OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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Valuentum Securities Inc.
www.valuentum.com info@valuentum.com

Portfolio Return	Benchmark Return	Outperformance
94.9%	68.6%	26.3pts

Our Best Ideas (see page 8): AAPL, BABA, MO, CSCO, EBAY, XLF, GE, GILD, GOOG, XLV, INTC, KBE, RSG, RIO, PCLN, 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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Image Source: DonkeyHotey

Last Email Transaction Alert: Priceline (PCLN) February 26

Special Newsletter Edition: Lessons from the Oracle of Omaha

By Brian Nelson, CFA

Brian Nelson, CFA
President, Equity Research
brian@valuentum.com

KEY CONCEPT: Firms in the Best Ideas portfolio (see page 8), which have generally registered a 9 or 10 on the VBI when added, should be considered our best ideas at any point in time. After adding firms to the Best Ideas portfolio, we may tactically trade around these positions when they have VBI ratings between 3 and 8 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 equivalent to a 'we'd hold'). We tend to remove firms from the Best Ideas portfolio when they register a 1 or 2 (we'd sell). View page 27 for more details about how the team utilizes the Valuentum Buying Index to run the portfolio.

For those that have enjoyed my notes on this topic on our website www.valuentum.com, this newsletter edition may be a bit repetitive, but hopefully you see the tremendous value in having access to both the newsletter and website, where one you can enjoy in print while the other you can enjoy in a timely fashion.

I recently had a chance to read the annual newsletter of Warren Buffett's Berkshire Hathaway (BRK.A/B), and this year's installment was not a disappointment. I like reviewing the newsletter because it is invaluable for new investors. In the many paragraphs that follow, I have pulled out a sentence or paragraph from the 2014 Berkshire Hathaway annual report (in italics) and added to it or commented on it with my own words in order to provide further perspective.

Hope you enjoy this special edition, and of course, all of the many features of your membership!

"Market prices, let me stress, have their limitations in the short term. Monthly or yearly movements of stocks prices and intrinsic value almost invariably converge."

It is no surprise that stock prices are very difficult to predict in the short term. We know that prices are driven by the buy and sell decisions of investors, and these buy and sell decisions do not have to be based on a company's fundamentals *at all*. For example, a long-term investor who has held shares for 40 or more years may have to sell to pay for his/her medical bills. Or a CEO, who is a majority owner in the company, is selling shares under a designated plan to diversify his wealth. Or a company is removed from an index, and those that are tracking the index have to sell.

There are a variety of reasons why stock prices are unpredictable *in the near term*. We'd have to know the risk tolerances and behaviors of all major investors within each company to know what they will do, buy or sell, and when, in order to be able to predict with precision the market price movements of equities. This is an insurmountable task, and not worth one's time. Even if such information could be aggregated, it would absorb considerable resources

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such that the payoff may not be worth the effort.

There is one thing we can count on, however. Over time, stock prices and intrinsic value tend to converge due to the presence of the behavior of value investors in the market who buy undervalued stocks and sell overvalued stocks. In most cases, these two different concepts (price versus value) may not converge completely (because value is a range not a point estimate), but stock prices tend to be attracted to intrinsic value over time, much like a magnet is attracted to steel or iron, for example.

Within our 16-page reports, we arbitrarily choose 3 years as the price-to-convergence period, but there's really no hard-and-fast rule. A stock's price can converge to its intrinsic value in the next trading session or it could take 10 years or longer. In some value traps, the true intrinsic value is $0, even if the company has tangible net assets. Investing will never be precise. In many cases, investing is about having the odds stacked in your favor – or owning a stock that is trading at a significant discount to intrinsic value and is going up. This leads to outperformance. Owning good companies at intrinsic value leads to the market return, or the cost of capital less the dividend yield.

It is partly because of the uncertainty of both timing and intrinsic value estimation that the Valuentum process waits for an *undervalued* stock's price to turn higher before adding it to the newsletter portfolio. If we like the stock's valuation and business model anyway, what's the harm in waiting until the market starts to agree? We won't miss much. In fact, we'd only miss further declines, making the potential entry point even more attractive.

That's why we like undervalued stocks that are in the process of converging to intrinsic value. It takes a lot of risk out of the equation, and it optimizes time-weighted returns. We won't be holding a stock, for example, that goes down for years before it turns higher. A 25% return in one year is much better than a 25% return in 20 years. A lot of what we do is common sense.

The increase in Berkshire's per-share intrinsic value over the past half-century has been roughly equal to the ~1,800% gain in the market price of its shares. Remember, stock prices are attracted to intrinsic value. That's why intrinsic value estimation is so important.

"BNSF is, by far, Berkshire's most important non-insurance subsidiary and, to improve its performance, we will spend $6 billion on plant and equipment in 2015. That sum is nearly 50% more than any other railroad has spent in a single year and is a truly extraordinary amount, whether compared to revenues, earnings or depreciation charges."

BNSF is one of the largest railroads in the US. The reason why I've pulled this quote is to illustrate the capital intensity of the railroad industry. A company's intrinsic value is based on the future enterprise free cash flows of the organization, where net investment (capital spending less maintenance expense) is subtracted from earnings before interest, going forward. Net cash is added or net debt is subtracted from the present value of a company's enterprise free cash flows when arriving at its equity value.

Though railroads have fantastic monopolistic positions due in part to the private ownership of track networks, their business models are heavily dependent on spending a large portion of cash flow from operations to maintain these track networks. By definition, the less a company has to reinvest in the business in the form of capital spending to maintain cash flow from operations, the better the free cash flow generation of the entity. Railroads are very capital intensive operations.

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Berkshire Hathaway owns BNSF because it is a fantastic business that won't go away anytime soon, the quintessential investment of Warren Buffett. In market parlance, we'd say that railroads have economic moats, but their economic castles aren't highly rated. The very best types of businesses are the ones that throw off tons of cash without having to invest much of that cash to maintain a growing free cash flow stream. Asset light companies that generate lots of cash are the best businesses.

Think like a business owner.

"Charlie and I encourage bolt-ons, if they are sensibly-priced. (Most deals offered us aren't.)"

This is an important point and why sometimes we're *not* fans of a merger or acquisition, even if we may like the deal from a strategic standpoint. Remember, you can like a company to the moon, but if it engages in a merger or acquisition where the target's takeout price cannot be reasonably justified with merger accounting via a discounted cash-flow process (including synergies), it doesn't matter how much you like the company -- its capital allocation decisions are destroying value.

Of course you can still like the company, but the deal is not in your best interest.

In the case where a suitor pays too much for a target, the suitor's intrinsic value falls, while the target's shareholders are paid more than they should. When the takeout premium is unjustified, value is transferred from the acquirer's shareholders to the target's shareholders. In today's overheated market, some of the transaction multiples that we've seen have been astronomical.

Siemens (SIEGY), for example, continues to take flak for its buyout of Dresser-Rand, where it paid 14 times this year's EBITDA for the company, far greater than comparable multiples and the company's own one. Some management teams are engaging in something called "empire building" under the guise of "strategy." The discounted cash-flow model does not lie.

"Berkshire increased its ownership interest last year in each of its 'Big Four' investments – American Express, Coca-Cola, IBM and Wells Fargo. We purchased additional shares of IBM (increasing our ownership to 7.8% versus 6.3% at year-end 2013)." The earnings these investees retain are often used for repurchases of their own stock – a move that enhances Berkshire's share of future earnings without requiring us to lay out a dime. Their retained earnings also fund business opportunities that usually turn out to be advantageous. All that leads us to expect that the per-share earnings of these four investees, in aggregate, will grow substantially over time (though 2015 will be a tough year for the group, in part because of the strong dollar).

This paragraph needs clarifying because there are a lot of moving parts. For starters, Warren Buffett thinks American Express (AXP), Coca-Cola (KO), IBM (IBM) and Wells Fargo (WFC) are undervalued. It's important to make this distinction because not all share buybacks are a good thing. Buybacks completed on company stock that is overvalued are value-destroying, regardless of whether earnings-per-share is enhanced. Remember, in repurchasing overvalued stock, net cash on the balance sheet is reduced by a factor that is greater than the net benefit generated from dividing equity value by a lower share count. You wouldn't want to buy overvalued stock, right? So why would you want management to?

"I've mentioned in the past that my experience in business helps me as an investor and that my investment experience has made me a better businessman. Each pursuit teaches lessons that are applicable to the other. And some truths can only be fully learned through experience."

How true!

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"Indeed, who has ever benefited during the past 238 years by betting against America? If you compare our country's present condition to that existing in 1776, you have to rub your eyes in wonder. In my lifetime alone, real per-capita U.S. output has sextupled. My parents could not have dreamed in 1930 of the world their son would see. Though the preachers of pessimism prattle endlessly about America's problems, I've never seen one who wishes to emigrate (though I can think of a few for whom I would happily buy a one-way ticket). The dynamism embedded in our market economy will continue to work its magic. Gains won't come in a smooth or uninterrupted manner; they never have. And we will regularly grumble about our government. But, most assuredly, America's best days lie ahead."

In classic Warren Buffett fashion, it's hard to disagree with him. The Great Recession was the worst our generation has ever witnessed, and it saw the toppling of firms from Lehman Brothers to General Motors (GM). Yet, the stock market is making new highs again. The resiliency of America is truly amazing. The one nugget of wisdom, however, is that prior to the housing crisis of the last decade, investors thought housing prices could only go up. Is America truly a riskless investment as Warren Buffett says it is? I'm not so sure, but the country's track record is fantastic.

