technologies

Our Favorite Aerospace Idea

We think it's difficult to go wrong in aerospace, but metal-bender Precision Castparts has long been a favorite of ours. The firm makes the structural castings (metal blocks) and the rotating airfoils (blades) that form aircraft jet engines. Though a structural casting has a relatively longer useful life, a jet engine's airfoil components frequently need to be replaced upon maintenance (think razor, razor-blade model). Precision's components are also critical to flight safety, so it retains a high degree of pricing power with its long-time customers, which can't afford the risk of switching to unproven rivals.

The firm not only benefits from the burgeoning backlogs at the airframe makers, but also is not levered to whether Boeing or Airbus wins in the large commercial aircraft market or whether Bombardier or Embraer wins in the regional jet market – Precision Castparts' products are ubiquitous. The company is also led by one of the best CEOs in our coverage universe in Mark Donegan, and he knows how to take costs out of businesses and new acquisitions like no other that we've seen. The potential margin expansion associated with the firm's recent Titanium Metals acquisition will be significant, and we think the Street will be surprised at the profit growth associated with the transaction once it's fully integrated.

Our fair value estimate of Precision Castparts is nearly $300 per share, offering material upside to holders on the basis of this valuation. Investors should understand, however, that stocks don't converge immediately to fair value, and an equally likely outcome to fair-value convergence could see Precision's shares fall to $200 or lower before rising yet again. In any case, the company remains a position in the Best Ideas portfolio (as it does not pay a meaningful dividend).

Ford's China Sales Continue to Impress

By Valuentum Analysts

June proved to be another great month for Best Ideas portfolio holding Ford (F) in China. First-half sales numbers, released Monday, increased to nearly 550,000 wholesale vehicles compared to just over 400,000 in the first half of 2013. Ford's June sales alone increased 17%, to 87,783. The news showcases Ford's continued sales momentum in the country, something we've been monitoring closely for some time. The Ford Focus, Ford Kuga, Ford Mondeo and the Ford EcoSport have been key sources of strength, with the Focus becoming a huge hit with consumers in the country.

A latecomer to China, Ford may be trailing early-movers such as GM (GM) and Volkswagen (VLKAY), but the automaker's rate of sales growth continues to significantly outpace that of the overall market. As a result, we would expect the market-share gap to inevitably close, especially in light of the pace of Ford dealership growth in the country. The company, for example, added 88 new dealerships in China in just *one* day in June (the 19th), and management expects to reach 800 dealer points in China by the end of this year. Ford will continue to climb the market-share ladder.

"Ford added 88 new dealerships in China in just one day in June (the 19th), and management expects to reach 800 dealer points in China by the end of this year. Ford will continue to climb the market-share ladder."

Automakers by Market Share, China (2013)	
Volkswagen	15.1%
General Motors	**14.5%**
Hyundai	7.6%
Renault/Nissan	4.8%
Changan	4.7%
Toyota	4.6%
Ford	**4.4%**
BAIC	3.9%
Donfeng	3.7%
Honda	3.6%
Source: WSJ, IHS Auto	

Image Source: Valuentum

Rival GM's (GM) June sales in China increased roughly 9% and first-half sales increased 10.5%, roughly in-line with overall market growth in the country. GM has a much larger footprint in China than Ford, so the pace of its growth in the country, while slower, is still quite respectable. GM, too, is expanding rapidly and expects production capacity in China to be 65% higher by 2020. In the US, GM's performance has been mixed. Though the automaker's US sales revealed the best June since 2007, such performance comes on the heels of massive and recurring recalls. The latest total puts the number of GM vehicles recalled near 30 million. The executive suite at GM will have to stay focused to prevent such poor publicity from becoming a serious distraction. To be fair, Ford has not been without recalls either, but they've been on a much smaller scale.

Ford's China Sales...continued on next page

*Ford's China Sales...*from previous page

Ford Remains in the Best Ideas Portfolio

GM has come a long way since the depths of the Great Recession, but we believe the best risk-adjusted investment opportunity in the automotive industry is in rival Ford's shares. Ford has an investment-grade credit rating, and its automotive cash generation will only strengthen as it captures pent-up automobile demand from the credit crisis years ago. Ford has a fresh and invigorating new CEO in Mark Fields, who will continue the progress started by turnaround expert Alan Mulally, and we expect the automaker to be the biggest upside surprise in terms of market share in China in coming years.

We first outlined our bullish case on Ford in August 2011, first added shares to the Best Ideas portfolio in November 2011, added to the position in May 2012 at ~$10 per share, and today (as we did as recently as early May), we are reiterating our view that the company is worth north of $20 per share. Our Best Ideas are always included in the Best Ideas portfolio and Dividend Growth portfolio.

eBay is One of the Cheapest Stocks on the Market

By Brian Nelson, CFA

A data breach and a Google (GOOG) search algorithm change were key concerns heading into June for eBay (EBAY), but the firm's same-store sales pace during the month showed that little could stop the fundamental momentum at the online retailing giant. Though the pace of its same-store sales expansion may never reach the breakneck rate of Amazon (AMZN), we prefer eBay's profit focus and believe its competitive advantages are as strong as--or even stronger than--Amazon's.

Here is the June same-store sales data from ChannelAdvisor (ECOM):

> **Amazon** - Amazon's June SSS came in at 34.4%, an increase compared to May's 28.1%. The Amazon Fire Phone was announced in June and could have caused some knock-on effects.
>
> **eBay** - eBay's June came in at 12.3% up from May's 11.5% indicating that eBay started to recover from the double whammy of the data breach and Google Panda problems from May.

All-in, ecommerce remains healthy, and we expect eBay's stock to perform well in light of the sequentially stronger growth in the month of June. Many investors had been expecting a same-store sales *decline* at eBay during the period, and the acceleration is a very welcome data point, largely diffusing concerns over the data breach and search algorithm change. We expect the strengthening trend to continue.

Why eBay Remains a 'Best Idea'

For the full-year 2014, eBay expects net revenue in the range of $18-$18.5 billion with non-GAAP earnings per diluted share in the range of $2.95-$3.00. Factoring in the current pace of same-store sales growth and considering no earnings leverage or share buyback acceleration (i.e. very conservative forecasts), we think ~$3.40 per share for full-year 2015 is a very achievable forecast, which is roughly in-line with consensus.

This means that, with shares at ~$51 each, the company is trading at just 15 times forward earnings. *The current 12-month forward P/E for S&P 500 firms is 15.6.* In our view, eBay has significantly better long-term growth prospects than the average S&P firm, and we think its competitive advantages are among the best in our coverage, particularly when considering PayPal's entrenched user base.

Said differently, the market is getting eBay's valuation wrong, and while we haven't been happy with the firm's news flow as of late, shares are a bargain. Our fair value estimate of the firm is close to $90 per share, and we fully expect pricing upside from current levels. The company remains a holding in the Best Ideas portfolio (it does not pay a dividend).

Nelson on Bogle, Part I

By Brian Nelson, CFA

These variables determine stock market returns over the long term:

1) The dividend yield at the time of initial investment.

2) The subsequent rate of growth in earnings.

3) The change in the price-earnings ratio during the period of investment.

The total of these three components explains nearly all of the stock market's returns over extended holding periods. By analyzing the contribution to total return of the three factors, reasoned consideration of future returns can take place. The initial dividend yield is a known quantity. The rate of earnings growth has usually been relatively predictable within fairly narrow parameters. And the change in the price-earnings ratio has proven highly speculative. Total return is simply the sum of these three factors. For example, an initial dividend yield of, say, 3 percent plus a forecasted earnings growth of 7 percent annually over the next 10 years would bring the return to 10 percent. A change in the price-earnings ratio—from, say, 15 times at the beginning of the period to a forecasted 18 times at the end—would add 3 [sic] percentage points to that total, bringing the return on stocks to 13 [sic] percent. –

-– John C. Bogle, Common Sense on Mutual Funds

John C. Bogle, founder and retired CEO of the Vanguard Group, is one of the most influential people in the investment world. For those that don't know Bogle, he is credited with popularizing index funds and driving costs significantly lower across the mutual fund industry. There are even large groups of investors dedicated to following investing advice inspired by Bogle – they are called Bogleheads.

The excerpt above from his highly-influential book *Common Sense on Mutual Funds*, pages 37-38 in my copy, is helpful to investors looking to understand what drives the long-term returns of stock prices. What I would like to do is expand upon these three drivers so members know exactly how these three components interact with each other. Let's tackle these considerations in this article.

Understanding Total Return

As Bogle indicated, the total return of any stock is broken into three pieces: dividend income (1, dividend yield) and capital appreciation (2, rate of growth in earnings and 3, change in price-earnings ratio). The best way to explain total return, in my view, is to walk through an individual's personal financial situation as an example. Let's get started.

A person may have a source of annual income that he/she generates each year, and that same person may have savings in the bank and debt in the form of a mortgage or automobile payment. Let's say that this person makes $25,000 per year in annual income after taxes and that he/she has $15,000 in savings and a total of $150,000 in mortgage and automobile debt. Let's also assume that this person will receive a 3% raise every year for as long as he/she lives. The prevailing personal interest (borrowing) rate is 8% per annum. How might one think about this person's financial situation?

Nelson on Bogle...continued on page 9

Our Best Ideas Portfolio

By Valuentum Analysts

Portfolio Return	Benchmark Return	Outperformance
82.7%	56.4%	26.4pts

Below we outline the constituents of the portfolio and their respective weightings and returns thus far. 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 about 24% 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 Newsletter 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.

