OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

October 15, 2016
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Valuentum Securities Inc.
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Portfolio Return	Benchmark Return	Outperformance
107.5%	75.5%	32.0 pts

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

See page 8.

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

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"If the returns of the Best Ideas Newsletter portfolio during the past 5+ years are any measure of the VBI rating system, it is performing fantastically well."
- Brian Nelson, CFA

How Do We Use the Valuentum Buying Index?

By Brian Nelson, CFA

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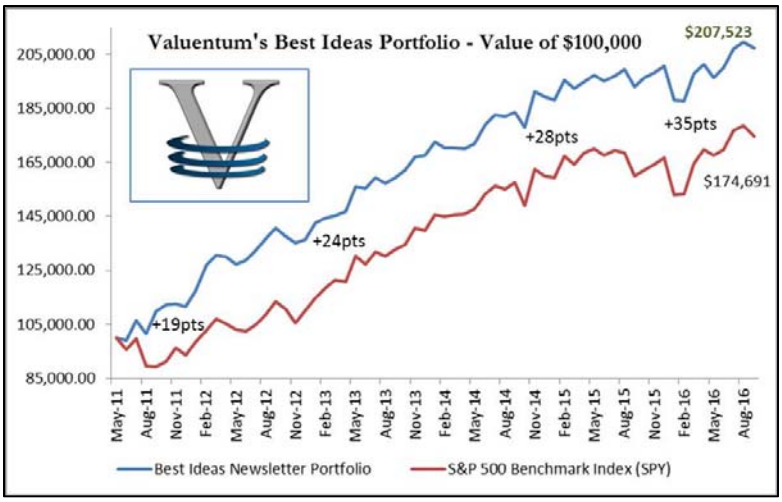

Hi everyone,

Hope you are doing great!

We often receive questions about how we use the Valuentum Buying Index (VBI) rating system, but I think it is equally important to mention that it is only one of the many facets of our website and services. For example, if you haven't checked out the Dividend Cushion ratios on the stocks in your portfolio or the dividend growth product (from individual reports to the newsletter and beyond), surely you are not maximizing your membership! **We love dividends**, but you can also trust us to make sure you're aware of the real risks of any dividend strategy in today's market.

No matter your strategy or process though, the Valuentum Buying Index rating system is still a helpful tool to have at your disposal, even if you are not using it. Admittedly, the VBI, as we call it, is not as easy to use as 1, 2, 3, or even buying 9s and 10s and selling 1s and 2s until their VBI changes upon the next update. Within any quantitative process, **we value the human, qualitative overlay, which captures a wealth of experience and common sense**. We want to make sure that we're surfacing the best ideas for members, and flying blind is never a good strategy, in my opinion. With prudence and care, the VBI process is carried out.

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

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In probably one of the most obvious cases, for example, an experienced investor knows when a price-to-earnings (P/E) ratio isn't informative (as in the case of negative or negligible earnings), but a quantitative rating system that uses a P/E ratio, which the VBI does, may not know any better. Of course the VBI has checks and balances to adjust for such instances, but I believe the human, qualitative overlay is still extremely important, especially when considering various business models and unique "un-modelable" risks (particularly with respect to the banks). In my opinion, a golf club is only as good as the player that uses it, and in a similar light, **a financial model or a rating system is only as good as the user that applies it.**

That said, we stake so much on the performance of the portfolios in the Best Ideas Newsletter and Dividend Growth Newsletter. They represent the *outcome* of all of the work we do on the website, rolled into one final assessment: our best ideas for each respective strategy. **Sure we have other screens on the website, but those are just screens -- listings of companies with similar data and information.** The ideas in the portfolios in the Best Ideas Newsletter and Dividend Growth Newsletter have undergone a painstaking process with our analyst team to ensure that we're delivering the very best to members *within a portfolio setting*. The thoughts behind the weighting of each idea and the portfolio management process revealed in full transparency on a month to month basis may be worth the cost of a membership alone, even if you're not using the portfolios!

Here's why. In a market environment where more than 90% of large-cap funds have trailed the S&P 500 since 2011 through August of this year, the Best Ideas Newsletter portfolio has exceeded the market return by 33 percentage points over a similar time period. *Absolutely phenomenal*. What's more, we didn't hide behind standard quarterly reviews and updates either, sending out pre-packaged information to members. We showcased this performance in full transparency, and we had to write every single day to capture interest! When **patience is the secret to success in investing**, do you know how much could have gone wrong when having to produce daily? Obviously, we're very disciplined, but we also credit the portfolio outperformance to the VBI methodology itself.

Let's talk about how the VBI helps to inform which ideas we include in the Best Ideas Newsletter portfolio (not the Dividend Growth Newsletter portfolio as additional criteria must be met, namely as it relates to yield and Dividend Cushion ratio). That's such an important word, "informs." Notice how we didn't say "dictate" in this reference. For starters, 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 (generally on a quarterly basis) or after material events and not daily or weekly. **Perhaps most practically though, 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 that we consider for the Best Ideas Newsletter portfolio, we expect our best ideas to generally work out over a 12-24 month time horizon (on average). Our holding period is targeted to be much, much longer for some ideas in the Dividend Growth Newsletter portfolio, however. Here is where the VBI rating system becomes somewhat more advanced than a simple 1, 2, 3. **We tend to add stocks to the Best Ideas Newsletter portfolio when they register a 9 or 10 on the Valuentum Buying Index (VBI), hold them for some time depending on a number of variables (the VBI, market conditions, sector weightings within the portfolio itself), and then we tend to remove stocks from our Best Ideas Newsletter portfolio when they register a 1 or 2 on the VBI.** You'll notice that we have a qualitative overlay for the Best Ideas Newsletter portfolio (and one for the Dividend Growth Newsletter portfolio, too, though it is based on dividend-related considerations).

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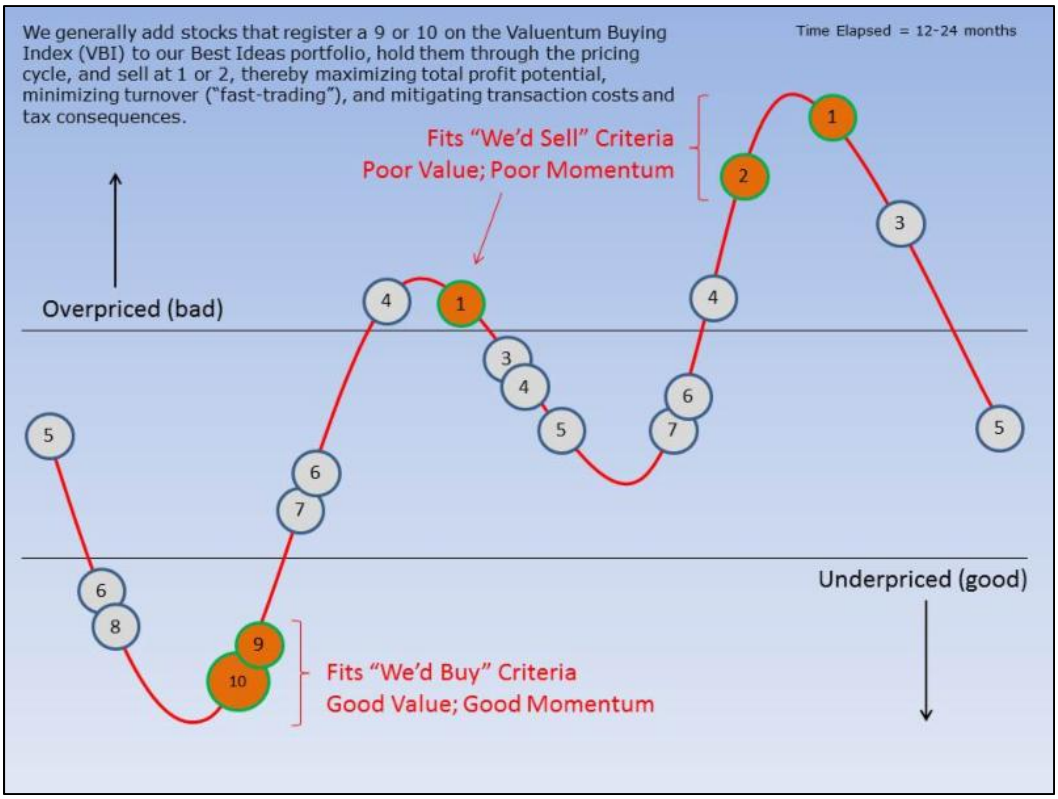

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But why don't we churn and burn by updating daily and trading a lot? Obviously, we don't think that's the secret to success. In quite the opposite approach, we like to maximize profits on every idea that we pursue, with the understanding that momentum does exist and that prices over and under shoot intrinsic value all of the time. For example, as shown in the image above, a value strategy (10 --> 5) truncates potential profits, while a momentum strategy (4 --> 1) ignores profits generated via value assessments. At Valuentum, we're after the entire profit potential of each idea. So, for example, if a firm is added to the Best Ideas Newsletter portfolio as a 10 and is removed as a 5, we would have truncated profit potential by not letting it run to lower ratings. Most of our highly-rated Valuentum Buying Index rated stocks have generated the vast outperformance of the Best Ideas portfolio, but these stocks' ratings declined over time as they were held (a good thing -- a declining VBI rating generally means the share price has advanced, assuming all else is well).

Critically, regarding the Valuentum process, as it is executed in the Best Ideas Newsletter portfolio, we do not add all firms that register a 9 or 10, nor do we add the ones we do immediately thereafter. For example, Google (GOOG, GOOGL), now Alphabet, a current Best Ideas Newsletter portfolio holding, registered a 10 on the Valuentum Buying Index, but we remained patient and didn't add the company to our portfolio until after it reported earnings at the time, providing us with an even better entry point (as new information came to light). There are more "structural/timing" instances like the one with Alphabet, for example, that are extremely difficult to capture in any model, and understandably aren't as obvious to those outside looking in.