"As much as Charlie and I talk about intrinsic business value, we cannot tell you precisely what that number is for Berkshire shares (nor, in fact, for any other stock)."

There's not much more we can say about this. The Valuentum process reflects this *truism* of equity investing. A stock's intrinsic value is based on the future free cash flows of the company, and the future has yet to be written (it's uncertain). Therefore, intrinsic value represents a probability weighting of all of a company's expected future free cash flow streams under various reasonable scenarios.

By extension, a reasonable valuation of a company can best be expressed as a fair value range (as we outline in the 16-page reports of every company). *Value will never be a precise estimate.* It will always be a range of fair value outcomes. A company is *truly* undervalued only when its share price falls below a reasonable range of fair value outcomes. To register a high rating on the Valuentum Buying Index, a company must meet this valuation criteria.

"Since 1970, our per-share investments have increased at a rate of 19% compounded annually, and our earnings figure has grown at a 20.6% clip. It is no coincidence that the price of Berkshire stock over the ensuing 44 years has increased at a rate very similar to that of our two measures of value. Charlie and I like to see gains in both sectors, but our main focus is to build operating earnings. That's why we were pleased to exchange our Phillips 66 and Graham Holdings stock for operating businesses last year and to contract with Procter and Gamble to acquire Duracell by means of a similar exchange set to close in 2015."

Warren Buffett is quite savvy. Exchanging stock for operating earnings ensures that the tax bill is minimized and that Berkshire Hathaway capitalizes on the cash-flow generation of the acquired tangible businesses that are less volatile than their underlying equity prices (which are impacted by a large variety of factors that are not firm-specific). In many cases, the cash flows of the business are more resilient during economic troughs than equity prices themselves, and said cash flows can then be reinvested to buy other companies on the cheap during difficult times. In pure equity investing, on the other hand, many companies that do not pay dividends do not provide explicit cash flows to investors for reinvestment. As a result, tangible operating earnings are the preferred choice for most investors in most cases.

The quoted paragraph also reveals why Warren Buffett may be less concerned about stock price moves. The link between future operating earnings, or earnings before interest (EBI), and intrinsic value estimation has been well-documented. In situations where the share price of a company falls below its

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intrinsic value, for example, investors like Warren Buffett, who are flush with cash, can buy the *entire* company outright, and exploit the value differential--the difference between the present value of a company's future free cash flows (and balance sheet considerations) and its share price. The tangible cash-flow link is in part why share prices are anchored to intrinsic value over time. If the deviation between a company's share price and its intrinsic value becomes too large, large investors (or activist investors) will step in and buy the company outright, exploiting the differential.

For stock-market-only investors, the opportunity to buy a company outright is usually not feasible. From our perspective, stock-market-only investors care more about stock prices than Warren Buffett, and they should. Unlike Berkshire Hathaway, stock-market-only investors cannot exploit the aforementioned value differential (between public share prices and the value accrued by taking a firm private), should it occur. The very presence of large investors that are scouring for new ideas, however, keeps share prices relatively close to intrinsic value. When discrepancies between share prices and intrinsic values do occur, they are usually resolved in time; such is the theory behind value investing.

Stock prices will always be anchored to intrinsic value.

*"One reason we **were** attracted to the property-casualty business (in 1967) was its financial characteristics: P/C insurers receive premiums upfront and pay claims later. In extreme cases, such as those arising from certain workers' compensation accidents, payments can stretch over many decades. This collect-now, pay-later model leaves P/C companies holding large sums – money we call "float" – that will eventually go to others. Meanwhile, insurers get to invest this float for their benefit. Though individual policies and claims come and go, the amount of float an insurer holds usually remains fairly stable in relation to premium volume. Consequently, as our business grows, so does our float."*

Warren Buffett has built most of the wealth of Berkshire Hathaway from investing insurance premiums and the accumulated float. It is not because of the insurance business itself that Warren Buffett has been successful, however. On the contrary, it is because of the timing mismatch of cash flows in the insurance business (between float and claims) that has given Warren Buffett the opportunity to invest the float to achieve above average returns. In the insurance business, over the *very* long run, premiums received should equal eventual losses (emphasis on *very long run*), where net underwriting profit is close to zero. Buffett says as much in subsequent paragraphs:

> If our premiums exceed the total of our expenses and eventual losses, we register an underwriting profit that adds to the investment income our float produces. When such a profit is earned, we enjoy the use of free money--and, better yet, get paid for holding it. Unfortunately, the wish of all insurers to achieve this happy result creates intense competition, so vigorous indeed that it frequently causes the P/C industry as a whole to operate at a significant underwriting loss.
>
> This loss, in effect, is what the industry pays to hold its float. Competitive dynamics almost guarantee that the insurance industry, despite the float income all its companies enjoy, will continue its dismal record of earning subnormal returns on tangible net worth as compared to other American businesses. The prolonged period of low interest rates our country is now dealing with causes earnings on float to decrease, thereby exacerbating the profit problems of the industry.

This is partly why we're not fans of the insurance business, in general. The other part rests in the commodity-type nature of insurance products. As Buffett outlines, insurers "simply can't turn their back on business that is being eagerly written by their competitors. That old line, 'The other guy is doing it, so we must as well,' spells trouble in any business, but in none more so than insurance."

We see no reason to own an insurer. Berkshire Hathaway is no such thing, however – it is a conglomerate with diversified sources of free cash flows.

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"GEICO's cost advantage is the factor that has enabled the company to gobble up market share year after year. (We ended 2014 at 10.8% compared to 2.5% in 1995, when Berkshire acquired control of GEICO.) The company's low costs create a ***moat*** *– an enduring one – that competitors are unable to cross. Our gecko never tires of telling Americans how GEICO can save them important money. The gecko, I should add, has one particularly endearing quality – he works without pay. Unlike a human spokesperson, he never gets a swelled head from his fame nor does he have an agent to constantly remind us how valuable he is. I love the little guy...Berkshire's great managers, premier financial strength and a variety of business models protected by* ***wide moats*** *amount to something unique in the insurance world. This assemblage of strengths is a huge asset for Berkshire shareholders that will only get more valuable with time."*

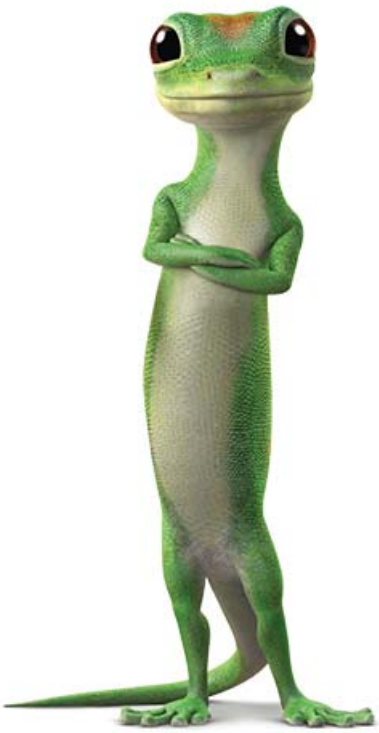

Image Source: Geico

I've spent a large part of my professional career talking about economic moats. The phrase is thrown around so frequently in all circles of finance that it has practically lost its meaning, at least to me. In many cases, the term economic moat has become an analytical crutch for some. Instead of talking about the tangible competitive advantages a company has, some simply say company XYZ has an economic moat. Those that are listening just nod in agreement. It's as if analysis can be skipped by saying company XYZ has an economic moat.

That's why we've developed the Economic Castle rating. We wanted to have something more tangible, something that means something. At least when someone says that a firm has a highly-rated Economic Castle, those that are listening know its economic returns are through-the-roof. It's hard to say having an economic moat means much of anything, other than the view that a firm has sustainable competitive advantages. But a moat without a castle isn't much of anything. Who wants a moat with alligators swimming in it if the castle (business) is crumbling? Not me.

Image Source: Elliot Brown

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Even Warren Buffett falls back on this terminology.

For example, just a few paragraphs prior to this one the Oracle was explaining how insurance is a terrible business, and then in this paragraph, he's talking about how GEICO's economic moat is supported by its low-cost position. We know one thing for sure. There's nothing structural about the car insurance industry that creates an economic moat. The products and business models can be duplicated, and they have been. Capital is not a barrier. GEICO has gained share primarily as a result of aggressive marketing tactics, which themselves can be duplicated.

We don't see an economic moat in the insurance business. Great managers, premier financial strength and a variety of business models don't make for an economic moat. A look back a few years during the Financial Crisis, for example, General Electric's (GE) consumer finance unit had been backed by highly-diversified industrial operations, which themselves could be broken into 3 or 4 or even 5 separate companies. But GE succumbed to the credit crunch anyway, being forced to cut its dividend to preserve cash. GE is now shedding its financial operations.

Under a severely-adverse mega-catastrophe, we think Mr. Buffett will change his tune. He probably won't stop saying that his businesses have wide moats though.

"Last year, for example, BNSF's interest coverage was more than 8:1. (Our definition of coverage is pre-tax earnings/interest, not EBITDA/interest, a commonly used measure we view as seriously flawed.)… Depreciation charges, we want to emphasize, are different: Every dime of depreciation expense we report is a real cost. That's true, moreover, at most other companies. When CEOs tout EBITDA as a valuation guide, wire them up for a polygraph test."

We take some exception to saying EBITDA/interest is a seriously flawed measure. As with most measures in finance, they only have informative value if you know what they mean. Investors don't have to pick only one measure to look at, and there's a lot to be said about evaluating a variety of metrics to ascertain the interest coverage of a firm. For example, free cash flow before cash interest divided by cash interest is another measure of interest coverage, perhaps the best of all if assessed on a forward-looking basis and over a meaningful time horizon.