OUR BEST IDEAS PORTFOLIO -- as of July 15, 2014 — **Best Ideas Portfolio Inception Date: May 17, 2011**

Portfolio Holdings	Symbol	Initial VBI*	Current VBI**	First Purchase	Cost Basis ($)	Total Shares	Total Cost ($)	Price/Share ($)	Current Value ($)	% of Portfolio	% Return (dividends included)
Bullish											
Apple Corp.	AAPL	10	6	17-Jun-11	51.92	161	8,372.96	95.32	15,346.52	8.4%	88.8%
Altria Group	MO	8	6	28-Jun-11	28.39	315	8,958.11	41.76	13,154.40	7.2%	62.2%
Baidu	BIDU	10	6	1-Aug-13	133.60	20	2,679.00	189.87	3,797.40	2.1%	41.7%
Buffalo Wild Wings	BWLD	7	6	13-Jul-11	65.42	77	5,044.34	154.63	11,906.51	6.5%	136.0%
eBay	EBAY	10	6	3-Oct-11	31.04	100	3,103.50	50.81	5,081.00	2.8%	63.7%
Financial Select SPDR	XLF	NA	6	9-Jan-11	13.46	150	2,026.00	22.99	3,448.50	1.9%	76.0%
Ford Motor	F	7	7	12-Sep-11	10.69	650	6,955.50	17.54	11,401.00	6.2%	69.0%
General Electric	GE	7	9	21-Oct-13	25.99	375	9,761.75	26.61	9,978.75	5.5%	4.4%
Google	GOOG	10	4	23-Oct-12	341.75	8	2,740.96	584.78	4,678.24	2.6%	70.7%
Health Care ETF	XLV	9	5	22-May-12	36.60	125	4,582.00	61.29	7,661.25	4.2%	72.4%
Intel	INTC	6	6	12-Sep-11	20.48	150	3,086.50	31.71	4,756.50	2.6%	62.8%
Precision Castparts	PCP	8	3	6-Jun-11	152.07	40	6,089.80	259.56	10,382.40	5.7%	70.7%
SPDR S&P Bank ETF	KBE	NR	NR	9-Jan-12	21.07	100	2,114.00	33.30	3,330.00	1.8%	63.1%
Republic Services	RSG	8	7	19-May-11	31.42	201	6,329.42	37.02	7,441.02	4.1%	28.5%
Rio Tinto	RIO	9	7	22-May-12	46.40	75	3,487.00	56.34	4,225.50	2.3%	28.9%
Teva Pharma	TEVA	6	5	24-Jul-13	41.22	77	3,180.94	54.41	4,189.57	2.3%	34.9%
Union Pacific	UNP	6	6	24-Jul-13	79.67	40	3,193.80	101.39	4,055.60	2.2%	29.1%
Utilities Select SPDR	XLU	NR	NR	18-Mar-14	41.12	83	3,419.96	42.56	3,532.48	1.9%	4.2%
Visa	V	7	6	30-Nov-11	107.46	47	5,064.39	221.78	10,423.66	5.7%	108.6%
Cash -- changes in monthly cash balance reflects dividends received and trading gains/losses, where applicable.									43,929.51	24.0%	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							100,000.00		**182,719.81**		**82.7%**
S&P 500 Index (SPY)				17-May-11	132.69	754	100,000.00	197.23	148,639.69	95.1%	
Cash									7,716.48	4.9%	
Benchmark Portfolio Value									**156,356.17**		**56.4%**
Relative Outperformance											**26.4%**

Data as of July 15, 2014. 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).

Standard Disclaimer: Our Best Ideas portfolio is for information purposes only and should not be considered a solicitation to buy or sell any security. Valuentum is not responsible for any errors or omissions or for results obtained from the use of our Best Ideas portfolio and accepts no liability for how readers may choose to utilize the content.

Nelson on Bogle...from page 7

Let's first assess the person's future income stream in present value terms. Though this person will not work forever, let's use a standard perpetuity function to value his/her income stream for simplification purposes. Here's what the equation looks like:

[(annual income)*(1 plus growth rate)]/(discount rate less growth rate)

[(25,000)*(1.03)]/(.08-.03)] = $515,000

Let's now consider the personal balance sheet, or the person's net debt position. Here's that equation:

(cash less debt)

(15,000-150,000) = -$135,000

The present value of this person's financial statement is $515,000 - $135,000 = $380,000.

Understanding How Dividends Interact with Capital Appreciation

What would the present value of this person's financial statement be one year hence?

Let's assume that out of the $25,000 in after-tax earnings generated during the year, $5,000 went toward paying down debt and $20,000 went directly to savings. For simplification purposes, let's ignore interest received on cash and interest paid on debt.

The standard perpetuity of the person's income stream would be valued the same one year into the future, or $515,000. However, the personal balance statement would be different one year hence. Here's the new equation:

($15,000+$20,000)-($150,000-$5,000)

($35,000-$145,000) = -$110,000

After the first year, this person's financial statement is $515,000 - $110,000 = $405,000. This person's financial situation has improved by $25,000 ($405,000 - $380,000) -- the difference is the $25,000 in after-tax earnings.

Let's now see what happens in a case where this person pays himself/herself a personal *dividend*, perhaps a trip to the South of France that costs $10,000. Instead of $20,000 going into the savings, only $10,000 goes into the savings, as $10,000 is needed to pay for the trip. The person's balance sheet is now the following:

($15,000+$10,000)-($150,000-$5,000)

($25,000-$145,000) = -$120,000

The person's personal financial statement would now be $515,000 - $120,000 = $395,000, the difference being after tax income (cash flow) less the dividend payment, or $25,000 less $10,000 -- or $15,000 ($395,000 - $380,000).

Nelson on Bogle...continued on next page

Nelson on Bogle...from previous page

Why Operating After-tax Earnings (Cash Flows) Drive Total Return

Let's nail down two points from this exercise:

1) In the case where the person did not pay a personal dividend, the increase in his/her personal financial situation equals the after-tax increase in income (cash flows), or $25,000. Let's call this scenario the 'Capital Appreciation' scenario, where the value of the personal financial situation increases from $380,000 to $405,000 during the first year.

2) In the case of the person paying a personal dividend, the increase in his/her personal financial situation still equals the after-tax increase in income (cash flows), or $25,000. However, the capital appreciation component accounts for $15,000 ($380,000 to $395,000), while the personal dividend (trip to the South of France) accounts for $10,000. Let's call this scenario the 'Capital Appreciation + Dividend' scenario.

The 'Capital Appreciation' scenario is rather easy to understand. The person generated $25,000 in after-tax earnings (cash flow), added some of it to savings and repaid some debt, and therefore, he/she has increased his/her personal financial situation.

The second scenario, or the 'Capital Appreciation+Dividend,' scenario is not as clear. The personal financial situation has increased $15,000 because of the personal dividend. However, the personal dividend is still a source of return because the person very much enjoyed the trip to the South of France.

Here's how the 'Total Return' breaks down in the two scenarios.

Scenarios -->	Capital Appreciation	Capital Appreciation+Dividend
Capital Appreciation Component	25,000	15,000
Dividend Component	0	10,000
Total Return	25,000	25,000

Let's now swap 'person' with 'firm' and make some very important observations. The total return of a firm is tied explicitly to the operations of the firm, and more specifically, the future after-tax earnings (cash flow) generation of the firm. A company that does not pay a dividend has greater stock-price capital appreciation potential *than if it were to pay a dividend* because cash is not leaving the company in the form of dividends. Remember: the balance sheet is a source of value, much like a person's savings is a source of value. A firm that pays out a dividend has lower capital appreciation potential *than if it didn't pay a dividend* because cash is leaving the company in the form of dividends. The dividend is still an important source of return, however. In both cases, the firm's total return is identical, as total return is explicitly based on the after-tax earnings (cash flow) generating capacity of any entity.

Why This Example Is Valuable

This example is valuable for a number of reasons. First, it shows how value (capital appreciation) is generated via after-tax earnings (cash flows) of the business. Second, it shows how the balance sheet (savings) is a source of value and how using internally-generated cash flows to add to cash on the balance sheet or pay off debt drives capital appreciation potential. And third, it shows how dividend payments impact a firm's capital appreciation potential. Since dividends detract from the cash that otherwise could have been added to the balance sheet or used to pay off debt, a firm is worth less than it otherwise would be if it had decided not to pay dividends. This dynamic explains why a firm's intrinsic value advances at the cost of capital less the dividend yield each year (or the cash flows generated less the cash flows paid out as dividends each year).

Nelson on Bogle...continued on next page

Nelson on Bogle...from previous page

Example in Practice

Under this framework, it's easy to see how total return is driven explicitly by the future after-tax earnings (cash flow) of a firm and how capital appreciation and dividends interact with each other to derive that total return: the higher the dividend payments, the lower the capital appreciation potential of the company (than if it didn't pay dividends), all else equal. This is based on the very real concept that a firm with significantly more net cash on the balance sheet is worth more than a firm with significantly less net cash on the balance sheet, all else equal.

Let's now apply the numbers Bogle used in his example to further this understanding.

> *For example, an initial dividend yield of, say, 3 percent plus a forecasted earnings growth of 7 percent annually over the next 10 years would bring the return to 10 percent. A change in the price-earnings ratio—from, say, 15 times at the beginning of the period to a forecasted 18 times at the end—would add 3 [sic] percentage points to that total, bringing the return on stocks to 13 [sic] percent.*

What may be going on in this example?

Let's get the more straightforward component out of the way first. The initial dividend yield is 3%, so we know that investors are going to receive 3% of their investment every year.

Let's now talk about the price-to-earnings ratio. We revealed in a previous article that the numerator of the PE ratio is a discounted cash flow model and that there are a large variety of inputs that can cause changes in the PE ratio. In Bogle's example, the PE ratio is expected to increase to 18 times from 15 times over this 10-year period.

What are some things that could cause this PE expansion? Well, quite simply, the firm could have retained a significant amount of cash over the 10 year period, growing the value of its net cash position on the balance sheet. Just like in the personal balance sheet, more savings relative to debt is a good thing.

For example, if the company had $20 million in net income and $20 million in net cash at the beginning of the period, the firm would be valued at $300 million (20 million in net income x 15 times). Excluding net balance sheet cash, the adjusted PE multiple would be 14 times earnings.

Assuming earnings grow 7% annually over the 10-year period, the firm would register $39.34 million in earnings at the end of Year 10. At 18 times earnings, the company would then be valued at ~$710 million on Year-10 earnings (~$39 million times 18 times = ~$708 million).

Applying a 14-times (ex-cash) PE multiple, which we derived at the beginning of this period, to Year-10 earnings (14 times $39.34 million=~$550 million), this analysis would suggest that the firm's net cash balance expanded significantly to ~$160 million (~$708 million less ~$550 million), even as it paid out dividends to shareholders. In this example, just retaining earnings and cash on the balance sheet can drive PE expansion, even if the core PE, excluding net cash, multiple did not change.

Nelson on Bogle...continued on next page

***Nelson on Bogle*...from previous page**

Below, please find the definition of the PE ratio and a list of factors that interact to derive each firm's intrinsic PE multiple at any given time:

Forward Price to Earnings Ratio =

{[(Sum of Discounted Future Enterprise Free Cash Flows – Total Debt – Preferred Stock + Total Cash)/Shares Outstanding]/ Next Fiscal Year's Earnings Per Share}

Note: The numerator of the PE ratio is a discounted cash flow model.