But why not add every highly-rated stock to the Best Ideas Newsletter portfolio? Think of it as if you were to imagine a value investor not adding and holding every undervalued stock to his/her portfolio. He or she wants the very best ones -- obviously, that means having to leave some good ideas behind. And then, of course, there are always tactical and sector weighting considerations in any portfolio construction, yet another reason why the human touch remains a vital aspect of the Valuentum process. At the core of how

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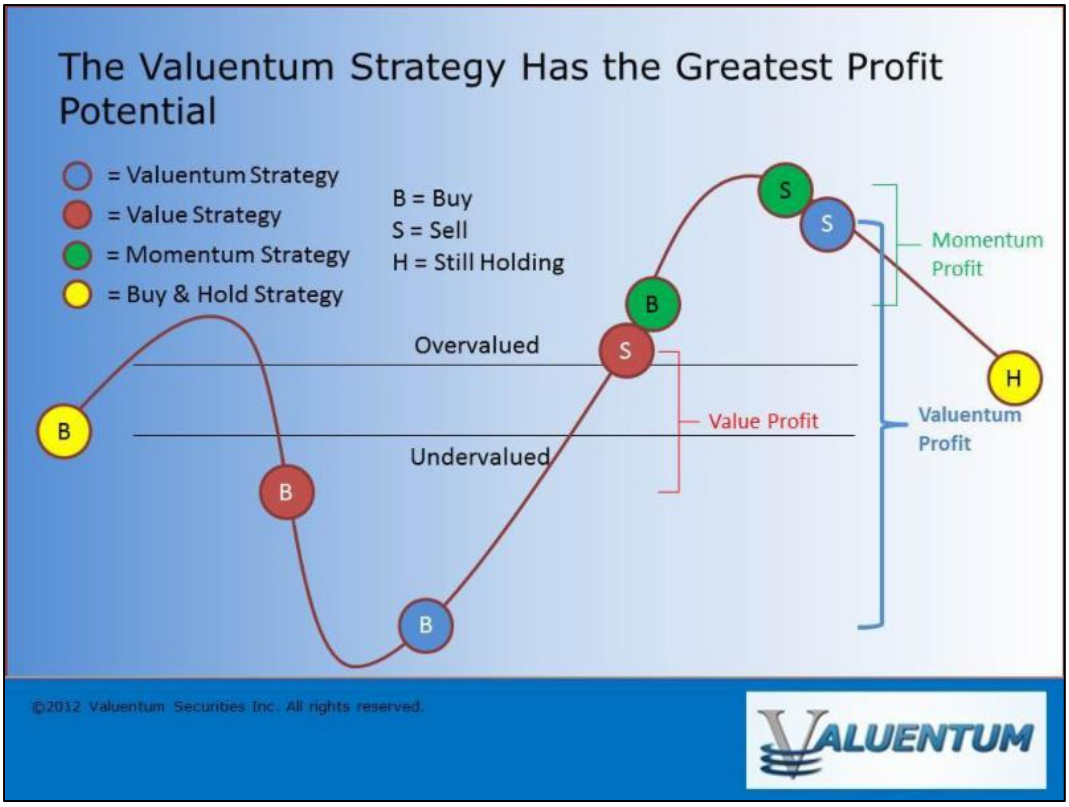

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we use the VBI in the Best Ideas Newsletter portfolio, however, is a qualitative portfolio management overlay. The VBI rating helps to inform the process, but the Valuentum team makes the allocation decisions of the newsletter portfolio on the basis of a number of other firm-specific and portfolio criteria. Sometimes, under certain market conditions, we may have to relax the VBI criteria entirely in order to achieve newsletter portfolio goals.

Okay, a couple examples. Take pre-split eBay (EBAY), which many years ago included PayPal (PYPL), as an example of our process in action. The stock initially flashed a rating of 10 in late September 2011, and we added it to the Best Ideas Newsletter portfolio. The VBI rating changed to a 6 in December 2011 and then back to a 10 in May 2012, but because the rating never breached a 1 or 2, we did not remove the position from the Best Ideas Newsletter portfolio. In the case of pre-split eBay, we sought to capture the entire pricing cycle and avoided truncating it as most pure value investors often do (and what we would had done, if we had removed the stock at that time). In many ways, pre-split eBay/PayPal has become one of the better examples to use for illustrating the prolonged outperformance driven by undervalued stocks that are beginning to generate good momentum. [We no longer include eBay in the newsletter portfolio, but its split-off PayPal is retained.]

There have been more straightforward opportunities in the Best Ideas Newsletter portfolio, too, especially in the case of EDAC Tech, which had tripled since it was added to the newsletter portfolio (never registering below a 9 along the way), and then of course, Apple (APPL), Visa (V) and Altria (MO), but it is usually through the nuances of the process that one truly comes to understand it. The VBI ratings on each stock's most recent 16-page report, downloadable directly from the website at www.valuentum.com, reflect our current opinion on the company. The VBI rating system, as with all methodologies, helps to *inform* the investment decision process, but in constructing the newsletter portfolio, a qualitative overlay is not only necessary, in my view, but helps to optimize performance. If the returns of the Best Ideas Newsletter portfolio during the past 5+ years are any measure of the VBI rating system, it is performing fantastically well.

Apple V. Samsung

By Kris Rosemann

Samsung's (SSNLF) issues with its Galaxy Note 7 smartphone began in late August when the firm postponed shipments of the smartphone due to product quality testing. The event was not a major issue, as early demand for the device had outpaced supply, already causing shipment delays to some markets. Shortly after the delay was announced, claims of the smartphones' batteries exploding surfaced, and Samsung subsequently announced it would recall Galaxy Note 7s across the globe.

The recall announcement only began the saga of despair for the Galaxy Note 7 series. One week later, the FAA issued a warning that the devices could be an airborne fire hazard and suggested consumers refrain from using the smartphones on airplanes altogether. The Consumer Product Safety Commission also urged consumers to power down their Galaxy Note 7s and discontinue device charging.

Though the process was initially expected to cost the firm more than $1 billion in total, Samsung appeared to be on track with its recall of all Galaxy Note 7s in early October until a replacement device overheated and caused a plane evacuation in Louisville, Kentucky. A total of three replacement phones were reported to have caught fire in the span of a week, and the Korean smartphone maker subsequently suspended production and sales of the Note 7 after US mobile carriers such as AT&T (T), Sprint (S), and T-Mobile (TMUS) stated they would stop issuing the devices. Samsung has since halted production of the embattled devices permanently.

The recall and later ceasing of production of the Galaxy Note 7 is now expected to result in roughly $4 billion in in costs and sales lost. Such a loss in the midst of an intense update cycle battle with Apple (AAPL), who recently released the iPhone 7, has caused material share price erosion and forced Samsung to slash its third quarter 2016 profit guidance by one third. If such forecasts are accurate, the firm is in danger of reporting its first operating loss in its mobile division since 2011, before the Galaxy Note franchise was introduced.

Some estimates expect Apple to gain approximately 8 million additional unit sales of the new iPhone 7 as a result of Samsung's woes; iPhone 7 shipments in 2016 were initially expected to be in the range of 70-75 million. More important than the near-term bump in demand for the iPhone 7 is the impact Samsung's missteps will have on the long-term share battle in the smartphone market.

Brand loyalty is a key advantage in a consumer facing end market, and Samsung appears to have damaged, at least to a degree, its level of trust with consumers. Apple has a chance to convert millions of former Galaxy users into loyal Apple consumers. In addition to the share growth potential in the smartphone market, Apple stands to benefit from a boost in its installed base of users, making its ecosystem increasingly stronger as its competitor suffers.

While all of this is taking place on the consumer front of the smartphone market, Apple and Samsung continue their legal battle as well; the US Supreme Court is set to determine the amount Samsung owes Apple for iPhone copying. Samsung has already been found to have infringed upon the iPhone's design, but the issue remains whether it owes Apple all or merely a portion of the profits from the phones that benefited from iPhone design features.

The case will be the first design patent case the US Supreme Court will hear in over 100 years, and a number of companies, in tech and beyond, have weighed in on the matter, many siding with Samsung. Facebook (FB), Google (GOOG, GOOGL), Hewlett Packard (HPQ), and Dell are among those who feel the decision is of "enormous practical importance" to them. It is worth noting that a lower court ruled in favor of Apple in 2012 to the tune of $930 million in profits, an amount that was later reduced.

While payments in the hundreds of millions of dollars is relatively immaterial for one of the world's largest electronics company, if Samsung is forced to reconfigure certain aspects of its smartphones in

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order to avoid meaningful penalties related to future patent infringements, it could result in additional consumer discomfort surrounding its devices. Apple will take every opportunity it can to crack into Samsung's share in the smartphone market.

Though we're never happy when consumers are put at risk by failing products, we love what the recent developments surrounding Apple's largest rival mean for the tech giant's long-term positioning in the smartphone market. We're happy to have held on to our positions in Apple in both newsletter portfolios throughout weakness in shares and largely negative sentiment that has surrounded the stock for a large portion of 2016, and we will continue to do so for the foreseeable future.

Honeywell's Stock Up 170% Since End of 2009; GE a Better Bet?

By Brian Nelson, CFA

Has Honeywell's business value truly increased by 170% in less than seven years, or are shares overheated? We think investors should continue to exercise prudence in today's stretched market. GE may be a better relative bet than Honeywell.

What a wonderful ride it has been these past seven years from the March 2009 panic bottom. The S&P 500 (SPY) has experienced one of its strongest showings in history during this time, and even large caps have posted returns that have turned heads. The share price of Honeywell (HON), for one, has leapt more than 170% since the end of 2009, simply a huge run for a company of its size. The question, however, on everyone's mind: Will Honeywell continue to set new heights, or will the ballast of the economic cycle begin to weigh on shares? Longtime CEO Dave Cote will step down March 2017. Will a more ominous picture begin to form as new management gets settled in?

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One thing remains: Honeywell continues to be an M&A story, as organic growth trends have been under pressure as a result of a global economy that has failed to stack up to expectations. During the past 15 years, for example, Honeywell has completed ~90 acquisitions and divested ~70 businesses. In 2015 alone, the company spent ~$5.8 billion in cash for the acquisitions of Elster, ComDev, Satcom, Sigma, and Aviaso. In August 2016, Honeywell completed the buyout of Intelligrated (automation solutions business), and unconfirmed reports suggest it is interested in acquiring JDA Software for $3 billion. Honeywell also spun-off AdvanSix (ASIX), its resins and chemicals operation, where shareholders received one share of AdvanSix for every 25 shares of common Honeywell stock they owned. It recently sold its government service provider to KBR (KBR).