Don't throw out EBITDA. It has its uses, particularly with respect to relative assessments, and particularly in the retail, restaurant, airline and energy arenas. In the case of retailers, restaurants, and airlines, comparing companies' EV/EBITDAR (R=rent) could be insightful as some may own while others may lease assets. For exploration and production companies, comparing companies' EV/EBITDAX (X=exploration expenses) could be insightful if one firm has significantly higher exploration costs than another in any given period. EBITDA has its uses, especially when it comes to comparing companies on an apples-to-apples basis.

There will be benefits and pitfalls of each measure, but the more ways you look at a company, the more familiar you'll become with its financial stature and business model. This can only be a good thing. We apply a discounted cash-flow valuation model as the primary component of our valuation process, so we're not partial to using any multiple, EPS or EBITDA, in valuation analysis.

"A few, however, have very poor returns, the result of some serious mistakes I made in my job of capital allocation. I was not misled: I simply was wrong in my evaluation of the economic dynamics of the company or the industry in which it operates. Fortunately, my blunders normally involved relatively small acquisitions. Our large buys have generally worked out well and, in a few cases, more than well. I have not, nonetheless, made my last mistake in purchasing either businesses or stocks. Not everything works out as planned."

Yes, even Mr. Buffett makes mistakes.

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The Best Ideas Portfolio

By Valuentum Analysts

Portfolio Return	Benchmark Return	Outperformance
94.9%	68.6%	26.3pts

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 ~29% of the portfolio in cash, a level we're looking to bring down in coming months. Tactically, we like to have the most cash when the market is making new highs and fully invested when the market is putting in short-term lows.

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

OUR BEST IDEAS PORTFOLIO -- as of April 15, 2015 — **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	126.78	20,411.58	10.5%	152.0%
Alibaba	BABA	IPO	3	19-Sep-14	92.95	78	7,264.10	84.67	6,604.26	3.4%	-9.1%
Altria Group	MO	8	3	28-Jun-11	28.39	315	8,958.11	51.61	16,257.15	8.3%	102.4%
Cisco	CSCO	9	9	14-Nov-14	26.15	100	2,622.00	28.25	2,825.00	1.4%	8.5%
eBay	EBAY	10	7	3-Oct-11	31.04	100	3,103.50	57.01	5,701.00	2.9%	83.7%
Financial Select SPDR	XLF	NA	6	9-Jan-11	13.46	150	2,026.00	24.42	3,663.00	1.9%	88.2%
General Electric	GE	7	7	21-Oct-13	25.99	375	9,761.75	27.46	10,297.50	5.3%	10.3%
Gilead Sciences	GILD	10	6	19-Sep-14	106.76	68	7,273.34	104.03	7,074.04	3.6%	-2.7%
Google	GOOG	10	4	23-Oct-12	450.92	14	6,326.84	532.53	7,455.42	3.8%	17.8%
Health Care ETF	XLV	9	6	22-May-12	36.60	125	4,582.00	73.97	9,246.25	4.7%	108.3%
Intel	INTC	6	6	12-Sep-11	20.48	150	3,086.50	32.83	4,924.50	2.5%	71.6%
SPDR S&P Bank ETF	KBE	NR	NR	9-Jan-12	21.07	100	2,114.00	34.19	3,419.00	1.8%	68.8%
Priceline	PCLN	10	10	26-Feb-15	1248.97	3	3,753.91	1200.95	3,602.85	1.8%	-4.0%
Republic Services	RSG	8	4	19-May-11	31.42	201	6,329.42	40.31	8,102.31	4.2%	40.7%
Rio Tinto	RIO	9	6	22-May-12	46.40	75	3,487.00	42.59	3,194.25	1.6%	4.0%
Teva Pharma	TEVA	6	4	24-Jul-13	41.22	77	3,180.94	65.97	5,079.69	2.6%	65.4%
Union Pacific	UNP	6	3	24-Jul-13	79.67	40	3,193.80	107.40	4,296.00	2.2%	38.6%
Utilities Select SPDR	XLU	NR	NR	18-Mar-14	41.12	83	3,419.96	44.55	3,697.65	1.9%	11.0%
Visa	V	7	6	30-Nov-11	26.86	188	5,064.39	65.68	12,347.84	6.3%	147.4%
Latest change: A new position in PCLN was opened 2/26/2015. Please contact us at info@valuentum.com if you are not receiving the email transaction alerts.											
Cash -- changes in monthly cash balance reflects dividends received and trading gains/losses, where applicable.									56,680.74	29.1%	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		**194,880.03**		**94.9%**
S&P 500 Index (SPY)				17-May-11	132.69	754	100,000.00	210.43	158,587.69	94.1%	
Cash									9,981.16	5.9%	
Benchmark Portfolio Value									**168,568.84**		**68.6%**
Relative Outperformance											**26.3 pts**

Data as of April 15, 2015. Cost basis includes commissions. Results include dividends, but not interest received on cash balance.
* VBI score at the time we added the firm to the portfolio.
** See our methodology regarding the Valuentum Buying Index (VBI). Best Ideas portfolio is not a real money portfolio.

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.

Lessons from the Oracle of Omaha ...from page 7

"Of course, a business with terrific economics can be a bad investment if it is bought for too high a price. We have paid substantial premiums to net tangible assets for most of our businesses, a cost that is reflected in the large figure we show for goodwill. Overall, however, we are getting a decent return on the capital we have deployed in this sector."

This is an area that we try to do our best in communicating to members. If one of your favorite companies is trading significantly above its true worth, it can turn out to be a bad investment from here on out. The translation is rather simple. Investing is not about owning your favorite company at any price; it's about owning a good or great company at bargain-basement prices. The investment decision rests on the price versus fair value equation, not on a company's economic moat, business quality or any other qualitative dynamic.

We use this example a lot, but Apple (AAPL) at a million dollars per share would be a horrible investment (after all, it's trading at $120 at present). But Apple at $0.50 per share, investors probably couldn't get enough of shares. They can be sold immediately on the market for ~$120. Price matters. Intrinsic value matters. Price versus fair value is paramount. As Buffett puts it, "a business with terrific economics can be a bad investment if it is bought for too high a price." We had to repeat it.

Shares**	Company	Percentage of Company Owned	12/31/14 Cost*	12/31/14 Market
			(in millions)	
151,610,700	American Express Company	14.8	$ 1,287	$ 14,106
400,000,000	The Coca-Cola Company	9.2	1,299	16,888
18,513,482	DaVita HealthCare Partners Inc.	8.6	843	1,402
15,430,586	Deere & Company	4.5	1,253	1,365
24,617,939	DIRECTV	4.9	1,454	2,134
13,062,594	The Goldman Sachs Group, Inc.	3.0	750	2,532
76,971,817	International Business Machines Corp.	7.8	13,157	12,349
24,669,778	Moody's Corporation	12.1	248	2,364
20,060,390	Munich Re	11.8	2,990	4,023
52,477,678	The Procter & Gamble Company	1.9	336	4,683 ***
22,169,930	Sanofi	1.7	1,721	2,032
96,890,665	U.S. Bancorp	5.4	3,033	4,355
43,387,980	USG Corporation	30.0	836	1,214
67,707,544	Wal-Mart Stores, Inc.	2.1	3,798	5,815
483,470,853	Wells Fargo & Company	9.4	11,871	26,504
	Others		10,180	15,704
	Total Common Stocks Carried at Market		$55,056	$ 117,470

Image Source: Berkshire Hathaway

We won't comment on the top 15 equity positions in Berkshire Hathaway's portfolio in this article, but we will make the observation that IBM is the sole position that is trading below cost. Most of Berkshire's positions were established many moons ago, so a higher market value is not saying much. Mr. Buffett tends to hold onto his positions for long periods of time (forever in some cases), which makes the market versus cost comparison in the above table great marketing material for Berkshire stock, but not much more than that. We're not afraid to lock in gains and remove companies from the newsletter portfolios, even if it

Lessons from the Oracle of Omaha ...continued on next page

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means the portfolio doesn't show as nicely. We have some big gains that are no longer there. Even Mr. Buffett admits that some stocks can get too pricey to hold.

"The unconventional, but inescapable, conclusion to be drawn from the past fifty years is that it has been far safer to invest in a diversified collection of American businesses than to invest in securities – Treasuries, for example – whose values have been tied to American currency. That was also true in the preceding half-century, a period including the Great Depression and two world wars. Investors should heed this history. To one degree or another it is almost certain to be repeated during the next century.

Stock prices will always be far more volatile than cash-equivalent holdings. Over the long term, however, currency-denominated instruments are riskier investments – far riskier investments – than widely-diversified stock portfolios that are bought over time and that are owned in a manner invoking only token fees and commissions. That lesson has not customarily been taught in business schools, where volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: Volatility is far from synonymous with risk. Popular formulas that equate the two terms lead students, investors and CEOs astray."

Warren Buffett's reference to history is always welcome, and we can learn a lot from the past. It's important, however, to acknowledge that history is just that, history. It's over. We'll always shy away from saying that just because something has been the case in the past, it "almost certain(ly)" will be repeated in the future. History may repeat or rhyme sometimes, but not always. The housing bust of the last decade taught us that this sort of thinking could lead to a disaster of unforeseen proportions.