Revenue Growth: Impacts Future Enterprise Cash Flows (Mostly Positive)

Operating Earnings Growth: Impacts Future Enterprise Cash Flows (Positive)

Taxes: Impacts After-tax Earnings; Cost of Debt (Mostly Negative)

Capital Expenditures: Impacts Future Enterprise Cash Flows (Negative)

Return on Invested Capital (ROIC): Function of Operating Earnings and Net New Investment, Capital Expenditures (Positive)

Risk-free Rate, 10-year Treasury: Impacts WACC (Negative)

Discount Rate (WACC): Impacts Present Value of Enterprise Cash Flows (Negative)

Total Debt: Impacts Enterprise Value and Discount Rate (Mostly Negative)

Preferred Stock: Impacts Enterprise Value and Discount Rate (Mostly Negative)

Total Cash: Impacts Enterprise Value (Positive)

Shares Outstanding: Changes in Shares Outstanding (Neutral, assuming reinvestments' ROIC equal the firm's WACC)

As outlined above, the numerator of the PE multiple considers a plethora of factors in determining which multiple the market applies to a company's earnings. The calculation of the numerator of the PE is derived by a discounted cash-flow model, and the resulting equity value per share (the output of the discounted cash-flow model) is then divided by future earnings to arrive at the PE.

If a company does not pay dividends, the equity value would be higher *than it otherwise would be if it did pay dividends* because a company's net cash would be higher. A company's PE and capital appreciation potential are always higher than they otherwise would be if the firm opts to not pay a dividend (assuming the firm does not engage in value-destructing activities with the accrued cash). In Bogle's example, the firm's total return potential would still be 13% if it didn't pay a dividend -- but all of it would come from capital appreciation, as its PE ratio would simply be higher (due to the higher net cash on the balance sheet, all else equal). The dividend is not incremental return but a component of total return.

Varying calculations of equity value relative to earnings are why we have a variety of different PEs on the market today for companies with identical earnings. Capital-light companies (software, advertising companies) garner higher earnings multiples than capital-intensive companies (auto manufacturers) because capital-intensive companies have to re-invest a significant amount of cash back into their businesses. In a more pertinent example for this article, firms with billions in net cash garner higher PE multiples than firms with billions in net debt.

***Nelson on Bogle*...continued on next page**

Nelson on Bogle...from previous page

Wrapping Things Up

Dividend payments *reduce* a firm's capital appreciation potential from what it otherwise would have been under a scenario in which it doesn't pay a dividend. The discounted cash-flow model represents Bogle's second and third components – the earnings (E) and price-earnings (PE) together. Changes in earnings and changes in the PE collectively represent changes in firm value, and firm value is precisely what the discounted cash-flow model calculates.

It's important that investors note that total return is not augmented by the dividend, but the dividend replaces a portion of the capital appreciation component. In the market today, this very concept is being misconstrued. Dividend paying firms are receiving higher PE multiples (rightly or wrongly) *because* they are paying a dividend, and the very concept of a growing dividend payment is leading to more capital appreciation, bolstering overall total returns.

Please don't fall into the trap of thinking that the dividend is incremental return. It's nice to receive the dividend check, but it means the firm's balance sheet cash is not as big as it could be, and you *now* know how important the balance sheet is to intrinsic value and capital appreciation potential.

Stay tuned for Part II of 'Nelson on Bogle' as President Brian Nelson addresses the 'Concept of Inertia.'

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. 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). When important drivers change or when new information comes to light, fair value estimates change. There are two primary reasons for fair value 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, 2013 to 2014, or in the case of what will happen next year, from 2014 to 2015. 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.

Fair Value Estimates...continued on next page

Fair Value Estimates...from previous page

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 the balance sheet (specifically the net cash/debt position) and the future free cash flow stream (revenue, EBI, capital spending, working capital and other 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.

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.

Fair Value Estimates...continued on next page

Fair Value Estimates...from previous page

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, 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.

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. 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. Though we will write another article on the topic of the margin of safety, we only consider a firm to be undervalued or overvalued when its share price is trading outside of the fair value range. In the 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, but just thinking about the key variables behind a discounted cash-flow model will make you a better investor. I 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.

How Members Use Valuentum's Investment Services

By Brian Nelson, CFA

Many members have asked about the best way to use our services. Let's walk through the topic.

First, please allow me clarify a few things. We serve a wide variety of investors, including dividend growth investors, value investors, and pure Valuentum investors, among others. Many different types of investors and professionals use our research in a whole host of applications from individual stock-selection to the evaluation of closed-end funds to an overlay in a money-management setting and beyond. We think it's important that, if you're a strict dividend growth investor, for example, that you're not "thrown off" if you read something on the website about the Valuentum process. And likewise, if you're a strict practitioner of the Valuentum system, you should be aware that we also serve dividend growth investors, and our research evaluates the health and long-term growth potential of a company's dividend. Many different strategies have significant benefits for many different types of investors.

With that out of the way, let's get started. At Valuentum, we are bound by an internal code of ethics that prevents us from making any specific and personal recommendations. We don't think this is unique to Valuentum. To our knowledge, other investment research publishing companies are bound by these rules, too. We offer our opinion of an investment via its attractiveness on the basis of the Valuentum Buying Index and the attractiveness of the company's valuation via our estimate of its fair value range. The Valuentum Buying Index is based on volumes of research and the experiences of many of the most influential investors, from Benjamin Graham and Warren Buffett to Peter Lynch and T. Rowe Price, Jr. On our website, we don't have buy, hold, or sell recommendations that you might find at brokerage firms, for example (we're not a broker).

On our website and in any correspondence, we can only tell you the goals of our process and newsletter portfolios and/or our opinion of the company's valuation and business fundamentals. We can't tell you what actions you should take because we're not aware of your risk tolerances, personal financial situation, and goals. We can only tell you what we are doing. We can never tell you to buy XYZ company right now, even though this may be what many members want. That being said, it's perfectly reasonable to assess what we're trying to do and see if that's a fit for you. Do the goals of the newsletter portfolios fit well with what you're looking for? Are you looking for the next incremental idea via our transaction alert emails? Does an in-depth valuation process that covers both discounted cash-flow valuation analysis and relative valuation analysis meet your objectives? Do you want to utilize timeliness indicators in a value-based setting? Does the Valuentum Dividend Cushion ratio help you understand the strength and safety of dividend holdings in your income portfolio? Do you require underpriced ideas with strong dividend growth prospects? You choose your own path, and you decide what is best for you.

That said, our favorite investment ideas at any given time are always included in the actively-managed portfolios—the Best Ideas portfolio and Dividend Growth portfolio—and the goals of the respective portfolios are as follows:

> The Best Ideas portfolio seeks to find firms that have good value and good momentum characteristics and typically holds each idea from a Valuentum Buying Index rating of a 9 or 10 (consider buying) to a rating of a 1 or 2 (consider selling). Just like a value manager may not include every single undervalued company in the market in his/her portfolio, not all highly-rated companies on the Valuentum Buying Index are included in the portfolio. We may tactically add to or trim existing positions in the portfolio on the basis of sector or broader market considerations, but we seek to capture a stock's

*How Members Use...*continued on next page

How Members Use...from previous page

> entire pricing cycle (from being underpriced with strong momentum to being overpriced with poor momentum). The goal of the Best Ideas portfolio is to generate a positive return each year and to exceed the performance of a broad market benchmark.
>
> The Dividend Growth portfolio seeks to find underpriced dividend growth gems that generate phenomenal levels of cash flow and have pristine, fortress balance sheets, translating into excellent Valuentum Dividend Cushion ratios. Firms in the portfolio may have lengthy dividend growth track records, but we focus most of our efforts on assessing the future safety and dividend growth potential of holdings. The goal of the Dividend Growth portfolio is to generate a mid-to-high single digit annual return over rolling three-to-five year periods. We have yet to have a Dividend Growth portfolio holding cut its dividend, and we credit this to the Valuentum Dividend Cushion methodology.

If one of the portfolio's goals matches up to what you're looking for, that portfolio or the ideas within it may be of interest to you. Some investors phase into the positions of the portfolios over time and replicate the portfolios in their entirety, while others like to cherry-pick their favorite ideas out of them. Others may wait for the next transaction alert email (long idea) to catch our thoughts on where incremental alpha can be generated in a portfolio setting. And others like to monitor the Valuentum Buying Index rankings list and 'undervalued' list for even more ideas. The screens are always available on the left column of our website. And still others like to overlay the Valuentum Buying Index ratings and Valuentum Dividend Cushion ratios with their own process to arrive at a combined strategy. The uses of Valuentum's services are many and varied.

You may have noticed that we also offer a full suite of products to financial advisors that range from an Excel-based screening tool to 'Ideas' and 'Dividend' publications that are released on a quarterly basis. Since advisors have a wide variety of clients with different needs and goals, we offer them a wide variety of detailed information. Our research product includes thousands of reports, fair values, fair value ranges, associated commentary, and hundreds of dividend reports with Valuentum Dividend Cushion ratios and expected dividend growth rates. We also have an Excel-based three-stage discounted free cash flow valuation model backing every fair value range in our coverage universe. Some members subscribe to our service only to gain access to the detailed valuation infrastructure behind our fair value estimates.

During the past few years, we've received quite a few questions on which membership plan may be most appropriate. The $149.99/year premium plan is among the most popular among individual investors. It offers complete access to the website, monthly newsletters, newsletter portfolios, and transaction alert emails. Investors of all types can benefit from the advisor plan at $499.99/year, which includes access to the quarterly publications and discounted cash-flow valuation infrastructure. Many individual investors have upgraded their subscription over the years.

We are honored to be working with you, and we hope this helps answer your questions. At any time, please don't hesitate to reach out to us.

The Watch List

By Valuentum Analysts

Our Valuentum Buying Index (VBI), which places a considerable emphasis on a firm's valuation, is the primary driver behind names 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).

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 (e.g. BIDU, EBAY, GE), 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.