Profit taking in Honeywell's shares became more prominent October 2016, as the company trimmed its full-year earnings per share guidance for 2016 and noted that core organic sales are now expected to be down 1-2% for the year. We find the bottom-line revision a little troubling because Honeywell had announced a $5 billion stock buyback program in April 2016 as a strategy to deploy cash. The buyback program in itself was peculiar and may have been the catalyst for CEO Cote's impending departure. One doesn't have to look much further than Cote's 2015 annual letter to shareholders to see that there may have been some disagreement in the board room regarding opportunistic share buybacks:

> As you may know, there has been significant Analyst support over the years for "meaningful" share buyback. To the consternation of several analysts and likely many short-term holders, we took a different path than many of our peers. We chose instead to keep our powder dry for the day when opportunity and pricing came together, limiting our buyback activity to periods where opportunistic market conditions existed and largely to keep share count flat over the long term. While that same $5.8 billion deployed to share buyback would have yielded higher EPS, I don't believe it would have made us a better long-term investment. And as it turns out, on top of the $5.8 billion deployed for acquisitions, the market conditions (particularly in the late third and early fourth quarters) presented an opportunity for us to repurchase almost $2 billion of our outstanding shares in 2015, almost twice the amount we have historically done.

Honeywell has its hands in a lot of end markets, and as the commercial aviation cycle matures, growth continues to slow. Its defense and space end market has also proved challenging, as oil and gas markets continue to be dislocated as a result of the collapse in energy resource pricing through much of the past 18 months. We like the visibility of commercial aerospace in light of the massive backlogs at the commercial airframe makers, but we're less enthused at the prospects of a resurgence in the defense/space and oil/gas markets. New products in homes/buildings should help offset some of the weakness, and prospects in turbo remain strong thanks to increasing penetration rates. Still, core organic growth remains under pressure.

$M	2015				FY 2015	2016	
	Q1	Q2	Q3	Q4		Q1	Q2
Aerospace	$3,607	$3,827	$3,820	$3,983	$15,237 (2%) Reported 2% Core Organic	$3,705 3% Reported 3% Core Organic	$3,779 (1%) Reported (2%) Core Organic
Home And Building Technologies	$2,093	$2,280	$2,313	$2,475	$9,161 (3%) Reported 3% Core Organic	$2,477 18% Reported 8% Core Organic	$2,676 17% Reported 4% Core Organic
Performance Materials And Technologies	$2,403	$2,455	$2,279	$2,338	$9,475 (10%) Reported (2%) Core Organic	$2,281 (5%) Reported (8%) Core Organic	$2,434 (1%) Reported (1%) Core Organic
Safety And Productivity Solutions	$1,110	$1,213	$1,199	$1,186	$4,708 (1%) Reported 2% Core Organic	$1,059 (5%) Reported (4%) Core Organic	$1,102 (9%) Reported (8%) Core Organic
Honeywell	$9,213	$9,775	$9,611	$9,982	$38,581 (4%) Reported 1% Core Organic	$9,522 3% Reported 1% Core Organic	$9,991 2% Reported (2%) Core Organic

Source: Honeywell International Inc. Form 8-K Furnished October 6, 2016
Note: The Information Above Reflects Honeywell's New Reporting Segment Structure And Move Of Industrial Combustion/Thermal Business To Performance Materials And Technologies

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Image source: Honeywell

The Best Ideas Portfolio

By Valuentum Analysts

Portfolio Return	Benchmark Return	Outperformance
107.5%	75.5%	32.0 pts

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

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

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

THE BEST IDEAS PORTFOLIO -- as of October 14, 2016 — **Best Ideas Portfolio Inception Date: May 17, 2011**

Portfolio Holdings	Symbol	Initial VBI*	Current VBI**	Fair Value	P/FV	First Purchase	Cost/Shr ($)	# Shares	Total Cost ($)	Price/Shr ($)	Current Value ($)	Cumulative Div's Rec'd	% of Portfolio	% Return (dividends included)
Bullish														
Apple Corp.	AAPL	10	7	$148.00	0.80	17-Jun-11	51.92	107	5,569.33	117.66	12,589.62	1,089.83	6.1%	145.6%
Altria Group	MO	8	6	$58.00	1.08	28-Jun-11	28.39	157	4,471.86	62.44	9,803.08	2,379.79	4.7%	172.4%
Berkshire Hathaway	BRK-B	6	5	$160.00	0.90	20-Apr-16	146.13	69	10,089.97	144.18	9,948.42		4.8%	-1.4%
Buffalo Wild Wings	BWLD	6	9	$190.00	0.75	27-Aug-15	179.81	16	2,876.90	142.60	2,281.60		1.1%	-20.7%
Cisco	CSCO	9	7	$39.00	0.77	14-Nov-14	26.33	221	5,831.87	30.18	6,669.78	275.38	3.2%	19.1%
Energy Select SPDR	XLE	NR	NR	NA	NMF	6-Oct-15	67.14	143	9,608.02	69.80	9,981.40	263.26	4.8%	6.6%
Facebook	FB	6	6	$142.00	0.90	29-Jan-16	112.10	50	5,612.00	127.91	6,395.50		3.1%	14.0%
Financial Select SPDR	XLF	NA	6	NA	NMF	9-Jan-11	13.46	178	2,405.83	19.42	3,461.01	271.05	1.7%	55.1%
General Electric	GE	7	6	$32.00	0.90	21-Oct-13	25.99	375	9,761.75	28.89	10,833.75	987.00	5.2%	21.1%
General Motors	GM	6	6	$43.00	0.74	26-Aug-16	31.65	132	4,184.80	31.87	4,206.84	50.16	2.0%	1.7%
Google - Class C	GOOG	10	7	$855.00	0.91	23-Oct-12	450.92	7	3,170.42	778.53	5,449.71	10.35	2.6%	72.2%
Google - Class A	GOOGL	10	7	$855.00	0.91	4-Apr-14	Split	7	Split	804.60	5,632.20		2.7%	+++
Health Care ETF	XLV	9	6	NA	NMF	22-May-12	36.60	125	4,582.00	69.62	8,702.50	491.44	4.2%	100.7%
Intel	INTC	6	6	$42.00	0.89	12-Sep-11	20.48	150	3,086.50	37.45	5,617.50	595.50	2.7%	101.3%
Johnson & Johnson	JNJ	6	7	$121.00	0.97	29-Jan-16	104.18	54	5,632.72	117.56	6,348.24	126.90	3.1%	15.0%
SPDR S&P Bank ETF	KBE	NR	NR	NA	NMF	9-Jan-12	21.07	100	2,114.00	33.38	3,338.00	247.76	1.6%	69.6%
Kinder Morgan	KMI	5	6	$20.00	1.02	17-Feb-16	17.29	157	2,721.53	20.36	3,196.52	39.25	1.5%	18.9%
Michael Kors	KORS	8	9	$66.00	0.71	27-Aug-15	43.44	68	2,953.80	46.65	3,172.20		1.5%	7.4%
PayPal	PYPL	UR	4	UR	UR	17-Jul-15	Spin-off	100	Splt	39.24	3,924.00		1.9%	+++
Priceline	PCLN	10	6	$1499.00	0.96	26-Feb-15	1239.49	6	7,450.91	1439.57	8,637.42		4.2%	15.9%
Republic Services	RSG	8	6	$44.00	1.13	19-May-11	31.42	201	6,329.42	49.82	10,013.82	1,223.10	4.8%	77.5%
SPDR S&P Dividend ETF	SDY	NR	NR	NA	NMF	20-Apr-16	81.33	124	10,091.92	82.08	10,177.92	123.77	4.9%	2.1%
Teva Pharma	TEVA	6	3	$58.00	0.74	24-Jul-13	41.22	77	3,180.94	42.96	3,307.92	337.91	1.6%	14.6%
Union Pacific	UNP	6	6	$87.00	1.11	24-Jul-13	79.67	40	3,193.80	96.84	3,873.60	240.00	1.9%	28.8%
Utilities Select SPDR	XLU	NR	NR	NA	NMF	18-Mar-14	41.12	83	3,419.96	47.75	3,963.25	328.41	1.9%	25.5%
Visa	V	7	6	$82.00	1.01	30-Nov-11	26.86	188	5,064.39	82.45	15,500.60	331.67	7.5%	212.6%
Latest changes: XLF stock dividend adjustment (9/19). 132 shares of GM purchased (8/26).														
Cash -- changes in monthly cash balance reflects dividends received and trading gains/losses, where applicable.											30,433.63		14.7%	0.0%
Bearish														
For investors seeking 'short' or 'put option' exposure, please consider firms with VBI ratings with 1 and 2 as ideas.														
Best Ideas Portfolio Value							Original -->		100,000.00	Current -->	**207,460.03**			**107.5%**
S&P 500 Index (SPY)						17-May-11	132.69	754	100,000.00	213.12	160,614.97	14,868.87	91.5%	
Cash											14,868.87		8.5%	
Benchmark Portfolio Value											**175,483.84**			**75.5%**
Relative Outperformance														**32 pts**

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

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

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

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.

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All in, there's a lot to like about Honeywell, particularly its tremendous free cash flow generation, which helps support its solid dividend payout, which translates into a ~2.2% yield at current price levels. Shares continue to trade near the middle of our fair value estimate range, however, so we're not rushing to add Honeywell to either newsletter portfolio at this time. Our favorite industrial giant remains General Electric (GE), though its shares, too, have been under material pressure, but from August of the year. GE seems like a much better bet than Honeywell at the moment, and the former boasts a higher yield of 3%. GE's decision to take on more debt, while pressuring its credit ratings, will offer a cash coffer to further pad its dividend profile. Though we tend to be debt-averse equity investors, GE's A1 unsecured debt rating is solid. GE is a holding in both newsletter portfolios.

I Thought I Made a Mistake

By Brian Nelson, CFA

It was nearing the end of 2015, and I don't think I was more bullish on a stock than Intel (INTC). In October 2015, I published that "Intel may have a breakout year in 2016." I liked what Intel had done to keep AMD's (AMD) back against the wall, and the chip giant was making nice strides in the mobile market against Qualcomm (QCOM), particularly with key phone-maker, Apple (AAPL). I liked the acquisition of Altera in part because the company is a free-cash-flow generating machine with little capital intensity. Field-programmable gate arrays (FPGAs) will continue to reshape the semiconductor landscape, and the Altera purchase will give Intel a leg up.

Well, it didn't take long for me to start worrying that I made a mistake with this one. A lackluster fourth-quarter 2015 report sent shares of Intel below the broader S&P 500 (SPY) market return, as shown in the image above. I was encouraged by unconfirmed reports in March that Intel won a portion of Apple's iPhone 7 baseband modem orders, but the company was still trailing the index by several points even then. In April, I brought to light the very interesting dichotomy of how many consumer staples

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entities like Coca-Cola (KO) are trading at lofty unadjusted earnings, despite reported revenue falling, while Intel, which many peg as a tech dinosaur, was actually experiencing revenue growth.