It's great to see the reference to volatility and risk. Within our discounted cash-flow valuation model, we do not use a stock-price-derived beta, which can be highly volatile and vary wildly depending on the measurement period. Instead, we use a fundamentally-derived beta that considers the underlying risks of a company's business model. Not only that, but we also don't change our long-term forecast of the risk free rate, the 10-year Treasury, in the model too frequently either. Can you imagine how volatile our fair value estimates would be if we tied the discount rate to both the market beta and the spot rate of the 10-year Treasury? We would see 5% or 10% changes in a firm's intrinsic value or more on a daily basis.

As Mr. Buffett states, stock-price volatility is not a proxy for the risks of a business. Fundamental operating dynamics are the sources of business risk. For example, how volatile is the company's revenue growth rate through the course of the economic cycle? What's the operating leverage inherent to the firm's business model? Share price volatility, on the other hand, offers investors opportunity. Therefore, it should not be considered a factor within the risk assessment. Why should a company's discount rate go up when the share price falls? The volatility of the stock price should not be a key factor in the investment decision-making process. The business schools have it wrong.

"If the investor, instead, fears price volatility, erroneously viewing it as a measure of risk, he may, ironically, end up doing some very risky things. Recall, if you will, the pundits who six years ago bemoaned falling stock prices and advised investing in "safe" Treasury bills or bank certificates of deposit. People who heeded this sermon are now earning a pittance on sums they had previously expected would finance a pleasant retirement. (The S&P 500 was then below 700; now it is about 2,100.) If not for their fear of meaningless price volatility, these investors could have assured themselves of a good income for life by simply buying a very low-cost index fund whose dividends would trend upward over the years and whose principal would grow as well (with many ups and downs, to be sure)."

Well said.

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"Investors, of course, can, by their own behavior, make stock ownership highly risky. And many do. Active trading, attempts to "time" market movements, inadequate diversification, the payment of high and unnecessary fees to managers and advisors, and the use of borrowed money can destroy the decent returns that a life-long owner of equities would otherwise enjoy. Indeed, borrowed money has no place in the investor's tool kit: Anything can happen anytime in markets. And no advisor, economist, or TV commentator – and definitely not Charlie nor I – can tell you when chaos will occur. Market forecasters will fill your ear but will never fill your wallet.

The commission of the investment sins listed above is not limited to "the little guy." Huge institutional investors, viewed as a group, have long underperformed the unsophisticated index-fund investor who simply sits tight for decades. A major reason has been fees: Many institutions pay substantial sums to consultants who, in turn, recommend high-fee managers. And that is a fool's game. There are a few investment managers, of course, who are very good – though in the short run, it's difficult to determine whether a great record is due to luck or talent. Most advisors, however, are far better at generating high fees than they are at generating high returns. In truth, their core competence is salesmanship."

Great comment, though I think Mr. Buffett is a master salesman himself. Within the annual newsletter, there is no shortage of shameless plugs to buy products from the companies in Berkshire's portfolio of businesses. If Buffett can do it and still be loved by many far and wide, then I'm going to give it a try. If you love what we're doing here at Valuentum, please recommend our services to friends and colleagues. *Even one subscription makes a difference for us.*

Berkshire Hathaway's annual meeting will be held Saturday, May 2, at the CenturyLink Center in Omaha, Nebraska. From our headquarters in Woodstock, Illinois, to Woodstock for Capitalists, I hope you enjoyed my notes thus far. I'll add more about this year's annual newsletter in the future.

The Time to Consider Owning Alcoa Has Passed

By Brian Nelson, CFA

Image Source: aushiker

First-quarter earnings season is already upon us, with aluminum giant Alcoa (AA) kicking things off April 8. If there is one thing investors should know about Alcoa, buying the company's equity nearly 7 years into an economic recovery is fraught with capital risk. No matter how much Alcoa's business shifts to value-add from commodity-type metal, core demand will always be cyclical.

There were a lot of good numbers in the Alcoa report. Revenue grew 7% thanks to organic expansion in automotive and aerospace, while net income came in at $0.28 per share. After-tax operating income of $191 million was a record for its 'Engineered Products and Solutions' division, while the same measure in its 'Alumina' segment doubled year-over-year.

But we were expecting strong performance from the firm at this point in the economic cycle.

Once metals demand slows, metal prices will come under pressure as they have in every other cycle to this point. With global aluminum demand to increase 6.5% in 2015, to a record 57.5 million metric tons, investors can probably expect decent fundamental performance at the aluminum giant this year. We also like the firm's deal to scoop up Firth Rixson, which enhances its exposure to burgeoning jet engine demand.

But look for Alcoa's equity to begin to sell off 6-9 months in advance of expectations for a flattening of aluminum demand growth, whenever this happens. Shares are already reflecting the good times, and we see no reason to own the company at the moment. From our perspective, Alcoa is only worth considering near the trough of the economic cycle, but even then, we can think off hundreds of other businesses with better revenue models.

If you're looking for the best metal-bender, we think Precision Castparts (PCP) is the one. Five years from now, we wouldn't be surprised to see both Alcoa and Precision look to tie the knot, though we're not sure such a deal would get a thumbs-up from the DOJ. Alcoa's acquisitions of Firth Rixson and titanium leaders TITAL and RTI International make it a very attractive candidate for Precision's management team, which we think is the best in the business at cost take-outs.

Mylan's Deal for Perrigo Boosts Teva

By Brian Nelson, CFA

Image Source: epSos.de

We outlined the case on Best Ideas portfolio holding Teva (TEVA) in our generics industry thesis here. The company was added to the portfolio July 24, 2013 at $41.22 per share. Teva Pharma's shares are now trading north of $66 each, converging to our fair value estimate in just less than two years. With valuations stretched throughout much of our coverage universe, we're going to continue to let this winner run.

Driving the firm higher April 8 was news of Mylan's (MYL) bid for Perrigo (PRGO) at a significant premium to the latter's share price. Under the conditions of the non-binding proposal, Perrigo shareholders would receive $205 in a combination of cash and Mylan stock for each Perrigo share, a takeout price that's nearly 30% greater than Perrigo's 60-day average share price. We don't cover Perrigo, but the lofty premium speaks to the multiples acquisitive firms are willing to pay for valuable assets.

And Teva has some significantly valuable assets!

In late March, Teva bought Auspex Pharma (ASPX) in an all-cash transaction, and many are looking to Auspex's lead product candidate SD-809--a potential treatment for disorders including Huntington's Disease, Tourette Syndrome and Tardive Dyskinesia in pediatric patients--to be a big winner. Teva is also working closely with Ignyta (RXDX) these days, recently acquiring 1.5 million shares of its stock after offloading the rights and assets to four of its oncology development programs. Teva's branded portfolio and generics business are sources of upside as well.

It's always good to share the good news on a Best Ideas portfolio holding, and we trust you are pleased. We know that many had scooped the company up on our email transaction alert. Who can forget when we pounded the table on Teva in May of last year? We nailed it.

Let the good times continue.

The 20 Something's Stock Portfolio

By Valuentum Analysts

The "20 Something's Stock Portfolio" is the first in a series of articles where we get to the core of what many brand new investors want to do when they are first introduced to the stock market: find exciting companies that they are familiar with that will help compound their wealth over time.

Other portfolios that we will share in this series include "The Ultra High Income Portfolio," "The Economic Castle Portfolio," "The Dividend Cushion Portfolio," and "The Intelligent ETF Investor's Portfolio," among others. The series of portfolios will serve as a supplement to Valuentum's existing Best Ideas portfolio and Dividend Growth portfolio.

"Valuentum's investment research runs the gamut from value through momentum investing, and we want to make it as friendly as possible for all audiences," said Brian Nelson, President of Equity Research and ETF Analysis at Valuentum. "We need to connect with the '20 somethings' because they don't have the experience of being in the business for 40 years or longer. They're just getting started, and we need to be there for them, and they want compelling ideas that they can relate to."

Hence, the "20 Something's Stock Portfolio" was born.

The "20 Something's Stock Portfolio" is not a model portfolio, meaning it's not for everyone, even if they are in their 20s. We are not your personal financial advisor, so we can never provide personalized financial advice to you. The reason is that we can't possibly know your risk tolerances and investment goals, nor do we know what is right for you in your particular circumstances at this particular time. Only a financial advisor can tell you this.

That said, the "20 Something's Stock Portfolio" is a portfolio of stock ideas that the Valuentum team thinks are worth considering for long-term wealth creation over the next 20 or 30 years and longer. The portfolio of ideas hosts some of the most exciting (and fun) companies with some of the best earnings growth prospects over the long haul. These aren't stable entities, but firms levered to long-term secular growth patterns. The "20 Something's" want investing to be fun!

Due to their fantastic equity price appreciation potential, the stocks on this list also have a lot of risk (a lot), and stock price moves around their quarterly earnings reports can be 10%, 20% or more at times. So you should be aware of such volatility. Capital can also become permanently impaired in the event any one of these firms declares bankruptcy as the business models of a few below have yet to be proven.

In most cases, however, a "20 Something" that selects more than 20 of the companies below in a equally-diversified portfolio should be able to handle the portfolio's volatility relatively well in the path to long-term wealth in coming decades. Oh and one more thing, be sure to check back every few months or so for changes and why.

3D Systems (DDD)

3D Systems is at the forefront of exciting 3D printing technology, and we expect the firm to eventually be acquired as operators consolidate. Could IBM be a suitor as it looks to sort out its own growth prospects?

Alibaba (BABA)

Alibaba is synonymous with e-commerce growth in China, which will be robust for some time. We think Alibaba is one of the best ways to play long-term economic expansion in the country.