Name	Symbol	DCF Valuation	Relative Valuation	Price/Fair Value
AIG	AIG	UNDERVALUED	ATTRACTIVE	0.79
Atwood Oceanics	ATW	UNDERVALUED	ATTRACTIVE	0.66
Baidu	BIDU	UNDERVALUED	ATTRACTIVE	0.71
Broadcom	BRCM	UNDERVALUED	ATTRACTIVE	0.73
Convergys	CVG	UNDERVALUED	ATTRACTIVE	0.75
CSG Systems	CSGS	UNDERVALUED	ATTRACTIVE	0.75
Diamond Offshore	DO	UNDERVALUED	ATTRACTIVE	0.66
eBay	EBAY	UNDERVALUED	ATTRACTIVE	0.63
Finisar	FNSR	UNDERVALUED	ATTRACTIVE	0.79
Francesca's Corp	FRAN	UNDERVALUED	ATTRACTIVE	0.71
General Electric	GE	UNDERVALUED	ATTRACTIVE	0.83
Gilead Sciences	GILD	UNDERVALUED	ATTRACTIVE	0.74
GNC	GNC	UNDERVALUED	ATTRACTIVE	0.80
Herbalife	HLF	UNDERVALUED	ATTRACTIVE	0.71
Koppers	KOP	UNDERVALUED	ATTRACTIVE	0.69
Micron Technology	MU	UNDERVALUED	ATTRACTIVE	0.75
NASDAQ	NDAQ	UNDERVALUED	ATTRACTIVE	0.80
NCR Corp	NCR	UNDERVALUED	ATTRACTIVE	0.77
Perficient	PRFT	UNDERVALUED	ATTRACTIVE	0.76
Realty Income Corp	O	UNDERVALUED	ATTRACTIVE	0.69
Symantec	SYMC	UNDERVALUED	ATTRACTIVE	0.70
Tech Data	TECD	UNDERVALUED	ATTRACTIVE	0.77
USG Corp	USG	UNDERVALUED	ATTRACTIVE	0.59
Vishay Intertech	VSH	UNDERVALUED	ATTRACTIVE	0.71

*The Watch List...*continued on next page

*The Watch List…*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.

Name	Symbol	Sector	Industry	VBI
AIG	AIG	Financials	Insurance - Property & Casualty	9
General Electric	GE	Industrials	Conglomerates	9
Micron Technology	MU	Information Technology	Computers & Peripherals	9
NASDAQ	NDAQ	Financials	Exchanges	9
NCR Corp	NCR	Industrials	Commercial Services	9
Perficient	PRFT	Information Technology	Business Services	9
Realty Income Corp	O	Financials	REIT - Retail	9
Tech Data	TECD	Information Technology	Computers & Peripherals	9

First American	FAF	Financials	Insurance - Property & Casualty	2
J.C. Penney	JCP	Consumer Discretionary	Multiline Retail	2
Magellan Midstream	MMP	Energy	Oil & Gas Pipelines	2
Mercury General	MCY	Financials	Insurance - Property & Casualty	2
NewMarket	NEU	Materials	Chemicals - broad	2
Public Storage	PSA	Industrials	Rental and Leasing	2
St. Joe	JOE	Consumer Discretionary	Homebuilders	2
Badger Meter	BMI	Industrials	Electrical Equipment	1
China Life	LFC	Financials	Insurance - Life	1
EnPro	NPO	Industrials	Electrical Equipment	1
J&J Snack	JJSF	Consumer Staples	Food Products	1
Jack Henry	JKHY	Information Technology	IT Services	1
LinkedIn	LNKD	Information Technology	Internet Software & Svcs	1
Manhattan Associates Inc	MANH	Information Technology	Software	1
Morningstar	MORN	Financials	Securities Research	1
Northern Trust	NTRS	Financials	Banks & Money Centers	1
Sigma-Aldrich	SIAL	Materials	Chemicals - broad	1
Sun Hydraulics	SNHY	Industrials	Electrical Equipment	1
TCF Financial	TCB	Financials	Banks & Money Centers	1
Under Armour	UA	Consumer Discretionary	Luxury Goods	1
Vulcan Materials	VMC	Industrials	Building Materials	1

Valuentum Retail Equity Research | Visit us at www.valuentum.com | Ratings as of 13-Jul-2014 | Data as of 3-Jul-2014

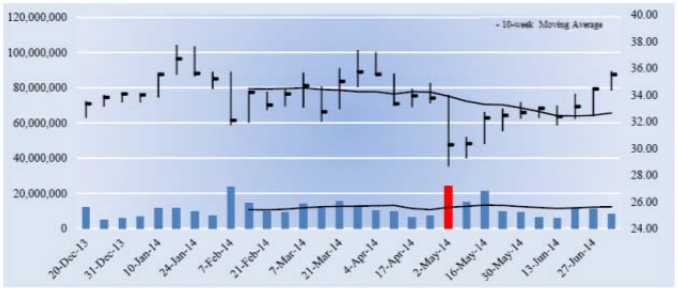
NCR Corp NCR UNDERVALUED 4.2%

Buying Index™ 9 | Value Rating ✓

Economic Castle	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry
Attractive	$46.00	$37.00 - $55.00	MID-CAP VALUE	Industrials	Commercial Services

NCR Corp's portfolio of solutions includes automated teller machines and point of sale devices.

Stock Chart (weekly)



The week with the highest trading volume out of the last 13 weeks was a week of heavy selling, or distribution (red bar).

Investment Considerations

DCF Valuation	UNDERVALUED
Relative Valuation	ATTRACTIVE
ValueCreation™	EXCELLENT
ValueRisk™	LOW
ValueTrend™	POSITIVE
Cash Flow Generation	WEAK
Financial Leverage	HIGH
Growth	MODEST
Technical Evaluation	BULLISH
Relative Strength	WEAK
Money Flow Index (MFI)	NEUTRAL
Upside/Downside Volume (U/D)	BULLISH
Near-term Technical Support, 10-week MA	33.00

DCF = Discounted Cash Flow; MFI, U/D = Please see glossary. MA = Moving Average

Business Quality

ValueCreation™

ValueRisk™	Very Poor	Poor	Good	Excellent
Low				■
Medium				
High				
Very High				

Firms that generate economic profits with little operating variability score near the top right of the matrix.

Company Vitals

Market Cap (USD)	$6,010
Avg Weekly Vol (30 wks)	11,235
30-week Range (USD)	28.64 - 37.73
Valuentum Sector	Industrials
5-week Return	8.8%
13-week Return	0.5%
30-week Return	9.8%
Dividend Yield %	0.0%
Dividends per Share	0.00
Forward Dividend Payout Ratio	0.0%
Est. Normal Diluted EPS	3.52
P/E on Est. Normal Diluted EPS	10.1
Est. Normal EBITDA	1,100
Forward EV/EBITDA	8.0
EV/Est. Normal EBITDA	7.0
Forward Revenue Growth (5-yr)	5.3%
Forward EPS Growth (5-yr)	7.2%

NMF = Not Meaningful; Est. = Estimated; FY = Fiscal Year

Investment Highlights

• NCR Corp is a leading global technology company. The firm's portfolio of self-service and assisted-service solutions includes automated teller machines (ATMs) and ATM and financial services software, point of sale devices (POS) and POS software, and self-service kiosks and software.

• NCR Corp's business quality (an evaluation of our ValueCreation™ and ValueRisk™ ratings) ranks among the best of the firms in our coverage universe. The firm has been generating economic value for shareholders with relatively stable operating results for the past few years, a combination we view very

• We're a bit concerned about the company's debt levels. At the end of 2013, NCR Corp had ~$3.4 billion of total indebtedness outstanding. Though free cash flow trends are expected to remain robust, we'd prefer a more manageable debt load. Still, obligations aren't holding back R&D spending, which recently reached all-time highs (~4% of sales).

• NCR is transforming into a software-driven transaction technology firm. It has been scooping up assets (Digital Insight) to enhance software-related and SaaS revenue. In its first quarter of 2014, for example, software-related revenue and SaaS revenue growth jumped 45% and 240%+, respectively.

• In the financial services end market (~50% of business), NCR Corp faces stiff competition, including Diebold, which is undergoing a transformation itself. Though higher-margin software revenue helps, we'll be watching NCR's gross margins closely.

Relative Valuation

	Forward P/E	PEG	Price / FV
Cintas Corp	22.4	2.4	112.5%
Iron Mountain	25.0	2.5	128.9%
Pitney Bowes	15.0	2.1	96.4%
R.R. Donnelley	10.7	1.6	79.3%
Peer Median	18.7	2.3	104.5%
NCR Corp	**11.7**	**1.9**	**77.2%**

Price / FV = Current Stock Price divided by Estimated Fair Value

Returns Summary

	3-year Historical Average
Return on Equity	16.6%
Return on Assets	3.2%
ROIC, with goodwill	10.4%
ROIC, without goodwill	15.7%

ROIC = Return on Invested Capital; NMF = Not Meaningful

Leverage, Coverage, and Liquidity

In Millions of USD

Total Debt	3,354
Net Debt	1,712
Total Debt/EBITDA	3.8
Net Debt/EBITDA	2.0
EBITDA/Interest	8.5
Current Ratio	2.3
Quick Ratio	1.6

NMF = Not Meaningful

Financial Summary

	----- Actual -----		Projected
Fiscal Year End:	Dec-12	Dec-13	Dec-14
Revenue	5,730	6,123	6,760
Revenue, YoY%	5.3%	6.9%	10.4%
Operating Income	232	666	733
Operating Margin %	4.0%	10.9%	10.8%
Net Income	140	452	520
Net Income Margin %	2.4%	7.4%	7.7%
Diluted EPS	0.85	2.67	3.04
Diluted EPS, YoY %	175.2%	212.4%	13.9%
Free Cash Flow (CFO-capex)	-450	26	376
Free Cash Flow Margin %	-7.9%	0.4%	5.6%

In Millions of USD (except for per share items)

Structure of the Commercial Services Industry — NEUTRAL

The commercial services industry runs the gamut of firms from those that provide document management services and/or mail-related operations to entities that offer records management solutions and corporate uniforms. Though there are pockets of strength, a number of participants must reinvent themselves to survive over the long haul. Industry constituents are levered to business spending and are not immune to competitive forces. Carving out a sustainable competitive advantage is difficult to do in this group, though returns on invested capital have been satisfactory. We're neutral on the industry's structure.

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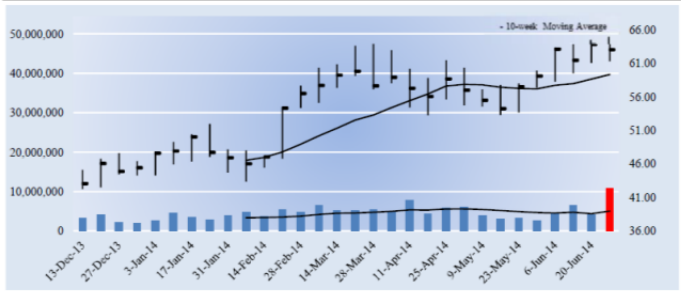
Spirit SAVE FAIRLY VALUED

Buying Index™ 6 Value Rating

Economic Castle	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry
Very Attractive	$68.00	$51.00 - $85.00	MID-CAP BLEND	Industrials	Major Airlines

Spirit has the right business model to survive the brutal cycles of the airline industry.