The second-quarter 2016 report showed that Intel's top line was still growing at a decent pace, and that's when I think the stock market finally started to "get it." In fact, the month of July 2016 was a great one for Intel, as during the month, it closed much of its underperformance relative to the broader stock market, as shown in the image above -- and then to really hit the "growth" point home, in July, I wrote in the piece, "Intel's Top Line Still Growing (July 2016)":

> The Intel "story" continues to be misunderstood, in our view. The company is growing, and its traction in mobile has been noteworthy, making ongoing gains against rival Qualcomm. Intel is also navigating the difficult PC market well, and strength in data center, the Internet of Things and programmable solutions will pave the way for ongoing company-wide expansion. Unlike the IBM's (IBM) of the world where revenue is in free-fall, Intel is not struggling, and its purchase of asset-light, free-cash-flow rich Altera was a very savvy move, even though it has strained the balance sheet a bit. By our measures, long- and short-term debt stood at ~$25 billion at the end of the second quarter, slightly higher than the sum of total cash investments and marketable equity securities (~$23 billion). Management said on the conference call that it expects to improve its net cash balance over the second half of the year, however.

In that same article, I talked about how Intel was trading at less than 15 times current-year non-GAAP earnings, emphasizing that it was a rare bargain in today's market, particularly relative to other dividend payers, sometimes fetching multiples north of 20 times on declining earnings. Then, the stock really closed the ground, and today, its return is now greater than that of the broader index this year. Now, is this a big deal? No. Is beating the market with one idea something to write home about. No – and especially not in the context of the market-beating returns of the Best Ideas Newsletter portfolio since inception. Has the return on Intel been blockbuster? Nope.

So why am I writing this article?

In many ways, it's to show how patience pays off. For example, if you'd bought Intel late last year when I had been talking about a big 2016, you would have been extremely disappointed if you were expecting outperformance through the first half of 2016 and sold during that time. You may have even wanted to cancel your membership during that time, thinking that I had lost the "magic" touch. It's clear that I can't predict the path of Intel's stock with precision, but I knew its fundamentals had been shaping up, I liked its dividend yield--which continues to capture interest in today's market--and I knew inroads with Apple would serve the market a nice headline catalyst to draw buying interest. All of this took time to come together--many months, but it turned a disappointment and perceived mistake into an outperformer.

Look--the market is going to play games with your head. It's going to make you think that you can't beat it (and others are going to tell you the same, so you park assets in index funds and **THEY** generate fees on them for their advice). Depending on your time horizon, the market is going to make you even think that winners are mistakes, especially if you're not patient and you don't build conviction in your thesis **BEFORE** you buy. For example, Intel in early 2016--not good; Intel in late 2016--good. Intel has been a big winner since it was added to the newsletter portfolios many years ago, but its path in 2016 had been weighing on my mind, as you can probably tell. I just wanted to share the good, if not less-bad news. The takeaway: What often look like mistakes are just good calls in progress. It happens time and time again. Don't be the fool!

Retail Weakness: Blame the Election?

By Kris Rosemann

The 2016 election cycle has been one characterized by unprecedented amounts of criticism and accusations, of both the personal and political variety, and it may be true that the perceived political environment from the view of the general public has not been in such a state of uncertainty for some time. Let's not get into the details of who called whom what in last night's Presidential debate, but some parents were reportedly not allowing their children to watch the debate out of fear that their values or outlook on democracy could be skewed.

But could the uncertainty surrounding the election actually be enough to impact consumer activity at retail outlets and restaurants? Some are beginning to believe so. Yum! Brands (YUM) CEO Greg Creed was the most recent executive to pin weakness in the industry on the general uncertainty surrounding the election. From the firm's fiscal third quarter conference call (October 6):

> I think there's just great uncertainty as to what's going to happen in the U.S., in particular, as a result of the outcome of the election. It goes without saying that people are sort of trying to decide who to choose and what the impact will be on the economy. And I think people maybe just hunkering down a little bit. …. And I think once we get through the election and then that uncertainty is removed, hopefully, the market will find some momentum.

Throughout the months of August and September, other executives have shared similar thoughts regarding the current political and retail environments, ranging from the executive teams of other fast food restaurants such as Wendy's (WEN) and Popeyes Louisiana Kitchen (PLKI) to traditional retailers including the likes of Gap (GPS) and Calares (CAL) to specialty retailers like jeweler Signet (SIG). McDonald's (MCD) had even warned about the implications of the election on its performance in July when the respective party conventions were generating headlines. We recently explored more tangible factors in the restaurant space, "Restaurant Traffic – What's Going On?"

While retailers are almost certainly correct in saying that the election has some consumers second guessing the shape the country is in, are they correct in their assessment that this is enough to impact spending habits? It is no secret that US Presidential elections create uncertainty in corporate board rooms across the US where massive investment decisions are made, but has such uncertainty really trickled down to American dining and living rooms as well?

We think it is a much more reasonable leap to make that management teams will take a wait-and-see approach to the election, as the differing policies of candidates could have an impact on their businesses' operations and investment decision, than it is to conclude that average consumers will put off buying new clothes or restocking the refrigerator. Are these retailers and restaurants suggesting that a large portion of Americans have turned into some mild form of doomsday preppers, hiding their assets in sock drawers while stockpiling cans of beans?

The appeal behind being able to blame the election cycle for these businesses is evident: it is a transient issue largely out of control of management. Taking uncertainty and spinning it into an issue that is expected to pass in the coming months is a minor victory in terms of damage control for executive teams as such an explanation temporarily takes the place of the major long-term threat to traditional retailers and restaurants: e-commerce (yes, even at restaurants).

As we continue, it is worth noting that consumer confidence in the US rose to a nine-year high in late September, according to a report from Conference Board. In addition to the counterargument being presented by rising consumer confidence despite the 'uncertainty,' the election does not appear to be impacting the sales of e-commerce giant Amazon (AMZN). Nevertheless, a disappointing 49% of US chains increased same store sales in the second quarter of 2016. While some retailers and restaurateurs continue to look around for something to pin their woes on, others are taking action. E-commerce was the focal point of retail giant Walmart's (WMT) recent investor meeting, and CEO Doug McMillan stated

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that the firm is going to continue to evolve into what looks more like an e-commerce company over time. Its investments in JD.com (JD) and Jet.com speak to this.

We are witnessing the genesis of the virtual restaurant market, particularly in New York City, which is being tabbed by some as the savior of the restaurant business. The concept is the same as any e-commerce business: consumers order online and the product is delivered. The idea of food delivery is clearly not a new one, but these virtual restaurants are new in the sense that they have no dining space or customer facing portion of their businesses. They instead are focused on using technology and data points to improve the desirability of their dishes to the consumers while lowering rent costs and reducing the amount of labor needed. The cost to fail is materially reduced from a standard restaurant, making experimentation, and ultimately innovation, an innate characteristic of the market.

Whether such a trend succeeds in mainstream marketplaces outside of New York City remains to be seen, but we view the development as a nod to the secular trend that continues to weigh on traditional brick-and-mortar retailers and restaurants. We see the continued shift in consumer preferences toward in-home shopping as a much more likely candidate for sales pressure than uncertainty surrounding the election. Competition among online retailers will only make the online shopping experience more attractive to consumers, as well as make e-commerce firms stronger operators as the industry evolves.

As an example of the growing popularity and demand for online shopping, let's consider an Amazon Prime membership, which currently costs $99 per year. With that membership, consumers receive access to Amazon's library of TV shows and movies--already a better value proposition than competitor Netflix (NFLX) when ignoring content preferences--as well as music, e-books, and free two-day shipping on any product purchased through Amazon. Ease of ordering technology continues to advance, and some products can be ordered with a literal push of a button. How will traditional retailers compete? Those leaning into the wind are more likely to ultimately remain standing, in our opinion.

Newsletter portfolios holdings Michael Kors (KORS) and Coach (COH) are both working to reduce their reliance on traditional department stores as mall traffic wanes and they attempt to avoid brand-damaging discounting from retailers, "Brand Image Taking Center Stage in Aspirational Goods." Coach expects to close ~250 of its wholesale locations while issuing a reduction in markdown allowances, while Michael Kors continues to see progress in expanding the footprint of its digital stores in North America.

We're not ruling out the potential for the election to be one of the factors driving down consumer spending for traditional brick-and-mortar retailers. In any case, however, we don't see a pressing need to adjust our exposure in either newsletter portfolio, though we continue to monitor the dynamics of the broader retail environment. Our favorite long-term picks in the restaurant sector remain Buffalo Wild Wings (BWLD) and Cracker Barrel (CBRL), while we are avoiding direct exposure to any traditional brick-and-mortar retailer.

Currency: Cases in Probabilistic Thinking

By Brian Nelson, CFA

The rally in the Mexican peso relative to the US dollar during the first Trump-Clinton debate of 2016 showcased the increased likelihood of a Clinton victory, in light of Trump's current political agenda. Instances like this, where currency markets serve to act as a probability indicator of the likelihood of a future event, have occurred through the course of history, the most fascinating of which happened during the American Civil War and with Confederate scrip specifically.

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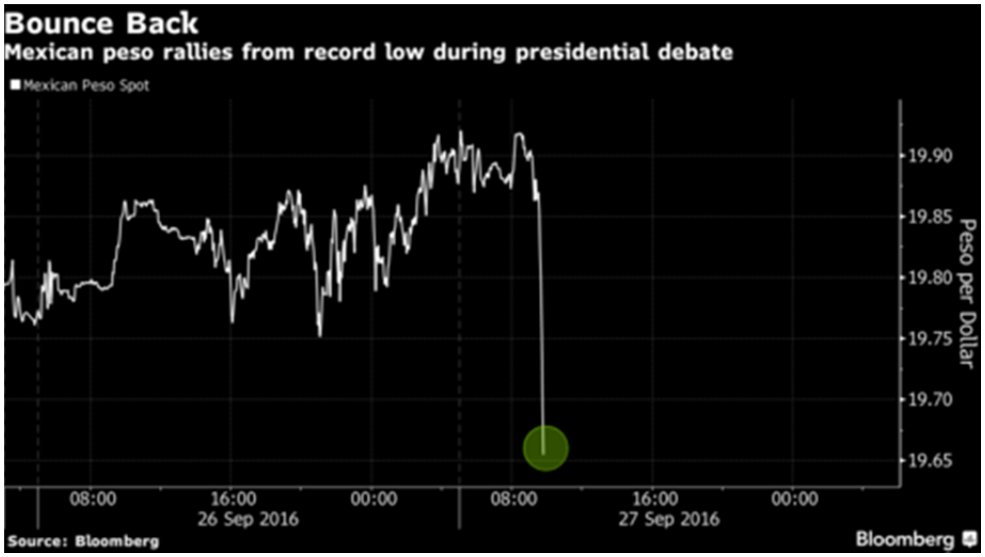

Image source: Bloomberg

At Valuentum, we talk a lot about how markets act as "discounting" mechanisms of the probability of future events, and more specifically as it relates to stocks, how a company's share price reflects the implicit probabilities assigned to future free cash flow trajectories of the company by the market. By extension, changes in equity prices therefore reflect a change of opinion by the market in the percentage it implicitly assigns to each of the company's future probable free cash flow streams or a change (a shift) in the magnitude or composition of the range of a company's probable free cash flow streams altogether.