*The 20 Something's Portfolio...*continued on next page

The 20 Something's Portfolio ...from previous page

Apple (AAPL)

Who doesn't know Apple? This company has more cash than a few of the market capitalizations of some of the largest companies in the S&P 500 combined. Wearable technology and Apple TV. What's next?

Biogen (BIIB)

Biogen has been off to the races in recent years, but it has a hidden gem in Phase III development for Alzheimer's disease. If things work out for the drug, the payoff could be huge.

Boston Beer (SAM)

For the craft brew drinker, the company that started the revolution. Will craft brews continue to proliferate? Boston Beer will have its hand in the growth.

Buffalo Wild Wings (BWLD)

Beer, wings, and sports? Need we say more? This company's unit store growth will be phenomenal in coming years, and management continues to discover new ways to manage input costs. B-Dubs also has a hidden fast-casual pizza concept in its portfolio.

Capella Education (CPLA)

It's hard to find an educator with better economic returns than Capella. This online based provider does more with one dollar of invested capital than most any other firm in our coverage universe.

Chipotle (CMG)

The fast casual burrito maker has revolutionized the segment. The pace of same-store-sales expansion and unit growth will continue to be phenomenal for the foreseeable future. What about breakfast? The Chipotle story is far from over.

Churchill Downs (CHDN)

How fun is this idea? For those that aren't going to Omaha in the first week of May, the first Saturday in May is home to "the most exciting two minutes in sports," the Kentucky Derby. Churchill Downs' growth-by-diversification strategy is paying dividends. It's no longer beholden to trends in thoroughbred racing. A name change may be warranted?

Continental Resources (CLR)

With oil prices cut in half, the bottom-catchers are out. Continental's position in the Bakken makes it an attractive take-out candidate. Continental means production growth in the energy sector.

Core Labs (CLB)

Talk about a firm with fantastic economic returns. The company is simply in a class by itself. For investors wanting to partner with an energy company laser-focused on return on capital, this is one of them.

Corning (GLW)

Gorilla glass? Saphire crystal displays? Whatever the future may bring with respect to cell phone display technology, Corning will likely have its hands on it.

*The 20 Something's Portfolio ...*continued on next page

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Costco (COST)

One of the best companies as it relates to a multi-stakeholder model. Who can overlook how much it pays its workers? A bet on the idea that highly-paid workers make a good company.

Facebook (FB)

Who doesn't know about Facebook? The company may own the Internet in 10, 20, or 30 years. What else might CEO Mark Zuckerberg have up his sleeve? Only time will tell.

First Solar (FSLR)

A highly-profitable play on the solar industry. The company also has a boatload of net cash on the balance sheet. Will it become acquisitive and rationalize the industry?

Gilead Sciences (GILD)

The company cures hepatitis C. What a breakthrough! Now paying a dividend and buying back stock, will its pipeline have other blockbusters?

Groupon (GRPN)

The company speaks of entrepreneurialism from its base in Chicago. Three cheers! The company is getting things in order as of late. Being free cash flow positive and having a boatload of cash on the balance sheet helps.

EOG Resources (EOG)

EOG Resources is the largest crude oil producer in the South Texas Eagle Ford Shale and North Dakota Bakken. The company won't remain independent for long. A suitor is looming.

Hasbro (HAS)

The licensing company has found new life. What else does it have up its sleeve? The *Frozen* franchise will be a boon for profits.

Intuitive Surgical (ISRG)

If you think robotic technology in surgery is the way of the future, Intuitive Surgical is worth a look. Boasting a nice razor/razor-blade model, there's a lot to like.

Michael Kors (KORS)

The aspirational brand is growing like a weed. The company's shares look cheap. Is the market getting the story completely wrong?

Qualcomm (QCOM)

Hugely-profitable licensing company with a cash hoard on the balance sheet. One of the strongest business models in all of technology.

Pandora (P)

The leader in Internet radio is not getting the respect that it deserves in the marketplace. What gives?

The 20 Something's Portfolio...continued on next page

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PPG Industries (PPG)

The company has a wonderful dividend growth track record, and we like its pricing power. This coatings firm is one of our favorites in the chemicals space.

Precision Castparts (PCP)

Can you say aerospace super cycle? Precision Castparts' metal parts are ubiquitous, meaning that they can be found on almost every major commercial aircraft program. Its customer ties are unbreakable.

Salesforce.com (CRM)

Deferred revenue growth is the key metric for this company. What a great sales team at the helm. Certainly one to keep a close eye on.

Synaptics (SYNA)

Think that human interface technology is the way of the future? Well then, Synaptics is a company worth a look. Believe it or not, the firm was the inventor of the click-wheel on Apple's first-generation iPod that started it all. Can you imagine what else might be in store decades from now?

Tesla (TSLA)

What a testament to capitalism! A brand new car company. Will it survive? Only time will tell.

Twitter (TWTR)

The latest in social media. Not yet sustainably profitable, but the company has a long time before it has to prove itself to shareholders. The technicals are driving this one.

Under Armour (UA)

Nike's younger brother. Under Armour is a huge entrepreneurial success story, and the firm has handled adversity well. Who can forget, "Protect This House."

USG (USG)

Mr. Buffett owns 30% of this wallboard maker. The firm arguably has the greatest operating leverage in our coverage. Watch earnings explode as revenue moves higher.

VCA Antech (WOOF)

Pet lover? VCA Antech is the leading provider of pet health care services in the US. Did you know that more than $30 billion is spent in the US on pets each year for veterinary care, supplies, medicine, boarding and grooming?

Visa (V)

Plastic anyone? One of the best business models out there with the highest operating margins. Does not take on credit risk like American Express and Discover.

Zoe's Kitchen (ZOES)

For the recent IPO in you. This fast-casual Mediterranean restaurant could be the best growth story in small cap today. It targets educated, affluent women and their families.

Think we missed an idea for the '20 Somethings'? Let us know.

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, and we continue to monitor the remainder for the most opportune time to add them. The names on this list are the cream of the crop for the value investor and can supplement your "shopping list" of new ideas.

Company Name	Symbol	Industry	DCF Valuation	Relative Valuation	Price / Fair Value
Nabors Industries	NBR	Energy Equipment - Large	UNDERVALUED	ATTRACTIVE	0.53
Commercial Vehicle	CVGI	Machinery - trucks	UNDERVALUED	ATTRACTIVE	0.60
Gilead Sciences	GILD	Pharma - Generic/Other	UNDERVALUED	ATTRACTIVE	0.63
Eastman Chemical	EMN	Chemicals - broad	UNDERVALUED	ATTRACTIVE	0.65
Century Aluminum	CENX	Aluminum	UNDERVALUED	ATTRACTIVE	0.65
Enerplus Corp	ERF	Independent Oil & Gas	UNDERVALUED	ATTRACTIVE	0.65
Ultra Petroleum	UPL	Independent Oil & Gas	UNDERVALUED	ATTRACTIVE	0.66
Avnet	AVT	Electronic Suppliers	UNDERVALUED	ATTRACTIVE	0.66
Domtar	UFS	Paper Products	UNDERVALUED	ATTRACTIVE	0.68
Patterson-UTI	PTEN	Energy Equipment	UNDERVALUED	ATTRACTIVE	0.69
Atwood Oceanics	ATW	Energy Svcs - Offshore Drilling	UNDERVALUED	ATTRACTIVE	0.70
QUALCOMM	QCOM	Communications Equipment	UNDERVALUED	ATTRACTIVE	0.70
Francesca's Corp	FRAN	Retail - Men's, Women's Apparel	UNDERVALUED	ATTRACTIVE	0.71
Big 5	BGFV	Retail - Sporting Goods	UNDERVALUED	ATTRACTIVE	0.71
Owens-Illinois	OI	Containers & Packaging	UNDERVALUED	ATTRACTIVE	0.73
USG Corp	USG	Building Materials	UNDERVALUED	ATTRACTIVE	0.73
Vishay Intertech	VSH	Broad Line Semiconductors	UNDERVALUED	ATTRACTIVE	0.74
Rio Tinto	RIO	Mining - diversified	UNDERVALUED	ATTRACTIVE	0.75
Perficient	PRFT	Business Services	UNDERVALUED	ATTRACTIVE	0.75
Michael Kors Hldg	KORS	Luxury - Ultra & Aspirational	UNDERVALUED	ATTRACTIVE	0.75
Priceline.com	PCLN	Internet & Catalog Retail	UNDERVALUED	ATTRACTIVE	0.75
Quad/Graphics Inc	QUAD	Book Publishing	UNDERVALUED	ATTRACTIVE	0.76
Korn/Ferry	KFY	Staffing Services	UNDERVALUED	ATTRACTIVE	0.76
Huntsman	HUN	Chemicals - broad	UNDERVALUED	ATTRACTIVE	0.76
Hanger Orthopedic	HGR	Health Care Services	UNDERVALUED	ATTRACTIVE	0.76
Microsoft	MSFT	Software	UNDERVALUED	ATTRACTIVE	0.77
Cisco	CSCO	Networking Equipment	UNDERVALUED	ATTRACTIVE	0.77
Convergys	CVG	Business Services	UNDERVALUED	ATTRACTIVE	0.78
AIG	AIG	Insurance - Property & Casualty	UNDERVALUED	ATTRACTIVE	0.79