Stock Chart (weekly)



The week with the highest trading volume out of the last 13 weeks was a week of heavy selling, or distribution (red bar).

Investment Considerations

DCF Valuation	FAIRLY VALUED
Relative Valuation	UNATTRACTIVE
ValueCreation™	EXCELLENT
ValueRisk™	MEDIUM
ValueTrend™	POSITIVE
Cash Flow Generation	STRONG
Financial Leverage	LOW
Growth	AGGRESSIVE
Technical Evaluation	BULLISH
Relative Strength	STRONG
Money Flow Index (MFI)	NEUTRAL
Upside/Downside Volume (U/D)	BEARISH
Near-term Technical Support, 10-week MA	59.00

DCF = Discounted Cash Flow; MFI, U/D = Please see glossary. MA = Moving Average

Business Quality

ValueRisk™ \ ValueCreation™	Very Poor	Poor	Good	Excellent
Low				
Medium				■
High				
Very High				

Firms that generate economic profits with little operating variability score near the top right of the matrix.

Company Vitals

Market Cap (USD)	$4,599
Avg Weekly Vol (30 wks)	4,566
30-week Range (USD)	42.25 - 64.94
Valuentum Sector	Industrials
5-week Return	9.9%
13-week Return	7.9%
30-week Return	42.0%
Dividend Yield %	0.0%
Dividends per Share	0.00
Forward Dividend Payout Ratio	0.0%
Est. Normal Diluted EPS	4.25
P/E on Est. Normal Diluted EPS	14.8
Est. Normal EBITDA	551
Forward EV/EBITDA	10.6
EV/Est. Normal EBITDA	7.4
Forward Revenue Growth (5-yr)	16.8%
Forward EPS Growth (5-yr)	16.2%

NMF = Not Meaningful; Est. = Estimated; FY = Fiscal Year

Investment Highlights

• Spirit earns a ValueCreation™ rating of EXCELLENT, the highest possible mark on our scale. The firm has been generating economic value for shareholders for the past few years, a track record we view very positively. Return on invested capital (excluding goodwill) has averaged 93.6% during the past three years.

• Spirit Airlines offers ultra low base fares with a range of optional services, where customers pay for extras. The airline is the lowest cost producer in its markets. It is targeting average annual capacity growth of 15%-20% and operating margins of 15%-17%.

• Spirit has an excellent combination of strong free cash flow generation and low financial leverage. We expect the firm' free cash flow margin to average about 10.4% in coming years, and the firm had no debt as of last quarter. We love its debt-free balance sheet.

• Based on Department of Transportation statistics, Spirit has the most efficient aircraft fleet. The airline's fuel burn on a gallons/ASM basis is 0.0092, tied with Virgin and better than any other airline out there, including Southwest's and JetBlue's.

• Spirit has the right business model to survive the brutal cycles of the airline industry. Still, we generally prefer firms with better control over their operations (pricing and fuel costs are largely unpredictable).

Relative Valuation

	Forward P/E	PEG	Price / FV
Delta	12.6	NMF	103.5%
JetBlue	15.8	1.4	90.7%
Southwest	17.4	1.7	108.6%
United Continental	10.6	1.0	92.2%
Peer Median	14.2	1.4	97.9%
Spirit	**21.1**	**1.6**	**92.6%**

Price / FV = Current Stock Price divided by Estimated Fair Value

Returns Summary

	3-year Historical Average
Return on Equity	29.7%
Return on Assets	14.1%
ROIC, with goodwill	93.6%
ROIC, without goodwill	93.6%

ROIC = Return on Invested Capital; NMF = Not Meaningful

Leverage, Coverage, and Liquidity

In Millions of USD

Total Debt	0
Net Debt	-531
Total Debt/EBITDA	0.0
Net Debt/EBITDA	NMF
EBITDA/Interest	Excellent
Current Ratio	1.9
Quick Ratio	1.6

NMF = Not Meaningful

Financial Summary

	----- Actual -----		Projected
Fiscal Year End:	Dec-12	Dec-13	Dec-14
Revenue	1,318	1,654	1,959
Revenue, YoY%	23.1%	25.5%	18.4%
Operating Income	294	428	347
Operating Margin %	22.3%	25.8%	17.7%
Net Income	108	177	218
Net Income Margin %	8.2%	10.7%	11.1%
Diluted EPS	1.49	2.42	2.98
Diluted EPS, YoY %	41.9%	62.2%	22.9%
Free Cash Flow (CFO-capex)	90	176	209
Free Cash Flow Margin %	6.8%	10.6%	10.7%

In Millions of USD (except for per share items)

Structure of the Major Airlines Industry — VERY POOR

The airline industry has undergone meaningful changes since the beginning of the last decade. The painful restructuring by most of the legacy carriers via Chapter 11, significant consolidation by the majors, the introduction of ancillary revenue streams, and the ongoing efforts to rightsize capacity to slow weakening real yields are but a few. Though unarguably these are steps in the right direction, airlines remain shackled to the very poor structural characteristics of their industry, which has sent more to bankruptcy than any other in our coverage. Airline stocks should be viewed as merely speculative bets.

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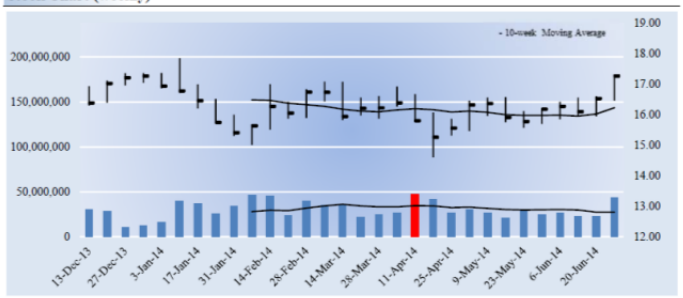
Western Union WU UNDERVALUED 4.3%

Buying Index™ 7 **Value Rating** ✓

Economic Castle	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry
Attractive	$23.00	$18.00 - $28.00	MID-CAP VALUE	Information Technology	Financial Tech Services

We've raised our fair value estimate of Western Union significantly on higher revenue expectations and a lower discount rate.

Stock Chart (weekly)



The week with the highest trading volume out of the last 13 weeks was a week of heavy selling, or distribution (red bar).

Investment Considerations

DCF Valuation	UNDERVALUED
Relative Valuation	NEUTRAL
ValueCreation™	EXCELLENT
ValueRisk™	LOW
ValueTrend™	NEGATIVE
Cash Flow Generation	STRONG
Financial Leverage	MEDIUM
Growth	MODEST
Technical Evaluation	BULLISH
Relative Strength	NEUTRAL
Money Flow Index (MFI)	NEUTRAL
Upside/Downside Volume (U/D)	BULLISH
Near-term Technical Support, 10-week MA	16.00

DCF = Discounted Cash Flow; MFI, U/D = Please see glossary. MA = Moving Average

Business Quality

ValueCreation™

ValueRisk™	Very Poor	Poor	Good	Excellent
Low				■
Medium				
High				
Very High				

Firms that generate economic profits with little operating variability score near the top right of the matrix.

Company Vitals

Market Cap (USD)	$9,655
Avg Weekly Vol (30 wks)	29,856
30-week Range (USD)	14.6 - 17.83
Valuentum Sector	Information Technology
5-week Return	9.0%
13-week Return	6.0%
30-week Return	2.8%
Dividend Yield %	2.9%
Dividends per Share	0.50
Forward Dividend Payout Ratio	34.1%
Est. Normal Diluted EPS	1.64
P/E on Est. Normal Diluted EPS	10.5
Est. Normal EBITDA	1,455
Forward EV/EBITDA	8.1
EV/Est. Normal EBITDA	7.7
Forward Revenue Growth (5-yr)	2.1%
Forward EPS Growth (5-yr)	4.5%

NMF = Not Meaningful; Est. = Estimated; FY = Fiscal Year

Investment Highlights

• Western Union provides convenient ways for people to move money around the globe. Its brand is recognized globally, and 90% of its 500,000 agent locations are located outside the US. Consumer-to-consumer (C2C) revenue accounts for 80% of sales.

• Western Union's business quality ranks among the best of the firms in our coverage universe. The firm has been generating economic value for shareholders with relatively stable operating results for the past few years, a combination we view very positively.

• Western Union has a good combination of strong free cash flow generation and manageable financial leverage. We expect the firm's free cash flow margin to average about 17.1% in coming years. Total debt-to-EBITDA was 3.1 last year, while debt-to-book capitalization stood at 79.2%.

• Western Union is benefiting from a strengthening consumer money transfer business. WU.com continues to grow at a rapid clip and C2C revenue is now advancing at a ~3% pace. Though PayPal and other upstarts have increased the competitive environment, global trade is still a growing market.

• Western Union should be able to expand revenue modestly in coming years, an upward revision from our previous expectations of declines. The updated discount rate in the model is not as punitive and now better reflects Western Union's risk profile, in our view.

Relative Valuation

	Forward P/E	PEG	Price / FV
Bottomline Tech	23.5	NMF	81.4%
Fiserv	17.8	1.7	116.1%
Mastercard	24.1	2.0	92.9%
Visa	23.0	1.9	85.8%
Peer Median	23.3	1.9	89.3%
Western Union	**11.8**	**2.7**	**75.0%**

Price / FV = Current Stock Price divided by Estimated Fair Value

Returns Summary

	3-year Historical Average
Return on Equity	115.9%
Return on Assets	11.0%
ROIC, with goodwill	25.7%
ROIC, without goodwill	65.5%

ROIC = Return on Invested Capital; NMF = Not Meaningful

Leverage, Coverage, and Liquidity

In Millions of USD

Total Debt	4,213
Net Debt	1,501
Total Debt/EBITDA	3.1
Net Debt/EBITDA	1.1
EBITDA/Interest	7.0
Current Ratio	1.1
Quick Ratio	0.6

NMF = Not Meaningful

Financial Summary

	----- Actual -----		Projected
Fiscal Year End:	Dec-12	Dec-13	Dec-14
Revenue	5,665	5,542	5,653
Revenue, YoY%	3.2%	-2.2%	2.0%
Operating Income	1,330	1,107	1,119
Operating Margin %	23.5%	20.0%	19.8%
Net Income	1,026	798	803
Net Income Margin %	18.1%	14.4%	14.2%
Diluted EPS	1.69	1.43	1.46
Diluted EPS, YoY %	-8.1%	-15.5%	2.7%
Free Cash Flow (CFO-capex)	1,124	1,008	953
Free Cash Flow Margin %	19.8%	18.2%	16.9%

In Millions of USD (except for per share items)

Structure of the Financial Tech Services Industry — EXCELLENT

The financial tech services industry is primarily composed of firms that generate revenue by charging fees to customers for providing transaction processing and other payment-related services. Constituents operate in a rapidly-evolving legal/regulatory environment, particularly with respect to interchange fees, data protection, and information security. Several participants benefit from a significant competitive advantage – the network effect. As more consumers use credit/debit cards, more merchants accept them, thereby creating a virtuous cycle. The industry is one of the most attractive in our coverage.