The currency markets reflect this probabilistic dynamic, too. For example, the rally in the Mexican peso relative to the US dollar during the first Trump-Clinton debate of 2016 showcased the increased likelihood of a Clinton victory, in light of Trump's current political agenda. Instances like this, where currency markets serve to act as a probability indicator of the likelihood of a future event, have occurred through the course of history, the most fasinating of which happened during the American Civil War and with Confederate scrip specifically. Let's take a trip back in time.

The Confederate dollar, nicknamed the "Greyback," had not been secured by hard assets but only by a promise to pay the bearer, much like the US dollar today. The South's self-embargo intending to starve Europe of cotton, the blockade of Southern ports by the Union, and the individual states' rights mantra that hurt tax receipts were contributing factors to runaway inflation in the Confederacy. An increase in the South's money supply, by a factor of 20 near the end of the war, and infamous Northern counterfeiter Samuel C. Upham, whose fake notes may have accounted for 1%-2.5% of all of Southern outstanding, would serve to place continued pressure on the price of Confederate money. By the end of the war, a cake of soap would reportedly sell for as much as $50 CSA.[i]

The fluctuating price of the Greyback during the American Civil War, however, could also be viewed in part as a reflection of Southern opinion of the probability that the South would eventually win the war. In the early years of the conflict, for example, the Greyback had high purchasing power as the probability of a peaceful settlement with the Union seemed especially high, in light of the potential for a foreign power to recognize the South and as Abraham Lincoln dealt with disappointment after disappointment, not the least of which was the country's revolving door of Union generals. It perhaps wasn't until the realization by Southerners that it would be a long and bloody war after the Battle of Antietam in September 1862 and the North's passing of the US Conscription/Finance Bill in March 1863 that confidence may have truly broke, if not openly at the time than reflected in the price of Confederate currency.[ii]

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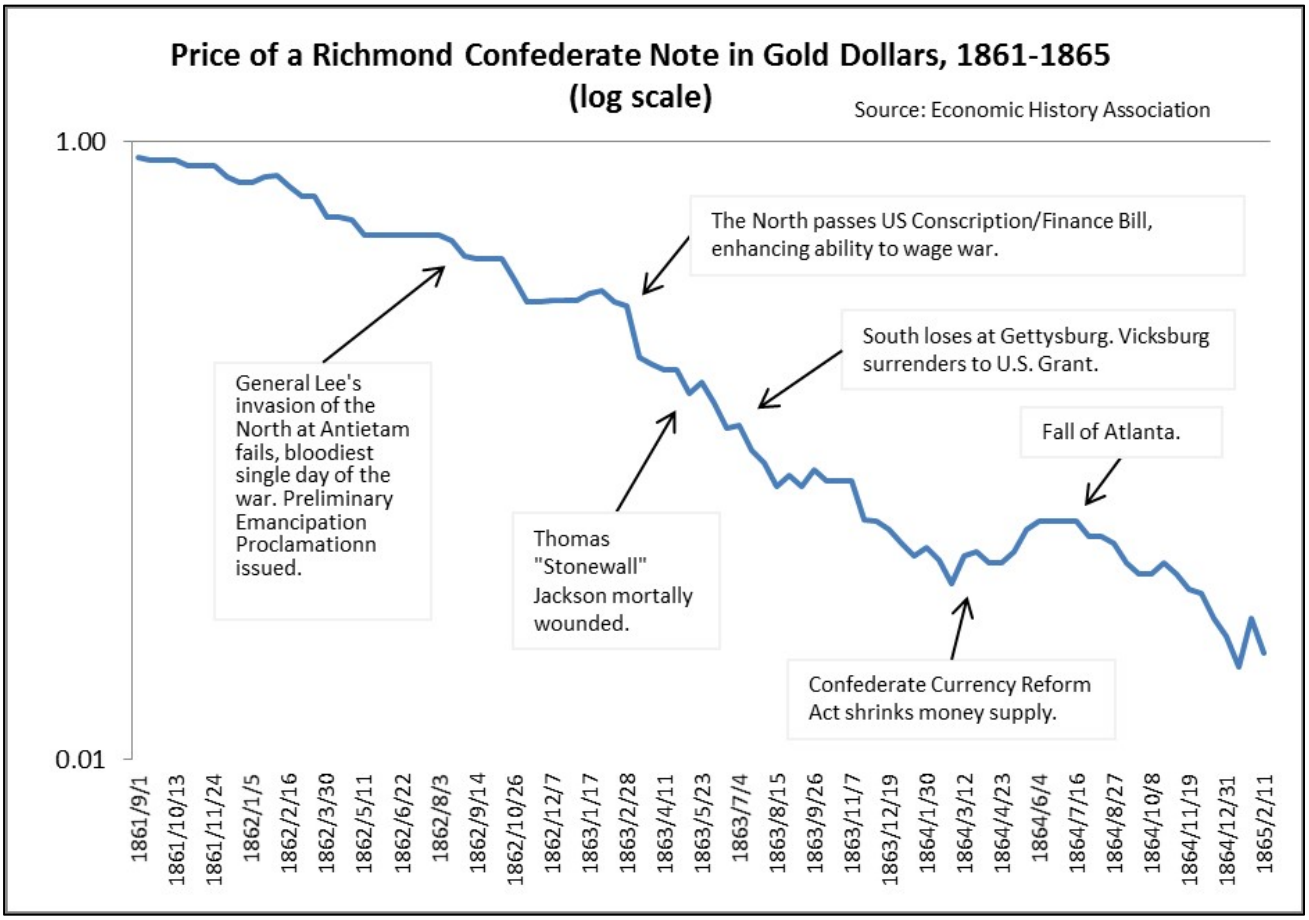
The South's loss of Thomas "Stonewall" Jackson due to "friendly fire" after the Battle of Chancellorsville, the "rebel" surrender at Vicksburg, Mississippi, to U.S. Grant, which severed the Confederacy in two, and the dear price that Southerners paid on those three fateful days in July 1863 near that small Pennsylvania town, each contributed uniquely to the ongoing decline of the price of Confederate money. The Currency Reform Act of 1864 would help stem the decline in the price of Confederate money somewhat by reducing the money supply by one third, but the eventual Fall of Atlanta and Union General William Tecumseh Sherman's "March to the Sea" would remind holders of Confederate scrip of the inescapable reality, that their sacrifices were a lost cause, that they would not win their independence, that a new nation would not be hatched, at least not the one they had been fighting for.[iii]



Pictured: Key battles and events during the American Civil War impacted the price of Confederate currency, while the overhang of the expanding supply of money and counterfeiting helped contribute to the overall downward trend.

Through the course of the conflict, citizens of the Confederacy may have, indirectly or directly, used war news in part to handicap the likelihood that they would be repaid in the event of a peace treaty with the United States. In forming the price level of Confederate scrip at any time during the war, forward-looking Confederate citizens, by doing so, were also implicitly quantifying the probability, in their collective view, that the South would eventually prevail. In the summer months of 1862, for example, with the Greyback quoted at 50 cents in gold, Southerners implicitly believed the chances were about even that they would win their independence. By the end of 1863, however, with the Greyback quoted at 6 cents in gold, chances were pegged at 6%, and by the time the armies had converged at a small town in Virginia called Appomattox Courthouse, Confederate notes essentially being worthless, the chances of a victory practically nil.[iv]

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The probabilistic mechanism that resulted in the ongoing depreciation of the price of the Greyback speaks to a classic and infinite truism in finance: Assets will always be priced, and their values estimated, in part on the basis of future expectations, with little regard to the past, whether it is a stock that is valued on the basis of future expectations at any time in the future, or Confederate currency that is priced on the basis of the probability of a Southern victory and repayment at any time during the American Civil War. That the bells of secession brought cheers to the South in 1861, for example, mattered little to the eventual price of the Greyback, which was forever doomed when Confederate General Robert E. Lee signed the generous surrender terms from U.S. Grant on the fateful day at the Wilmer McLean House in April 1865.

To understand the functioning of markets, one must "think probabilistically..."

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[i] Marc Weidenmier, "Bogus Money Matters: Sam Upham and His Confederate Counterfeiting Business" Business and Economic History 28 no. 2 (1999b): 313-324.

[ii] Marc Weidenmier, Claremont McKenna College, Money and Finance in the Confederate States of America, EH.net, accessed October 6, 2015. https://eh.net/encyclopedia/money-and-finance-in-the-confederate-states-of-america/

[iii] Marc Weidenmier, Claremont McKenna College, Money and Finance in the Confederate States of America, EH.net, accessed October 6, 2015. https://eh.net/encyclopedia/money-and-finance-in-the-confederate-states-of-america/

[iv] Marc Weidenmier, Claremont McKenna College, Money and Finance in the Confederate States of America, EH.net, accessed October 6, 2015. https://eh.net/encyclopedia/money-and-finance-in-the-confederate-states-of-america/

Yahoo's Cascade of Issues

By Valuentum Analysts

Yahoo (YHOO) has been in the news a lot lately, and not in a good light. The revelations recently uncovered at the Internet portal have put the terms of its pending deal to be bought by Verizon (VZ) at risk, perhaps jeopardizing the transaction altogether. Recent reports indicate that Yahoo shareholders may now get far less for their business from Verizon, to the tune of ~$1 billion, and top Verizon executives are even "wondering if (it) should pull out of the deal." The telecom giant could just be taking advantage of the "bad" situation at Yahoo in asking for a better price, but the company walking away would not be out of the question. Yahoo, after all, didn't disclose any of the issues during transaction negotiations with Verizon, and top executives at the suitor aren't happy about it.