*Ideas...*continued on next page

*Ideas...*from previous page

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

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

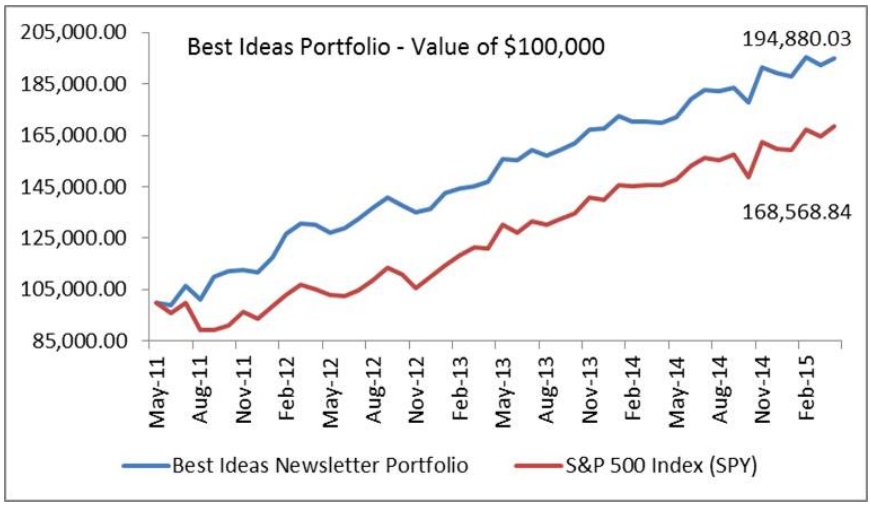
Company Name	Symbol	Sector	Industry	VBI
Convergys	CVG	Information Technology	Business Services	10
Priceline.com	PCLN	Consumer Discretionary	Internet & Catalog Retail	10
AIG	AIG	Financials	Insurance - Property & Casualty	9
Cisco	CSCO	Information Technology	Networking Equipment	9
Perficient	PRFT	Information Technology	Business Services	9
USG Corp	USG	Industrials	Building Materials	9

Bristol-Myers Squibb	BMY	Health Care	Pharmaceuticals - Big	2
DineEquity	DIN	Consumer Discretionary	Restaurants - Fast Cas & Full Svc	2
First American	FAF	Financials	Insurance - Property & Casualty	2
Home Depot	HD	Consumer Discretionary	Specialty Retailers	2
Intl Flavors	IFF	Materials	Chemicals - mid/small	2
Jack in the Box	JACK	Consumer Discretionary	Restaurants - Fast Food & Coffee	2
Mercury General	MCY	Financials	Insurance - Property & Casualty	2
Papa John's	PZZA	Consumer Discretionary	Restaurants - Fast Food & Coffee	2
Pinnacle West	PNW	Energy	Utilities	2
Red Robin	RRGB	Consumer Discretionary	Restaurants - Fast Cas & Full Svc	2
Sonic Corp	SONC	Consumer Discretionary	Restaurants - Fast Food & Coffee	2
Vulcan Materials	VMC	Industrials	Building Materials	2
BJ's Restaurants	BJRI	Consumer Discretionary	Restaurants - Fast Cas & Full Svc	1
Brown-Forman	BF.B	Consumer Staples	Beverages - alcoholic	1
China Life	LFC	Financials	Insurance - Life	1
Hyatt	H	Consumer Discretionary	Hotels	1
Marathon Oil	MRO	Energy	Independent Oil & Gas	1
Quidel Corp	QDEL	Health Care	Diagnostic Substances	1
Rayonier	RYN	Industrials	Conglomerates	1
Starwood	HOT	Consumer Discretionary	Hotels	1

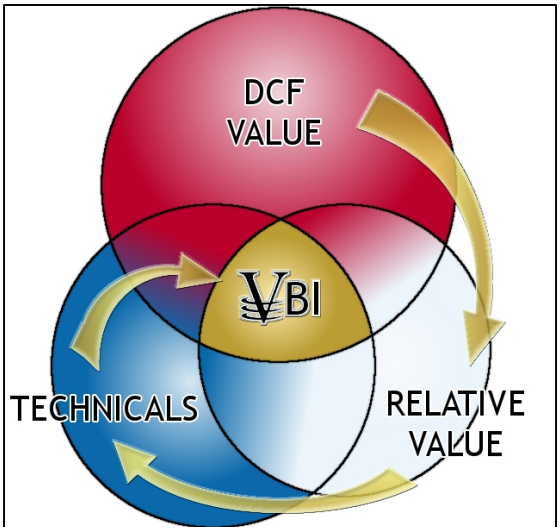
Our Methodology – The Valuentum Buying Index (VBI)

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.



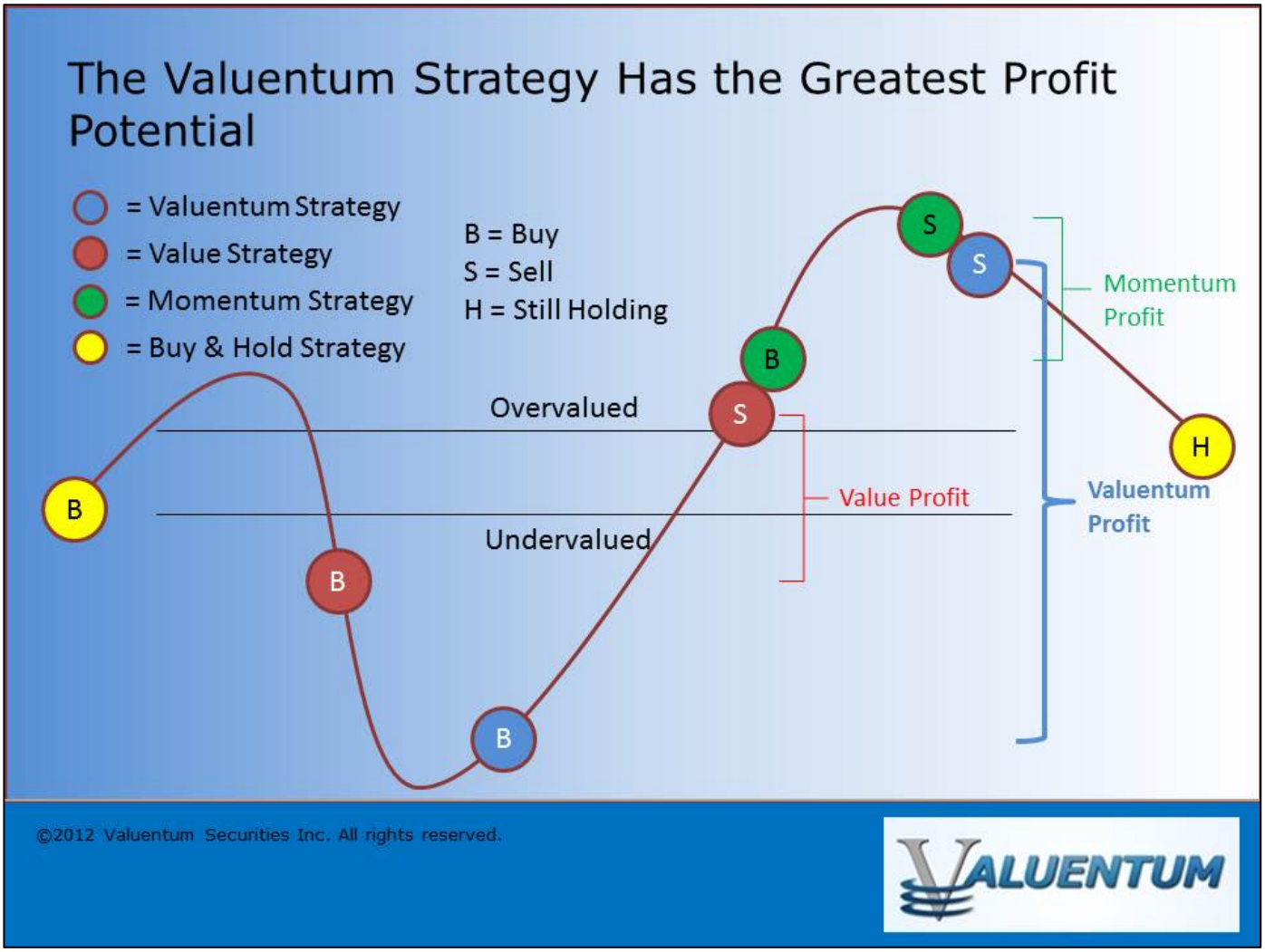
Our Methodology – The Valuentum Buying Index continued on next page

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.