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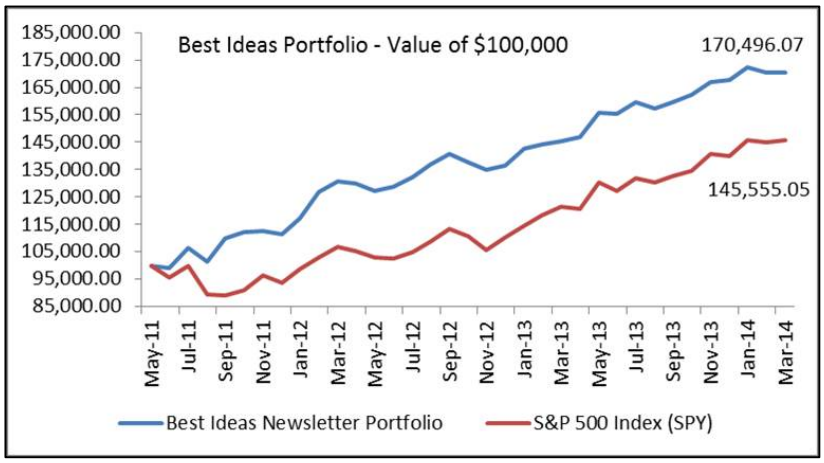
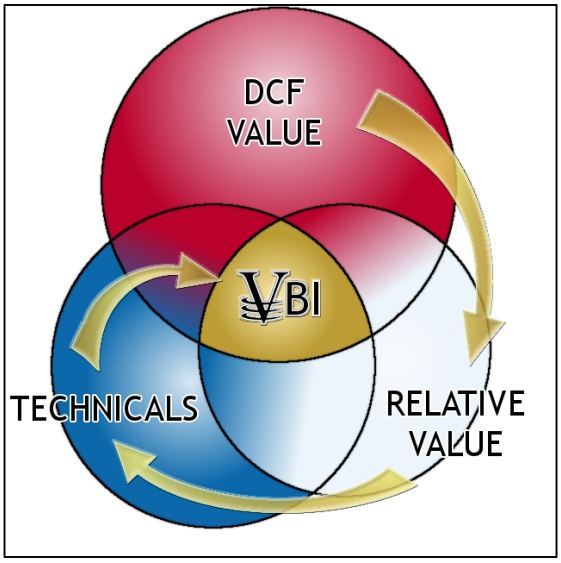
Our Methodology – The Valuentum Buying Index (VBI)

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.



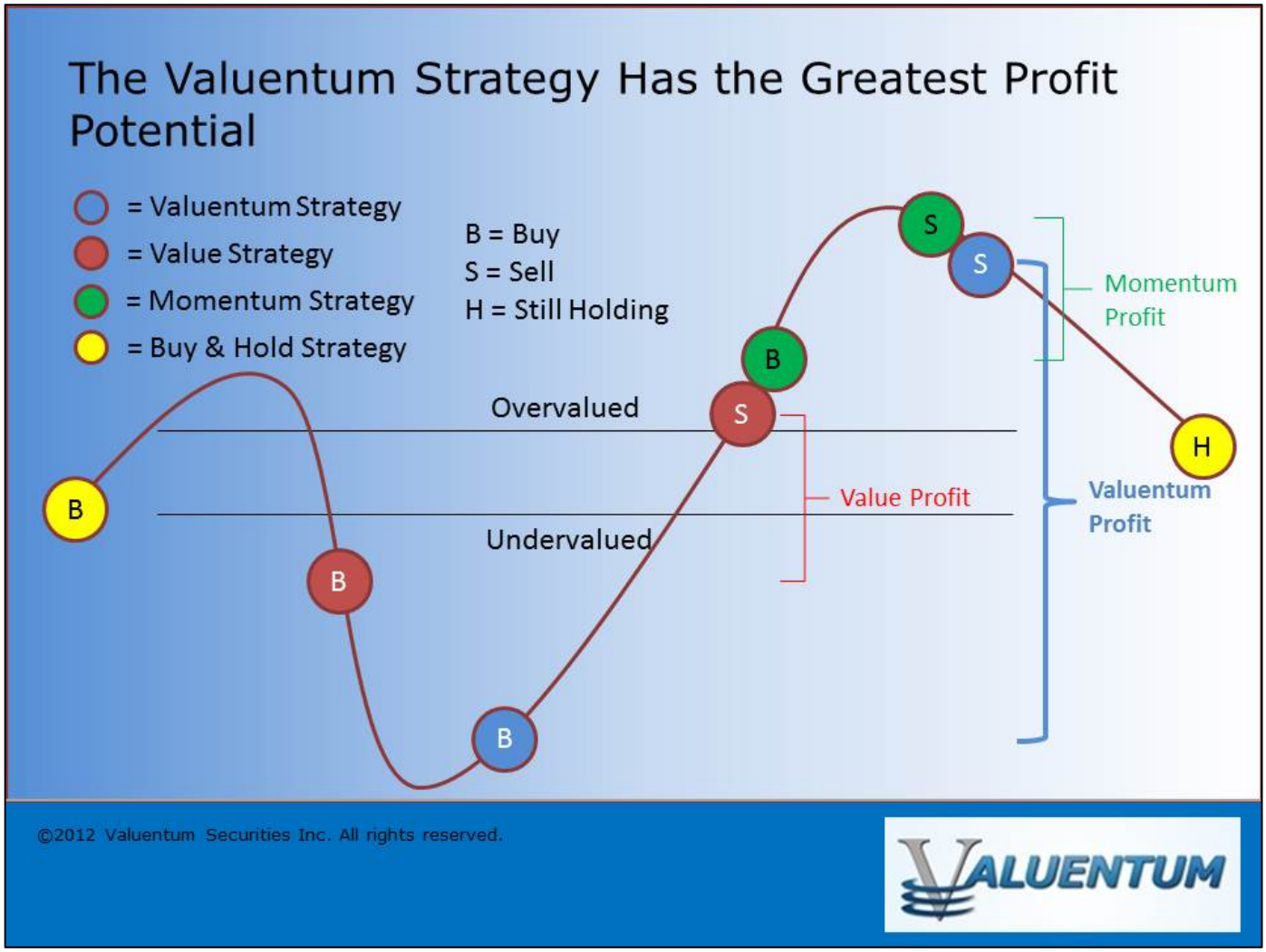
Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

The center of the Venn diagram above, 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.

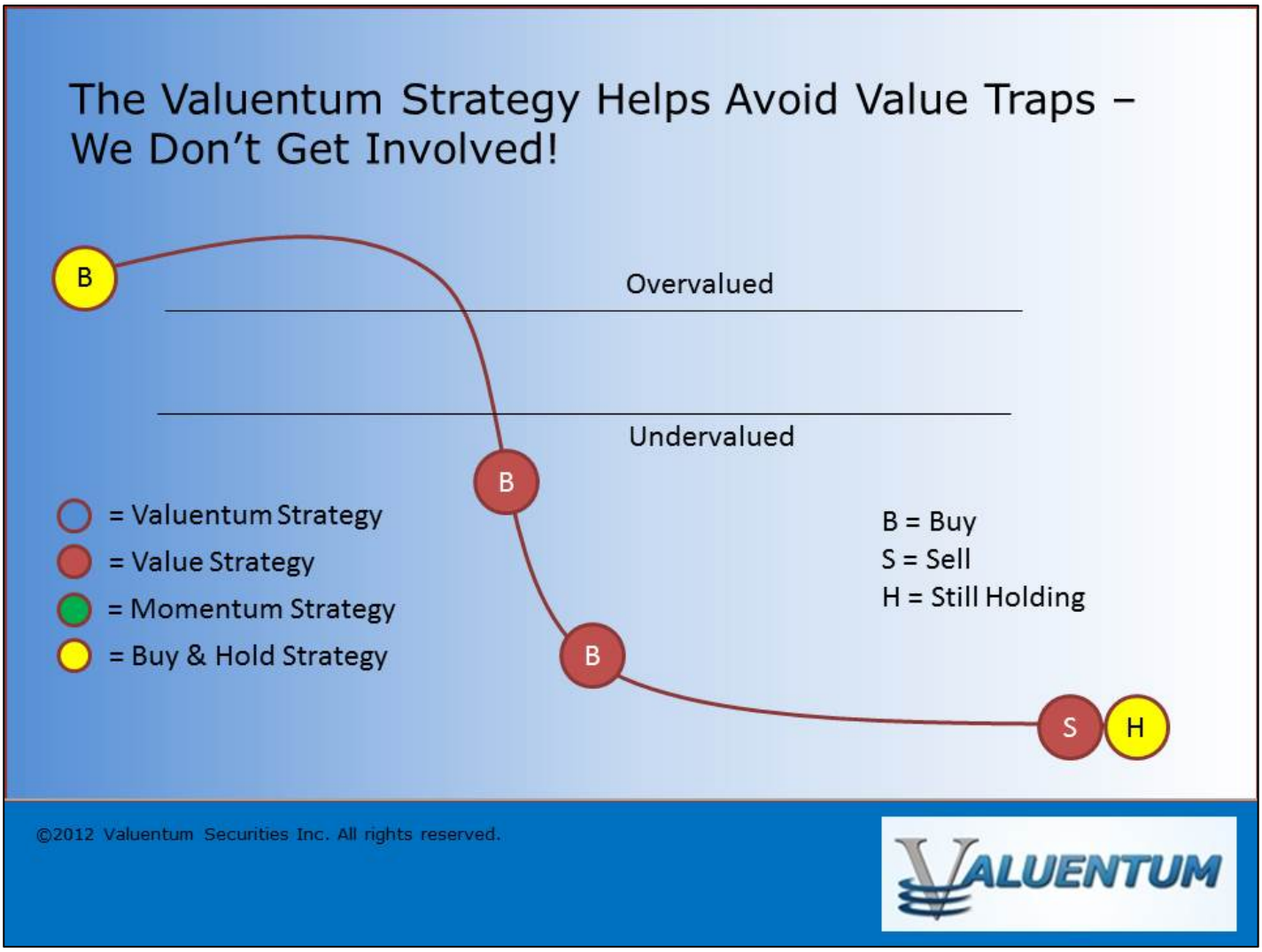


Our Methodology – The Valuentum Buying Index continued on next page

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.