But what's got Yahoo in hot water this time? Well, it started on September 22 when Yahoo confirmed a giant data breach to its system. The size of what has been identified as a Russian-sponsored attack is without precedent, as it has been estimated that 500 million names, email addresses, telephone numbers, and dates of birth were exposed. Though disappointed and frustrated, customers may still have been forgiving to some degree, as data breaches have unfortunately become part of corporate life, with some of the largest public players from JP Morgan Chase (JPM), Target (TGT), Home Depot (HD), and Sony (SNE) encountering issues within the past few years, just to name a few. But that the Yahoo breach occurred in 2014, two years ago, and that the Internet portal is only disclosing it now may be too much for any reasonable onlooker to offer sympathy. US senators are demanding answers.

The 2014 hacking of Yahoo's database was only the beginning of customer security issues at the company coming to light recently. On October 4, Yahoo was found to have been scanning emails for

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specific information last year under the directive of US intelligence officials. Yahoo exercising such power over the confidentiality of customer information is especially concerning when considering that it was so blatantly unable to protect its database from outside hackers. Since the accusations surfaced, Yahoo has denied involvement in email scanning as described by the media, but it did not expressly deny its participation in all forms of email scanning. Instead, the company declared that it was a law-abiding company that complies with all US laws.

It may not matter in the court of public opinion, however. The protection of customer information continues to be a critical business issue of the day, perhaps punctuated by Apple's (AAPL) recent run-in with the Federal Bureau of Investigation where the government under the All Writs Act of 1789 demanded that the tech giant unlock a phone that had been used by a shooter in the San Bernadino terrorist attacks December 2015. Apple vigorously defended the privacy of its customers, thereby avoiding customer backlash, but Yahoo may now face the wrath of a disappointed consumer. The days of Yahoo email may now be numbered, if they haven't been already. Consumer email rivals Alphabet (GOOG, GOOGL) and Microsoft (MSFT) were quick to issue public statements that their systems do not include any such email scanning programs.

The past few weeks have been a nightmare for the Internet portal, to say the least, and former interim Yahoo CEO Ross Levinsohn has done more to fan the anti-Yahoo flames. Levinsohn believes Yahoo knew of the attack on its database and the controversial situation regarding the dealings with the US government but *chose* not to disclose such information to Verizon during merger negotiations. He is in favor of Verizon hedging its bets regarding the acquisition of Yahoo and demanding a discount to the agreed-upon $4.8 billion price tag (which Verizon has done). It is also worth noting that the Chief Information Security Officer of Yahoo was not on board with the email searching program, which was eventually approved without his knowing. He later resigned in June 2015 under protest.

The chain of events surrounding Yahoo recently has been simply incredible. Why CEO Marissa Mayer and the rest of management have not been able to provide a clear timeline with respect to the Russian-sponsored attack or provide clear details on the firm's involvement in email scanning becomes evident when considering the impact such details would have had on its recent journey in the M&A market. Tensions are now running high. Verizon is asking for a $1 billion discount on the original $4.8 billion agreement, and Yahoo won't accept it without a challenge; Yahoo believes Verizon has no legal recourse to change the terms of the deal.

With the status of the Verizon-Yahoo deal up in the air, Yahoo shareholders are left out in the cold again. The purchase of the company was supposed to be the end of what has become a long saga of back-and-forths between Yahoo, the US government, potential suitors, and Yahoo shareholders. We still think the deal will get done, as Verizon has gone too far, and the company's ambitious to combine in-house AOL with Yahoo may be too great. Still, we continue to point to our open letter to the board of Yahoo if all should fail, "VALUENTUM ISSUES OPEN LETTER TO MARISSA MAYER, CHIEF EXECUTIVE OFFICER OF YAHOO!" We have no interest in getting involved with Yahoo's equity.

The "Uninvestable" Twitter and Netflix Buoyed By Takeout Chatter

By Kris Rosemann and Brian Nelson, CFA

At Valuentum, we like slam-dunk, no-brainer investment opportunities--like Microsoft (MSFT) in the mid-$20s before it doubled, or Visa (V) prior to its strong equity price performance in recent years, or even cigarette-maker Altria (MO) in advance of its ongoing march higher since the dawn of the release of the inaugural Best Ideas Newsletter. Our members count on us to use our knowledge of valuation to sort out "investable" stocks from "uninvestable" ones; good stocks with fundamental promise from bad ones built

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on fantasy outcomes. Benjamin Graham calls what we do "investing," while he may call readers that dabble in the two highlighted stocks in this piece "speculators." There is a difference, and it's a big one.

Don't jump to conclusions--we don't have an axe to grind against Twitter (TWTR) or Netflix (NFLX). They have a place in our social atmosphere (or is it blogoshere?), but investing has little to do with popularity or fads (sorry Peter Lynch), and entirely to do with the robustness, longevity, and predictability of a company's future free cash flows. *This is where Netflix and Twitter fall flat on their faces across the board (with all three prior considerations).* In the past (and please access each company's respective landing page on our website), we've expressed our grave concerns about the wide range of fair value outcomes for the shares of both Twitter and Netflix (think extreme but justified share-price volatility), and nothing has changed on that front. However, the market is starting to "build castles in the air" again with these two, and it has nothing to do with the operations of either firm. Takeover speculation has stolen the headlines at both companies. Though as imprudent for a suitor as it may be, Twitter could be the closer of the two to a sale, as reports have surfaced that the struggling social media (or is it now better described as a news) network could begin fielding bids as soon as this week.

Alphabet (GOOG, GOOGL) and Apple (AAPL) could be interested (some reports have already axed both as possibilities, however), but it's more likely that Salesforce (CRM), Disney (DIS), or another media giant such as Comcast (CMCSA), News Corp (NWSA) or 21st Century Fox (FOXA) could be much more interested. We can't forget about Facebook (FB) either – could you imagine if Facebook and Twitter tied the knot, the optimization of the latter that would prevail? In many ways, Facebook may be the best fit, especially if it can improve Twitter's "follower" performance for advertisers and facilitate a better experience for users (most can't even find friends or colleagues on the system). How is that social? Though less likely, Alibaba (BABA), Tencent (TCEHY), or Baidu (BIDU) could be considerations, and even Verizon (VZ) may have taken a look in light of its recent interest in accumulating the struggling businesses of AOL and Yahoo (YHOO) and apparent disregard for its own massive debt load.

Several companies mentioned could consummate the acquisition of Twitter (currently a ~$16.6 billion market cap) more easily than what has become the most probable rumored suitor of the bunch, Salesforce, but its CEO Marc Benioff has been looking to make a headline-grabbing purchase of a strong consumer brand with loads of data, a profile Twitter fits to a t. How can we forget that Salesforce recently lost a bidding war to Microsoft over LinkedIn (LNKD), which had a similar kind of appeal to the enterprise-focused cloud software provider that Twitter does. Benioff referred to Twitter as an "unpolished jewel," indicating that he feels Salesforce has the power to extract the hidden potential in Twitter, a power current and former management of the firm has not been able to harness. But he has also said that, while he looks at a lot of deals, he mostly passes. Could he now be on tilt after losing LinkedIn though, and could the draw of empire-building be growing within Benioff, much like it sucked in Microsoft CEO Satya Nadella to overpay for LinkedIn? Having avoided the "winner's curse" by losing LinkedIn, will Benioff make an even bigger mistake?

That said, there is some foundation to a Salesforce-Twitter tie-up. Twitter's brand and the idea that "Data is the currency in software's new world order," are two key factors behind the Salesforce CEO's desire for the company. In essence, the attractiveness of Twitter is that its massive consumer data library could be used to provide unique insights for Salesforce's corporate customers. In other words, the acquisition would not be pursued with confidence in its operations, but rather would be based on extracting information regarding its users' tendencies and preferences. The idea that this could cost Salesforce well over a third of its market capitalization may be troubling to shareholders, and Microsoft set a dangerous precedent with the $26+ billion purchase of LinkedIn for similar reasons. As we would expect, shares of Salesforce have reacted unfavorably to the news of the potential acquisition of Twitter. There's no way to confidently estimate Twitter's intrinsic value – it is "uninvestable," and therefore "unbuyable" by a *prudent suitor*, in our view (emphasis on prudent).

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(in millions)	FY 2014				FY 2015				FY 2016	
	Q1'14	Q2'14	Q3'14	Q4'14	Q1'15	Q2'15	Q3'15	Q4'15	Q1'16	Q2'16
Company Metrics										
Monthly Active Users (MAUs): Worldwide	255	271	284	288	302	304	307	305	310	313
QoQ%	*6%*	*6%*	*5%*	*2%*	*5%*	*1%*	*1%*	*0%*	*2%*	*1%*
YoY%	*25%*	*24%*	*23%*	*20%*	*18%*	*12%*	*8%*	*6%*	*3%*	*3%*

Image source: Twitter quarterly results

Twitter's business model is unproven, too, and the social media network has been battling concerning user growth trends in recent quarters as it struggles to turn a profit on a GAAP-basis, "Facebook Flying, Twitter Tumbling." Compare the growth and MAU figures in the above chart to Facebook's 22% year-over-year growth in daily active users, to more than 1 billion in the second quarter of 2016. Though Twitter management continues to throw around strong positive language in its quarterly reports such as "confidence in our product roadmap" and "progress on priorities," the long-term picture for the company is cloudy at best. We've seen many social media platforms come and go over the past decade or so, and why couldn't Twitter go the way of MySpace and others before it and since? A takeout may be the best case scenario for the company.

Shares of Netflix have also found some favor among investors more recently--not because of its fundamentals but due to takeout speculation, just like Twitter. Disney has again been cited as a potential suitor, and Apple had been rumored to be interested in the streaming service provider earlier in 2016, but both of these deals seem far-fetched in light of Netflix's extreme overvaluation, in our opinion. Also similar to Twitter, Netflix has had a difficult time executing its growth plan as of late. The firm missed its own expectations for subscriber growth in the second quarter of 2016, and we believe the market continues to overestimate its long-term international growth potential, if not steady-state subscriber numbers at full penetration then certainly the costs at which it will take to ramp to such performance. Netflix's credit rating is rightfully junk status, in our view.