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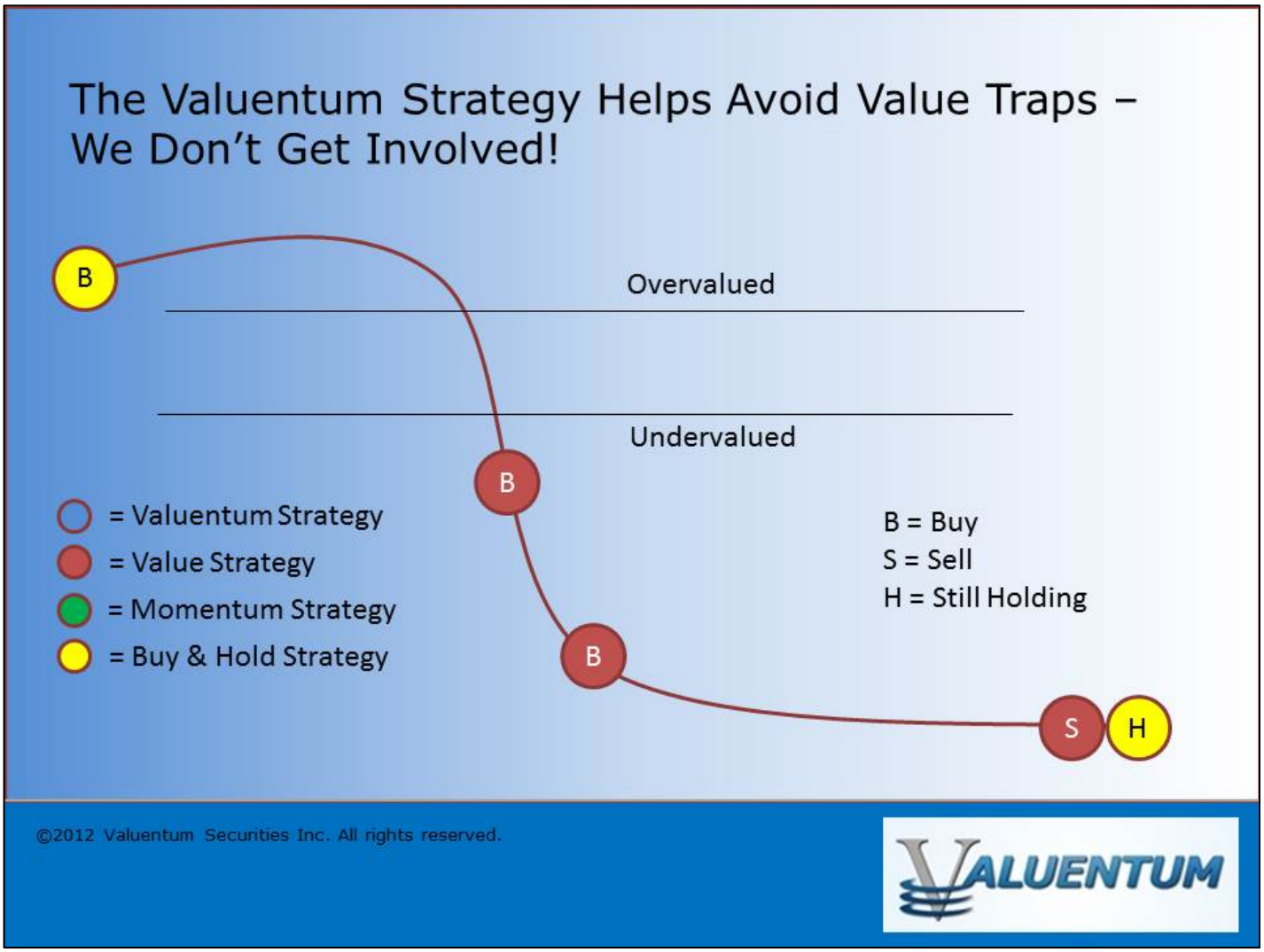
Furthermore, Valuentum subscribers are less likely to be involved in value traps because we demand material revenue and earnings growth for firms to earn a 10 on our Valuentum Buying Index. Value traps often occur as a result of secular declines in a firm's products or services, resulting in deteriorating 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.



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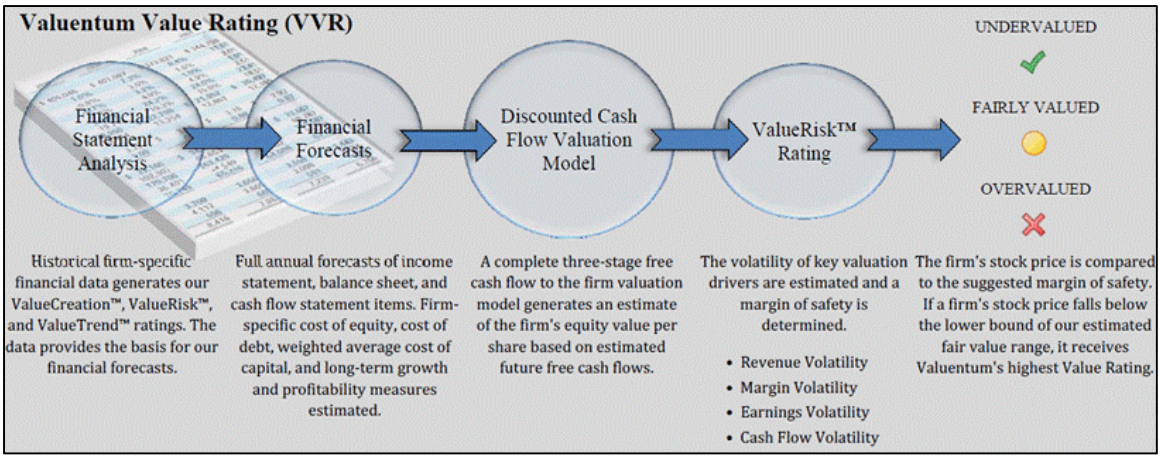
I. We Use a Rigorous Discounted Cash Flow Valuation Process

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.

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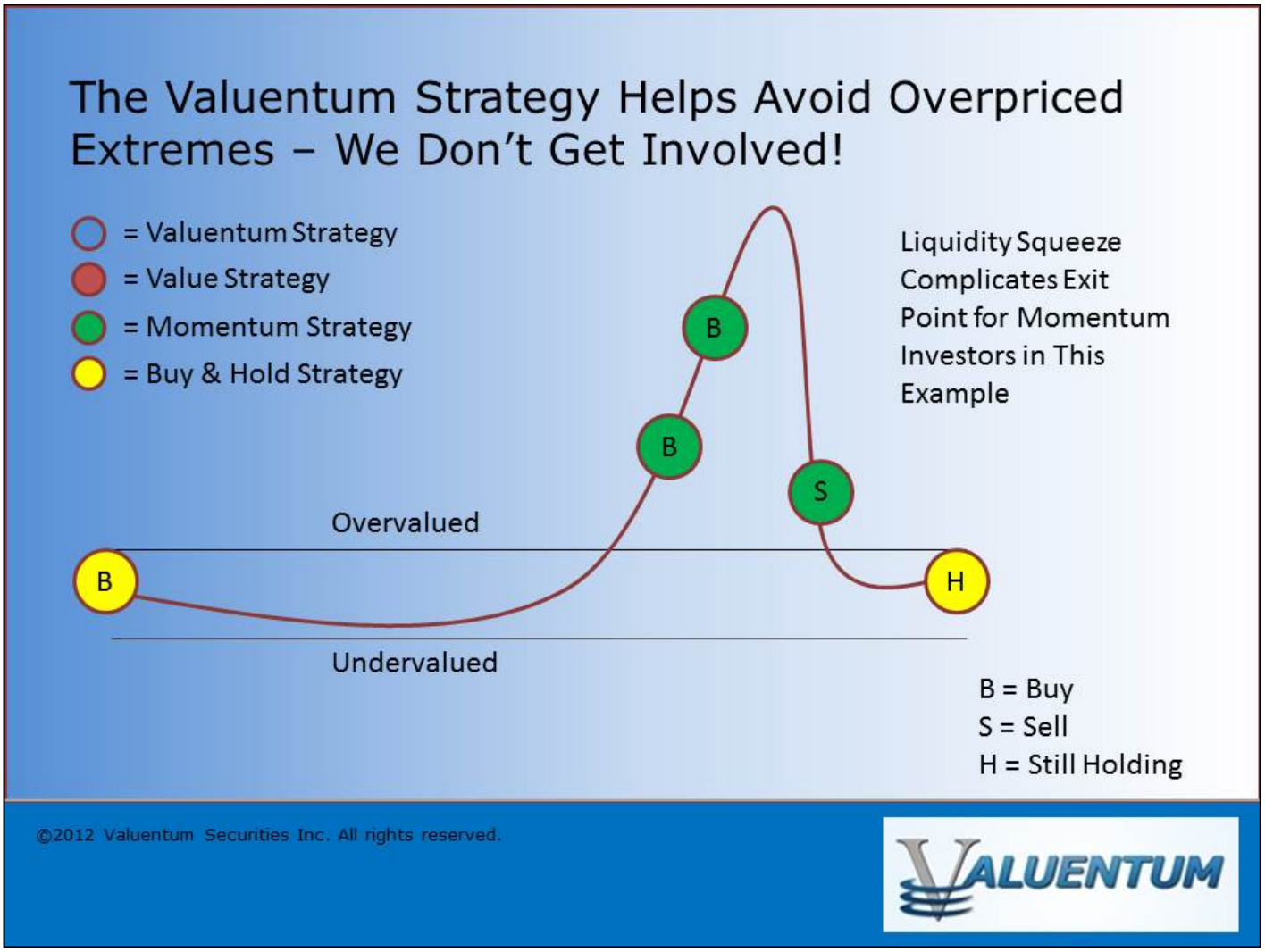