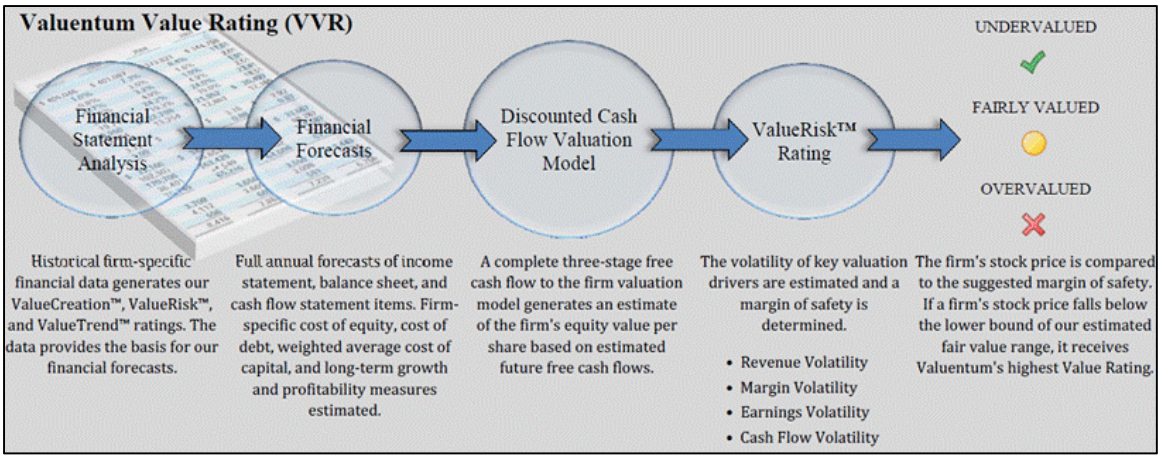


Our Methodology – The Valuentum Buying Index continued on next page

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

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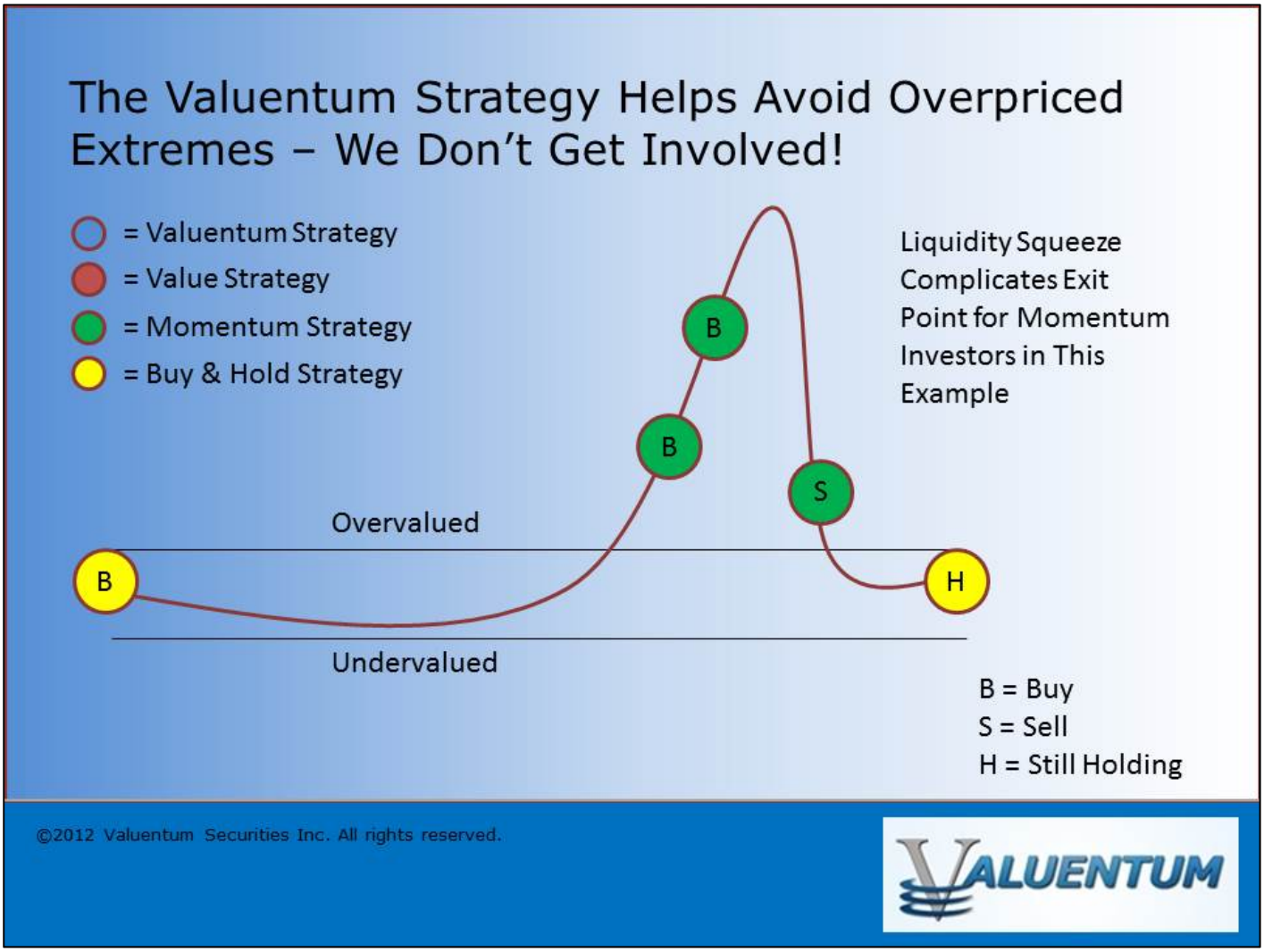

II. We Perform a Forward-Looking Relative Value Assessment

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

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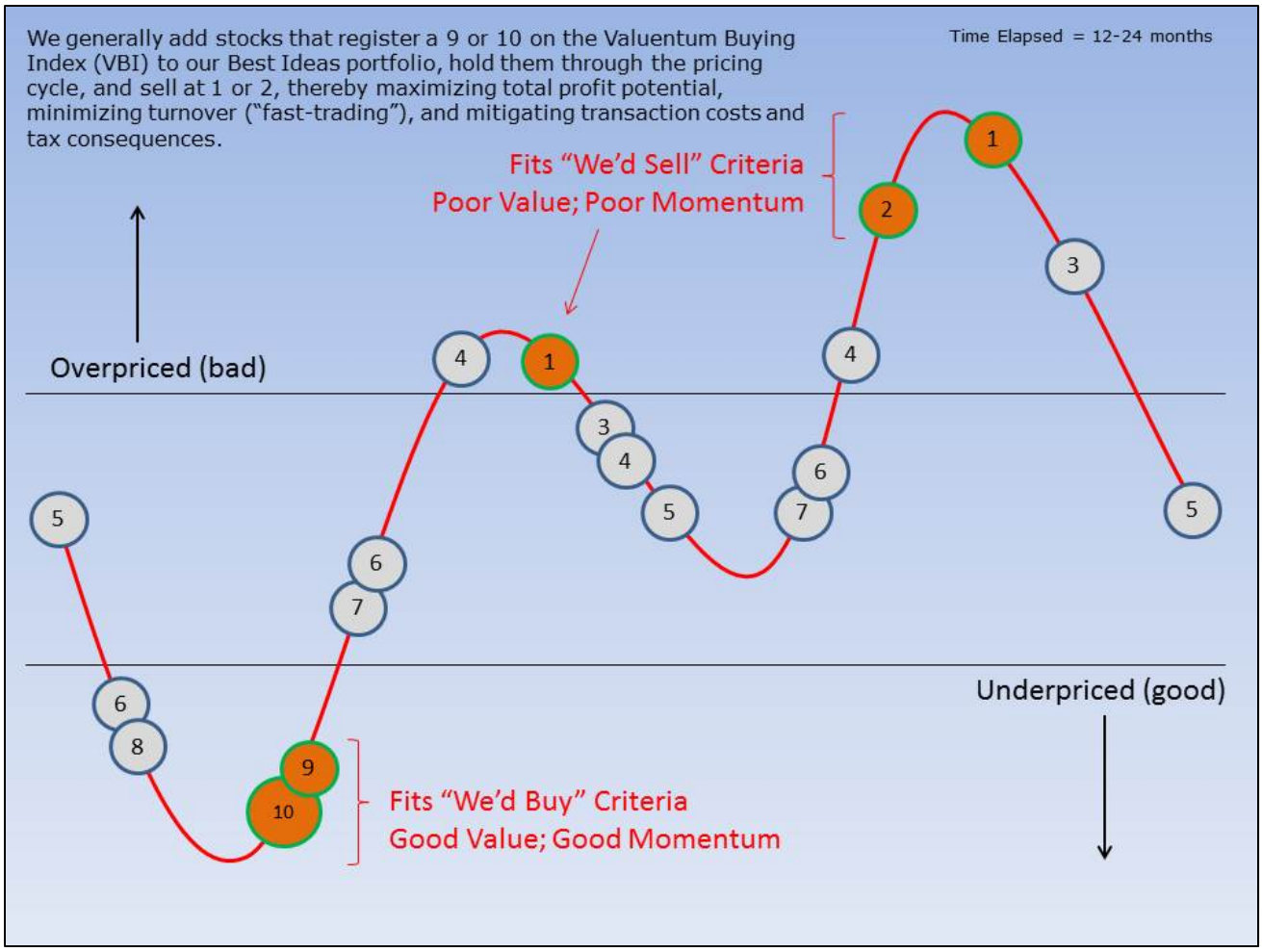
valuation criteria). Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster returns. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we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