(in millions except per share data and Streaming Content Obligations)	Q2 '15	Q3 '15	Q4 '15	Q1 '16	Q2 '16	*Q3 '16 Forecast*
Total Streaming:						
Revenue	$ 1,481	$ 1,581	$ 1,672	$ 1,813	$ 1,966	*$ 2,155*
Contribution Profit	$ 248	$ 277	$ 270	$ 309	$ 345	*$ 365*
Contribution Margin	16.7%	17.5%	16.2%	17.0%	17.6%	*16.9%*
Paid Memberships	62.71	66.02	70.84	77.71	79.90	*82.40*
Total Memberships	65.55	69.17	74.76	81.50	83.18	*85.48*
Net Additions	3.28	3.62	5.59	6.74	1.68	*2.30*
US Streaming:						
Revenue	$ 1,026	$ 1,064	$ 1,106	$ 1,161	$ 1,208	*$ 1,309*
Contribution Profit	$ 340	$ 344	$ 379	$ 413	$ 414	*$ 460*
Contribution Margin	33.1%	32.4%	34.3%	35.5%	34.3%	*35.1%*
Paid Memberships	41.06	42.07	43.40	45.71	46.00	*46.40*
Total Memberships	42.30	43.18	44.74	46.97	47.13	*47.43*
Net Additions	0.90	0.88	1.56	2.23	0.16	*0.30*
International Streaming:						
Revenue	$ 455	$ 517	$ 566	$ 652	$ 758	*$ 846*
Contribution Profit (Loss)	$ (92)	$ (68)	$ (109)	$ (104)	$ (69)	*$ (95)*
Contribution Margin	-20.2%	-13.1%	-19.2%	-16.0%	-9.1%	*-11.2%*
Paid Memberships	21.65	23.95	27.44	31.99	33.89	*35.99*
Total Memberships	23.25	25.99	30.02	34.53	36.05	*38.05*
Net Additions	2.37	2.74	4.04	4.51	1.52	*2.00*
Total (including DVD):						
Operating Income	$ 75	$ 74	$ 60	$ 49	$ 70	*$ 64*
Operating Margin	4.6%	4.2%	3.3%	2.5%	3.3%	*2.8%*
Net Income*	$ 26	$ 29	$ 43	$ 28	$ 41	*$ 22*
EPS*	$ 0.06	$ 0.07	$ 0.10	$ 0.06	$ 0.09	*$ 0.05*
Free Cash Flow	$ (229)	$ (252)	$ (276)	$ (261)	$ (254)	
EBITDA	$ 119	$ 123	$ 111	$ 107	$ 129	
Shares (FD)*	436.1	437.6	438.3	438.0	438.2	
Streaming Content Obligations** ($B)	10.1	10.4	10.9	12.3	13.2	

* EPS and shares adjusted for 7-for-1 stock split. Q4'15 Net Income/EPS includes a $13m / $0.03 benefit from a tax accrual release related to resolution of tax audits.

**Corresponds to our total known streaming content obligations as defined in our financial statements and related notes in our most recently filed SEC Form 10-K

Image source: Netflix quarterly results

*The "Uninvestable"...*continued on next page

The "Uninvestable"...from previous page

Competition from the likes of Amazon (AMZN), Hulu, and YouTube will only intensify in coming years, and both established and new entrants will bring fresh and innovative products to the market, some that we can only imagine at this time. Recent price hikes for Netflix's service, albeit minor by most measures, have not been met favorably by consumers, and original content development, in our view, has generally been underwhelming, with *Making a Murderer* perhaps arguably marking a peak in in-house originality. With little room for future price hikes and content costs skyrocketing (and necessary to retain existing members), the outlook is growing less exciting with each passing quarter. The costs to grow its international business aren't optimal either--brand strength is lacking outside the US, and Netflix is paying for it (it's all in the numbers, contribution margin). Management has yet to face the kind of challenges that we think it will have to sooner than later, even if sooner is still several quarters or years away (as we outlined in our original thesis).

In this light, the takeout rumors surrounding Netflix are the largest positive the stock has going for it, and we continue to believe that a purchase of the company near its current market capitalization would be among the best-case scenarios, especially in the context of our opinion of its intrinsic value. Unlike Twitter, however, Netflix has yet to express serious interest in being acquired, and we haven't seen anything of substance that would indicate a purchase of the firm is on the near horizon. Netflix CEO Reed Hastings may still believe that Netflix's future is bright on a standalone basis, but we maintain that it is rather ominous. Netflix can't compete on original content with the big studios, and we believe content is where the value lies in the value chain – if not, then how can one explain Netflix's foray into generating its own original content?

No matter what though, Netflix shareholders are in for a wild ride, and we can point to its wide range of fair value outcomes as the basis for such a view. On a fundamental basis, Netflix's future free cash flow stream is difficult to predict given pricing leverage, variable content costs, the uncertain long-term economics of its international operations and its ongoing efforts to reinvent itself. Regarding the latter, on October 5, for example, Netflix signed a deal with luxury theater chain iPic Entertainment in a continued effort to take its streaming service to the big screen. Under the terms of the deal, Netflix original movies will be screened in iPic's luxury theaters in New York and Los Angeles, and potentially its 13 other locations, the same day they appear on Netflix's streaming service. While Netflix and iPic view the partnership as the beginning to a disruptive force in the movie industry, we're not sure such a move will be the savior Netflix needs.

Obviously, we continue to prefer stable, cash-rich entities whose shares are not dependent on sentiment surrounding speculative news flow. You got it--Twitter and Netflix aren't our cup of tea. Can you blame us? Instead, we prefer readers look to the Best Ideas Newsletter portfolio to find our best ideas to consider for long-term capital appreciation. We're going to be spectators of Netflix's and Twitter's stock, not speculators in them. Hope you understand.

Apple Pushing for Growth in Healthcare and Corporate IT

By Kris Rosemann

Late September brought two announcements from Apple (AAPL) that should bode well for demand for its mobile devices and wearable technology and add to the reach of its ecosystem of apps.

On September 28, the firm announced a partnership with consulting firm Deloitte & Touche to form a service called 'EnterpriseNext' in which Deloitte is creating a service with over 5,000 strategic advisors focused on helping businesses maximize the effectiveness of their use of iOS with iPhones and iPads.

Apple Pushing...continued on next page

***Apple Pushing...*from previous page**

Deloitte CEO Punit Renjen pointed to his company's use of Apple products, and 75 custom apps, as a core driver behind the deal. Deloitte will not only offer consulting services across more than 20 industries but will also assist in producing native apps to fit with existing business platforms in areas such as enterprise resource planning, customer relationship management, analytics, and human resources.

Blackberry's (BBRY) recent exit from the hardware business has opened up some market share within the enterprise market, and such an opening makes the growing segment even more attractive. Businesses are buying more and more mobile devices for employees in place of personal computers as they too are following the secular trend of the Internet going mobile. Apple's iPad could benefit the most from the harder push into the enterprise space, but it is worth noting that the firm's sales to corporate entities jumped 40% to $25 billion in fiscal 2015.

In addition to its expanding enterprise IT offerings, Apple is expecting to gain an advantage for its Apple Watch in the wearable technology market thanks to Aetna's (AET) choice to begin subsidizing Apple Watches for certain employers and individual customers. The health insurer has also promoted a number of apps associated with managing health that are exclusive to the iOS. While we see this as an immaterial factor in Apple's overall top line, the deal could be an important one in terms of branding and market position, as well as a large positive for the proliferation of healthy lifestyle apps in its ecosystem. Fitbit (FIT), along with other competitors, will suffer as a result, and the firm's most recent product iteration has not yet been met with the fervor of its prior releases, particularly concerning as the holiday season approaches.

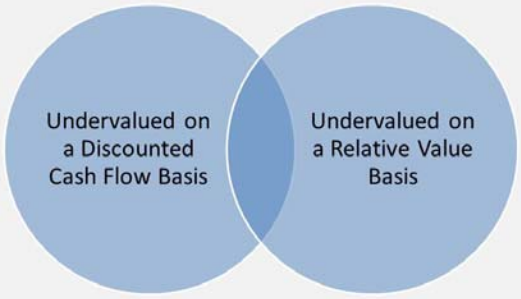
While these deals will not be major needle movers for Apple, we do believe they will play a role in the firm's ongoing battle to improve its competitive positioning. The increased adaptation of the Apple Watch in healthcare and health management is a driver of growth for the technology that Apple envisioned being an important one as it designed the watch, and Aetna subsidizing the Apple Watch should help the increase in activity in this area for Apple. We would love to see Apple's ecosystem fully infiltrate the health management practices of consumers.

On a similar note, Apple being able to further its relationships with enterprise customers via unique apps and expanded iOS functionality could provide a larger growth opportunity in terms of its ecosystem compared to the impact it could have on hardware sales. We will monitor progress from Deloitte in implementing its advisory practices, but if Apple is able to get anywhere close to its level of inclusion in consumers' everyday lives in the business world, the deal will be a home run for years to come. We're excited about the opportunities it brings.

The Watch List

By Valuentum Analysts

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



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

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

Company Name	Symbol	Sector	DCF Valuation	Relative Valuation	P/FV	FV Estimate
Supervalu	SVU	Consumer Staples	UNDERVALUED	ATTRACTIVE	0.46	$10.00
Virtu Financial	VIRT	Financials	UNDERVALUED	ATTRACTIVE	0.56	$29.00
Corrections Corp	CXW	Information Technology	UNDERVALUED	ATTRACTIVE	0.64	$21.00
Xerox	XRX	Industrials	UNDERVALUED	ATTRACTIVE	0.64	$16.00
Prudential Financial	PRU	Financials	UNDERVALUED	ATTRACTIVE	0.67	$116.00
Viacom	VIA	Consumer Discretionary	UNDERVALUED	ATTRACTIVE	0.67	$66.00
Omega Healthcare	OHI	Financials	UNDERVALUED	ATTRACTIVE	0.68	$52.00
Harman Intl	HAR	Consumer Discretionary	UNDERVALUED	ATTRACTIVE	0.69	$119.00
Bed Bath & Beyond	BBBY	Consumer Discretionary	UNDERVALUED	ATTRACTIVE	0.69	$63.00
CNO Financial	CNO	Financials	UNDERVALUED	ATTRACTIVE	0.69	$23.00
Korn/Ferry	KFY	Information Technology	UNDERVALUED	ATTRACTIVE	0.71	$33.00
Mylan	MYL	Health Care	UNDERVALUED	ATTRACTIVE	0.72	$53.00
Corporate Executive Board	CEB	Information Technology	UNDERVALUED	ATTRACTIVE	0.72	$72.00
Jabil Circuit	JBL	Information Technology	UNDERVALUED	ATTRACTIVE	0.73	$30.00
Juniper Networks	JNPR	Information Technology	UNDERVALUED	ATTRACTIVE	0.73	$31.00
Super Micro	SMCI	Information Technology	UNDERVALUED	ATTRACTIVE	0.74	$29.00
MetLife	MET	Financials	UNDERVALUED	ATTRACTIVE	0.75	$56.00
Regal Beloit	RBC	Industrials	UNDERVALUED	ATTRACTIVE	0.75	$76.00
AIG	AIG	Financials	UNDERVALUED	ATTRACTIVE	0.76	$78.00
Michael Kors Hldg	KORS	Consumer Discretionary	UNDERVALUED	ATTRACTIVE	0.76	$66.00
VMware	VMW	Information Technology	UNDERVALUED	ATTRACTIVE	0.77	$81.00
Buffalo Wild Wings	BWLD	Consumer Discretionary	UNDERVALUED	ATTRACTIVE	0.77	$190.00
PVH Corp	PVH	Consumer Discretionary	UNDERVALUED	ATTRACTIVE	0.80	$121.00

*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.