II. We Perform a Forward-Looking Relative Value Assessment

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

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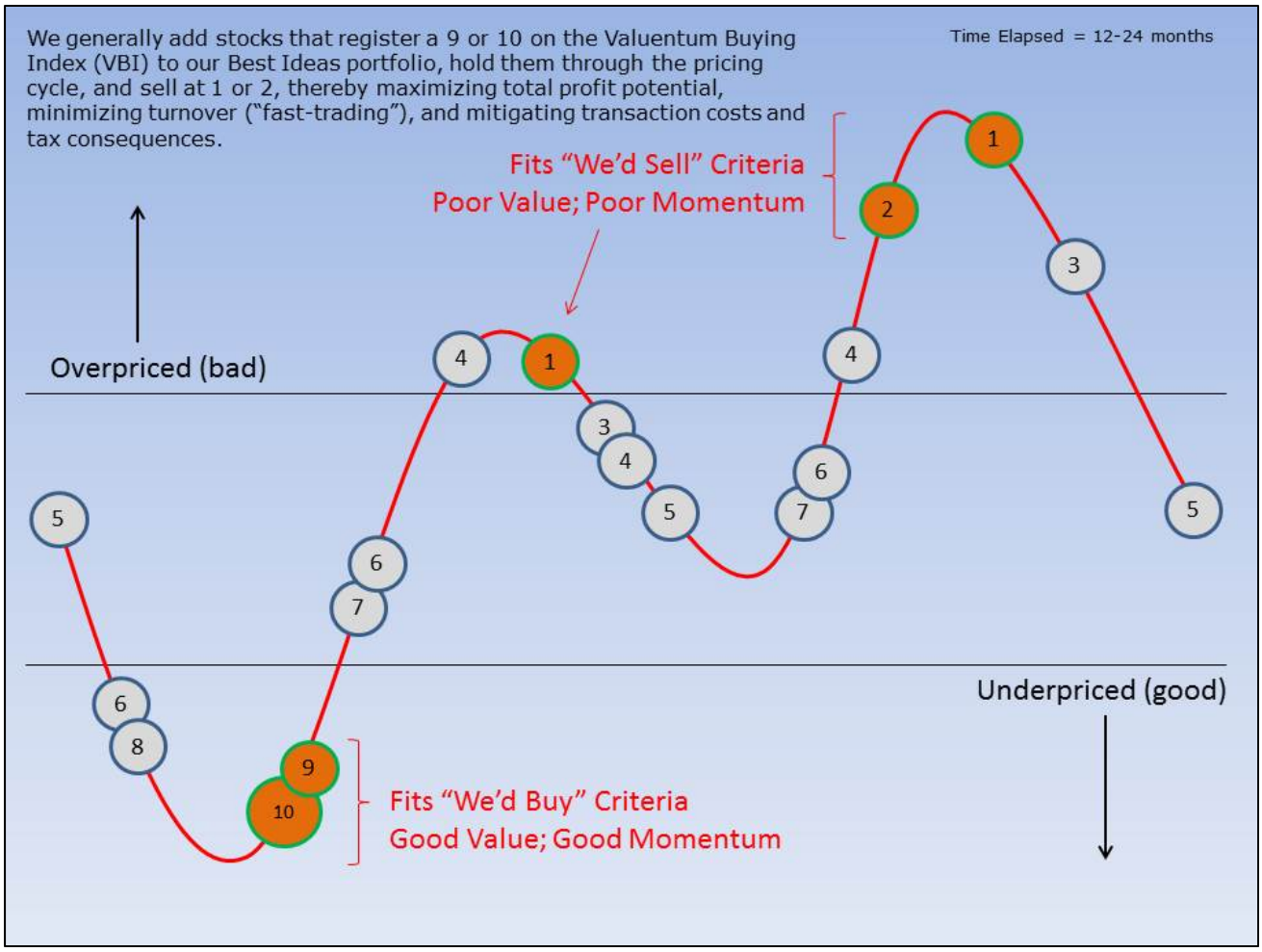
valuation criteria). Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster returns. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we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



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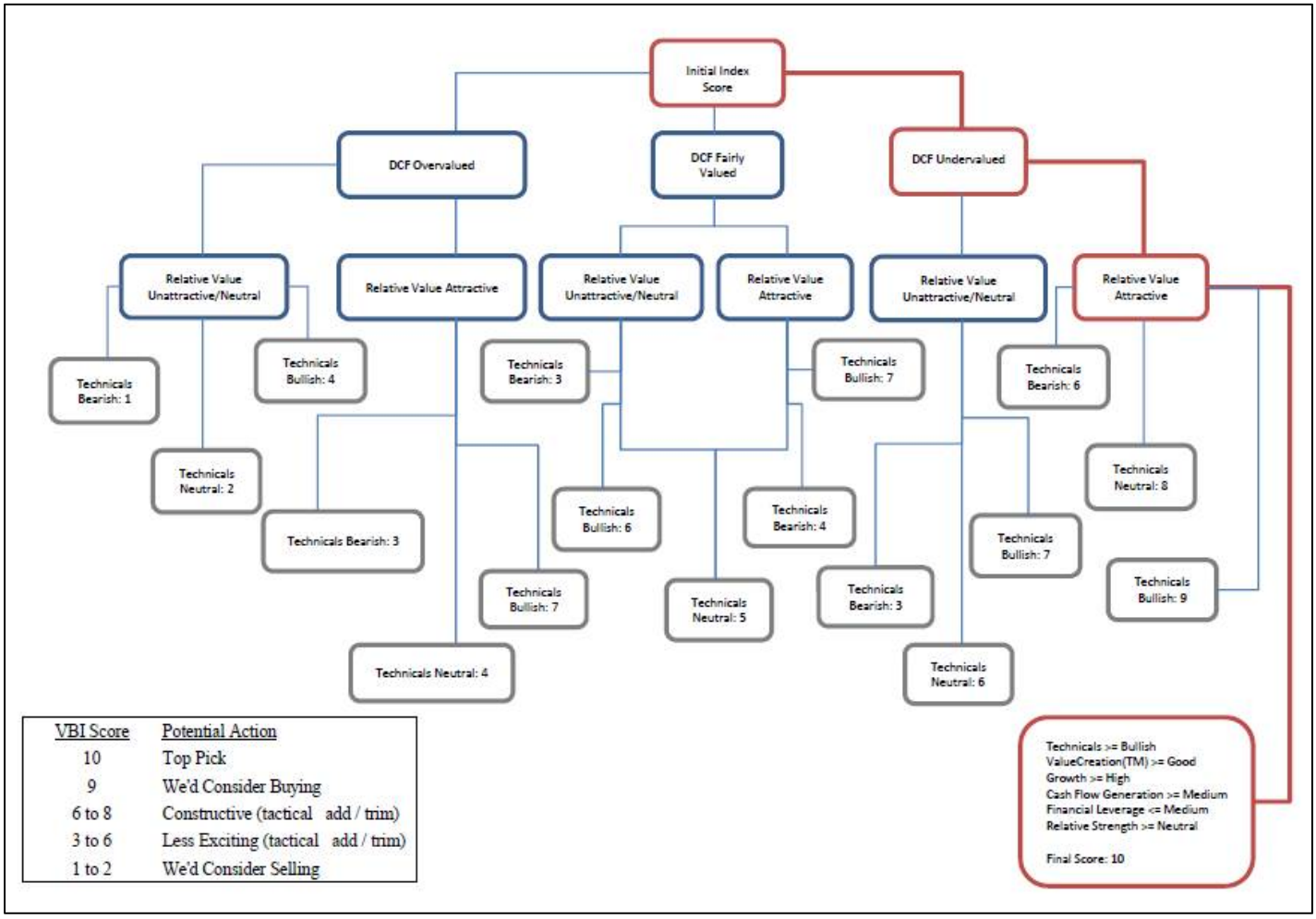
Let's follow the red line on the flow chart below to see how a firm can score a 10, the best mark on our index (a "Top Pick"). Please click here to view an enlarged pdf version. First, the company would need to be 'UNDERVALUED' on a DCF basis and 'ATTRACTIVE' on a relative value basis. The stock would 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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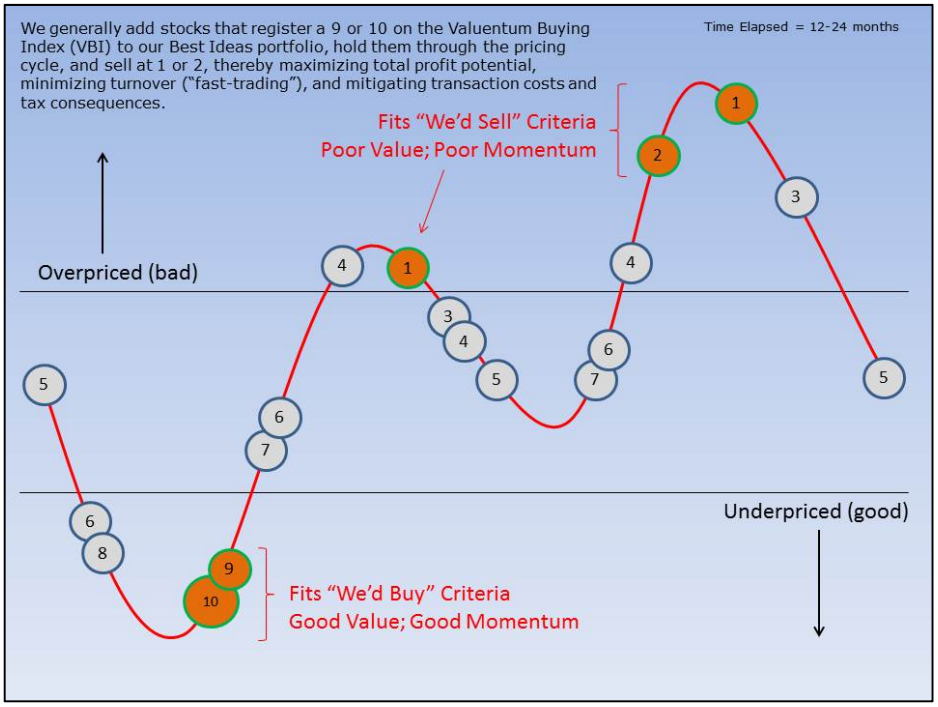
How We Use the Valuentum Buying Index in the Best Ideas Newsletter Portfolio

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 truncated 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 5, Issue 4

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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