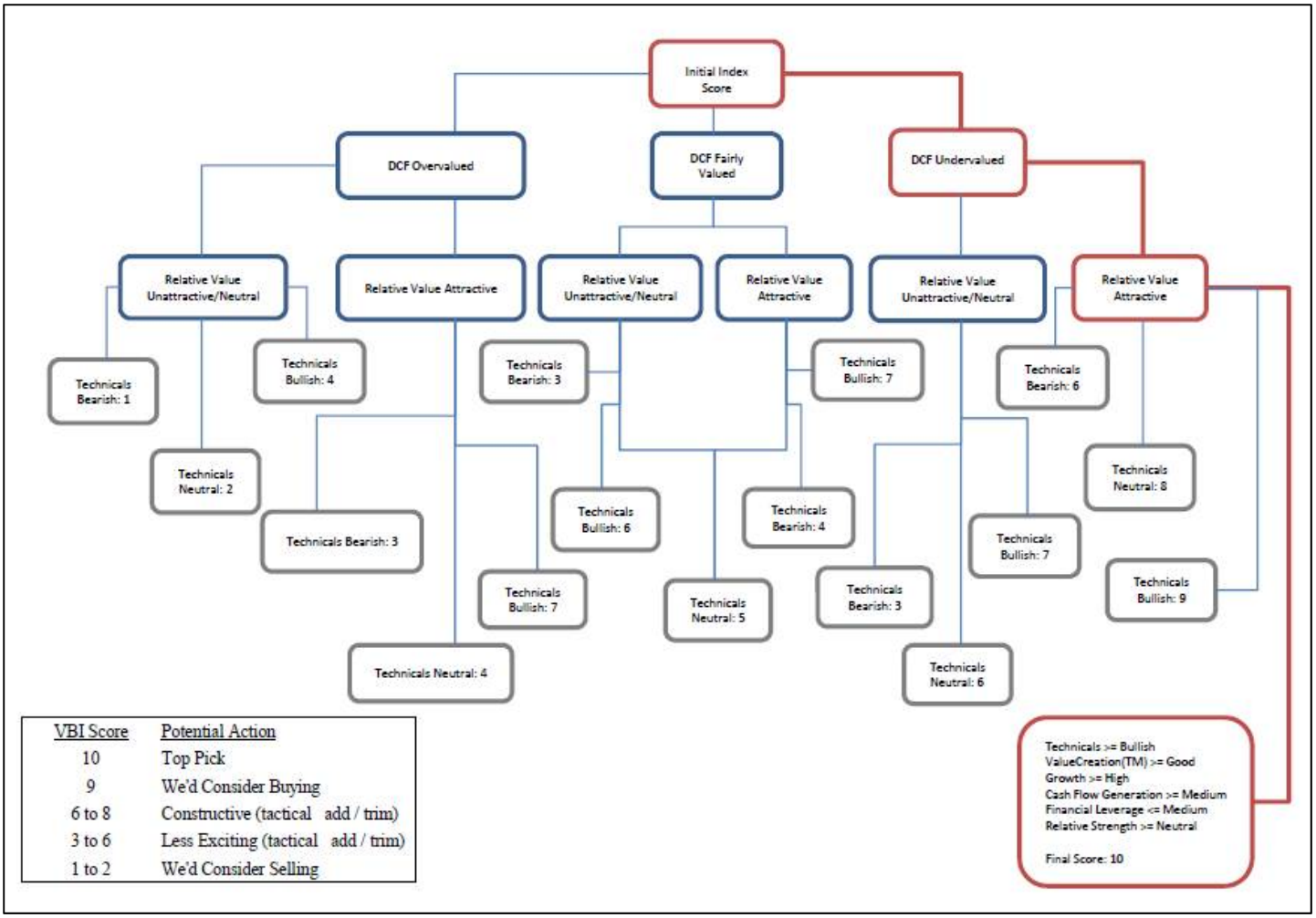


Our Methodology – The Valuentum Buying Index continued on next page

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.



VBI Score	Potential Action
10	Top Pick
9	We'd Consider Buying
6 to 8	Constructive (tactical add / trim)
3 to 6	Less Exciting (tactical add / trim)
1 to 2	We'd Consider Selling

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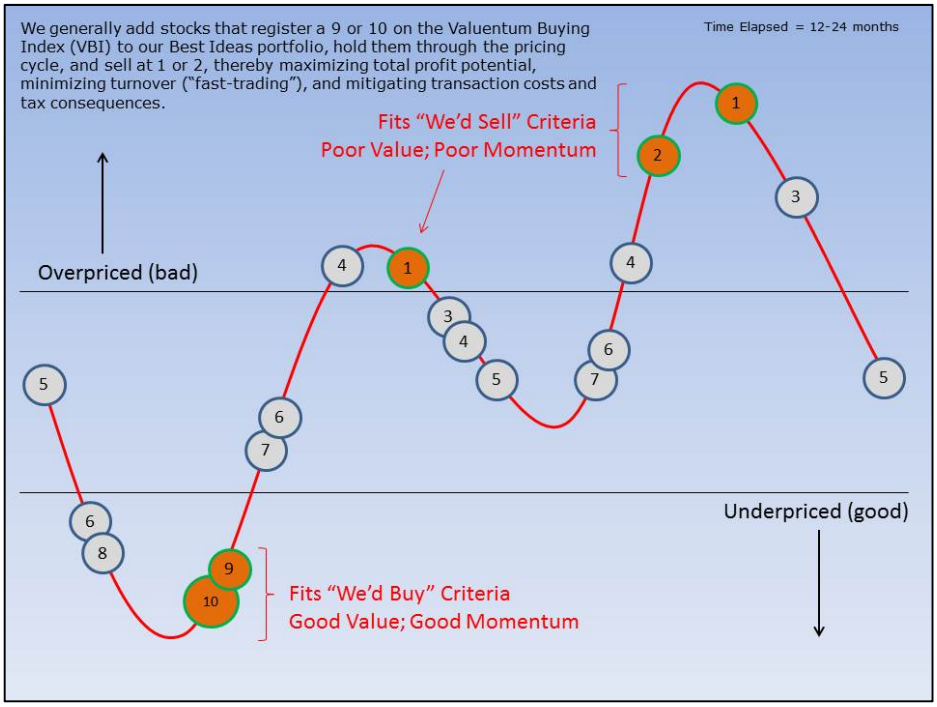
How We Use the Valuentum Buying Index in the Best Ideas Newsletter Portfolio

First and foremost, firms in our Best Ideas portfolio should be considered our best ideas at any point in time. The Best Ideas portfolio can always be found on page 8 of our monthly Best Ideas Newsletter. Firms in our Dividend Growth portfolio should be considered our best dividend growth ideas at any point in time. The Dividend Growth portfolio can always be found on page 5 of our monthly Dividend Growth Newsletter.

Let's talk about how the Valuentum Buying Index (VBI) informs which ideas we include in our actively-managed portfolios. We've noticed via our statistical backtesting that the momentum factor behind our process tends to be much more pronounced (powerful) over longer periods of time. This was one of the interesting findings of our academic white paper study. We try to replicate this dynamic with the update cycle of our reports (and the time horizon for our ideas to work out). That's why our reports are updated regularly (at least quarterly) or after material events and not daily or weekly. We don't want to whipsaw our membership, nor do we think churn is the way to generate outperformance.

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. You'll notice that we have a qualitative overlay in the portfolio, which is necessary and similar in thinking as if you were to imagine a value investor not adding every undervalued stock to his/her portfolio. There are always tactical and sector weighting considerations in any portfolio construction.

As for the time horizon for ideas, 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. So, for example, if a firm is added to the Best Ideas portfolio as a 10 and is removed as a 5, we would have tuncated profit potential. Most of our highly-rated Valuentum Buying Index rated stocks have generated the vast outperformance of the Best Ideas portfolio. Please view the pricing cycle below.



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Importantly, regarding our process, we don't blindly and immediately add firms to our portfolio once they score a 9 or 10 (and we do not add all firms that score a 9 or 10 to our portfolio). For example, Google (GOOG), a current Best Ideas portfolio holding, registered a 10 on our scale, but we remained patient and didn't add the company to our portfolio until after it reported earnings in late 2012, which provided us with an even better entry point (as new information came to light). We engage in a qualitative portfolio management overlay to maximize returns and minimize risk. The number informs our process, but the team makes the allocation decisions of the portfolio.

After adding firms to our 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 our portfolio or their attractiveness relative to other opportunities (a score of 3 through 8 is typically equivalent to a 'we'd hold'). We tend to remove firms from our Best Ideas portfolio when they register a 1 or 2 on our process. Importantly, however, firms in our Best Ideas portfolio, which have generally registered a 9 or 10 on our scale when we added them, should be considered our best ideas at any point in time.

Take eBay (EBAY) as another example of our process in action. The firm initially flashed a rating of 10 in late September 2011 (at $32 per share), and we added it to our Best Ideas portfolio. The VBI rating changed to a 6 in December 2011 and then back to a 10 in May 2012. Because the rating never breached a 1 or 2, we did not remove the position from our portfolio. In fact, we tactically added to it. eBay is probably one of the better examples to use for illustrating the prolonged outperformance driven by undervalued stocks that are beginning to generate good momentum. We like to capture the entire pricing cycle and not truncate it as most value investors do.

Though eBay may register a lower VBI rating in a subsequent update, we would still view it as one of our best ideas, as it is a holding in our Best Ideas portfolio (it has never flashed a 'We'd Sell' signal, 1 or 2). Obviously, there have been more straight-forward opportunities in our Best Ideas portfolio, especially in the case of EDAC Tech (EDAC), which had tripled since we added it to the portfolio (never registering below a 9 along the way). The VBI ratings on our most recent 16-page reports, downloadable directly from our website, reflect our current opinion on the company.

The Valuentum Buying Index, like all methodologies, informs the investment decision process, but in constructing a portfolio, a qualitative overlay is not only necessary but has been shown to optimize performance in the white paper study.

About Our Name

But how, you will ask, does one decide what [stocks are] "attractive"? Most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "growth,"...We view that as fuzzy thinking...Growth is always a component of value [and] the very term "value investing" is redundant.

-- Warren Buffett, Berkshire Hathaway annual report, 1993

At Valuentum, we take Buffett's thoughts one step further. 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 to momentum investing. And a combination of the two approaches found on each side of the spectrum (value/momentum) in a name couldn't be more representative of what our analysts do here; hence, we're called Valuentum.

Valuentum Best Ideas Newsletter: Volume 4, Issue 7

Valuentum's Best Ideas Newsletter is published monthly. To receive this newsletter on a monthly basis, please subscribe to Valuentum by visiting our website at www.valuentum.com. Or contact us at info@valuentum.com.

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