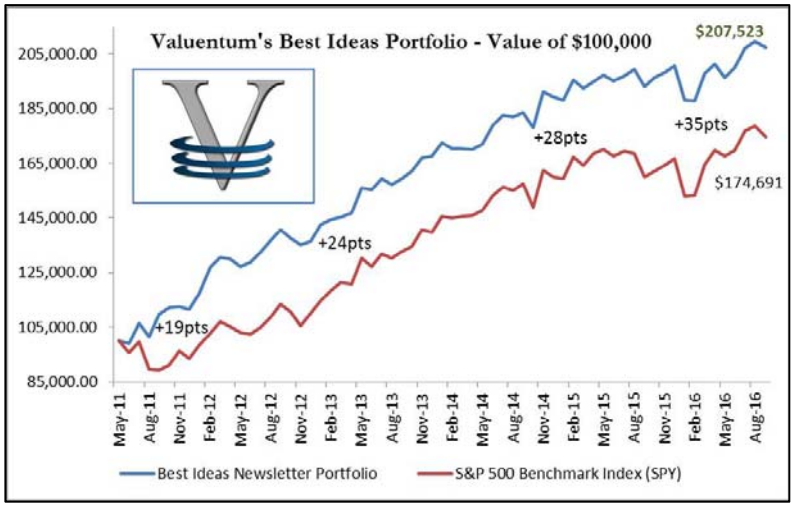
Company Name	Symbol	Sector	Industry	VBI
Buffalo Wild Wings	BWLD	Consumer Discretionary	Restaurants - Fast Cas & Full Svc	9
Harman Intl	HAR	Consumer Discretionary	Household Durables	9
Jabil Circuit	JBL	Information Technology	Electronic Suppliers	9
Michael Kors Hldg	KORS	Consumer Discretionary	Luxury - Ultra & Aspirational	9
Omega Healthcare	OHI	Financials	REIT - Healthcare	9
PVH Corp	PVH	Consumer Discretionary	Luxury - Established Brands	9
VMware	VMW	Information Technology	Business Services	9
Xerox	XRX	Industrials	Commercial Services	9
AIG	AIG	Financials	Insurance - Property & Casualty	8
Bed Bath & Beyond	BBBY	Consumer Discretionary	Specialty Retailers	8
Corrections Corp	CXW	Information Technology	Management Services	8
Prudential Financial	PRU	Financials	Insurance - Life	8

Amphenol Corp	APH	Information Technology	Electronic Suppliers	2
AO Smith Corp	AOS	Industrials	Electrical Equipment - industrial	2
Arch Capital	ACGL	Financials	Insurance - Property & Casualty	2
Church & Dwight	CHD	Consumer Staples	Household Products	2
Drew Indust	DW	Industrials	Recreational Vehicles	2
Infinity	IPCC	Financials	Insurance - Property & Casualty	2
Lancaster Colony	LANC	Consumer Staples	Food Products	2
New Oriental Education	EDU	Consumer Discretionary	Education Services	2
Nordson	NDSN	Industrials	Machinery & Tools	2
Northern Trust	NTRS	Financials	Banks & Money Centers	2
NuVasive	NUVA	Health Care	Medical Instruments	2
Quad/Graphics Inc	QUAD	Consumer Discretionary	Book Publishing	2
Rayonier	RYN	Industrials	Building Materials	2
South Jersey	SJI	Energy	Utilities	2
State Auto	STFC	Financials	Insurance - Property & Casualty	2
Ulta Salon	ULTA	Consumer Discretionary	Personal Services	2
Vulcan Materials	VMC	Industrials	Building Materials	2
American Electric	AEP	Energy	Utilities - Large	1
Badger Meter	BMI	Industrials	Electrical Equipment	1
Bright Horizons Family	BFAM	Consumer Discretionary	Personal Services	1
Cogent Comm	CCOI	Telecom Services	Wireless Telecom Services	1
Federal Realty	FRT	Financials	REIT - Retail	1
General Mills	GIS	Consumer Staples	Food Products - Large	1
Hyatt	H	Consumer Discretionary	Hotels	1
IDEX	IEX	Industrials	Machinery & Tools	1
Illinois Tool Works	ITW	Industrials	Machinery & Tools	1
Jack in the Box	JACK	Consumer Discretionary	Restaurants - Fast Food & Coffee	1
Kraft Heinz	KHC	Consumer Staples	Food Products - Large	1
Lockheed Martin	LMT	Industrials	A&D Prime	1
McDonald's	MCD	Consumer Discretionary	Restaurants - Fast Food & Coffee	1
Netflix	NFLX	Consumer Discretionary	Specialty Retailers	1
Northrop Grumman	NOC	Industrials	A&D Prime	1
Orexigen Therapeutics	OREX	Health Care	Biotechnology	1
Pool Corp	POOL	Consumer Discretionary	Sporting Goods	1
Toro Co	TTC	Industrials	Machinery & Tools	1

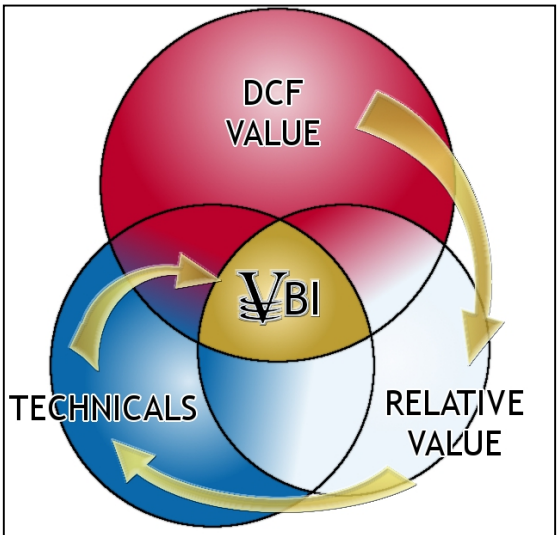
Our Methodology – The Valuentum Buying Index (VBI)

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

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

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

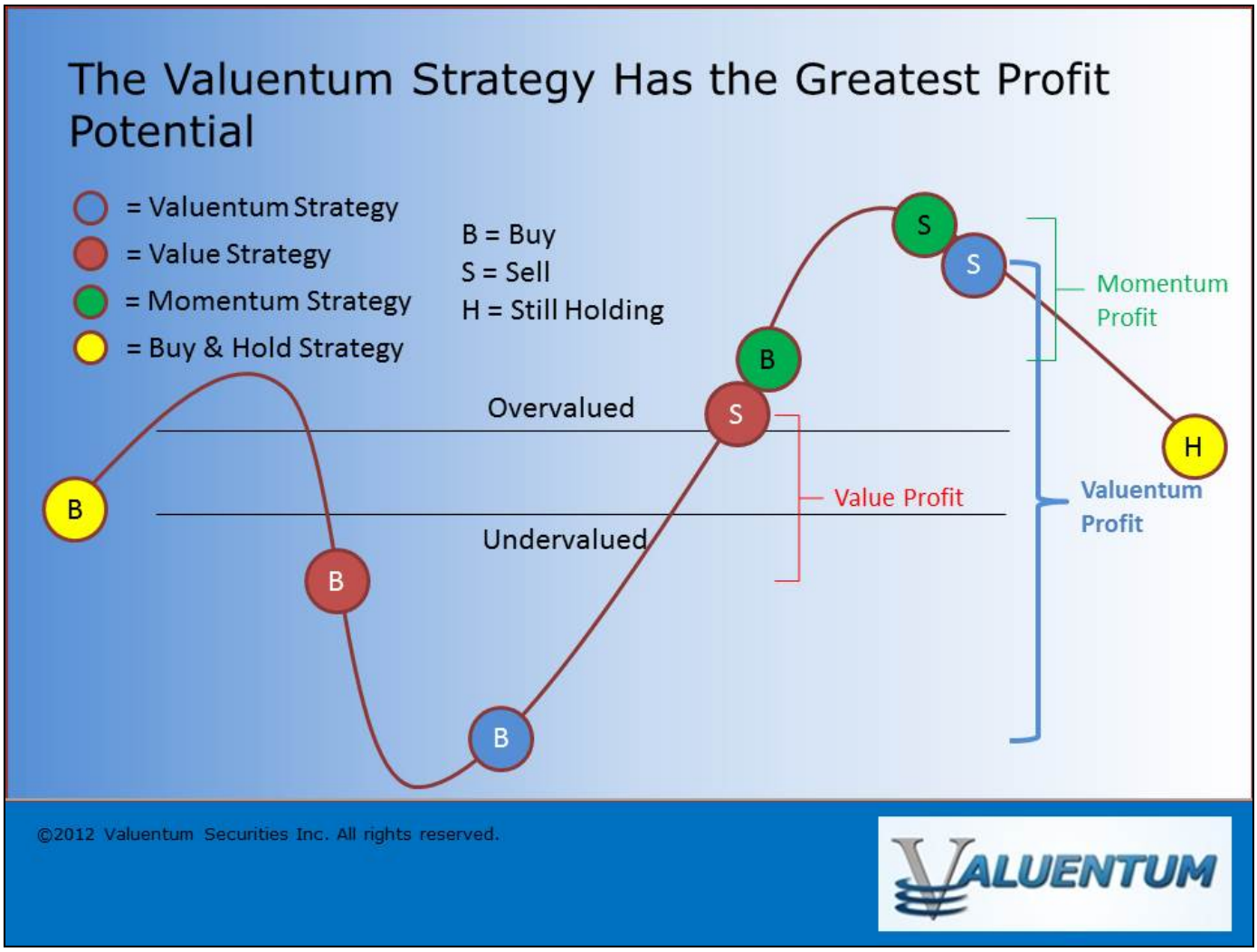


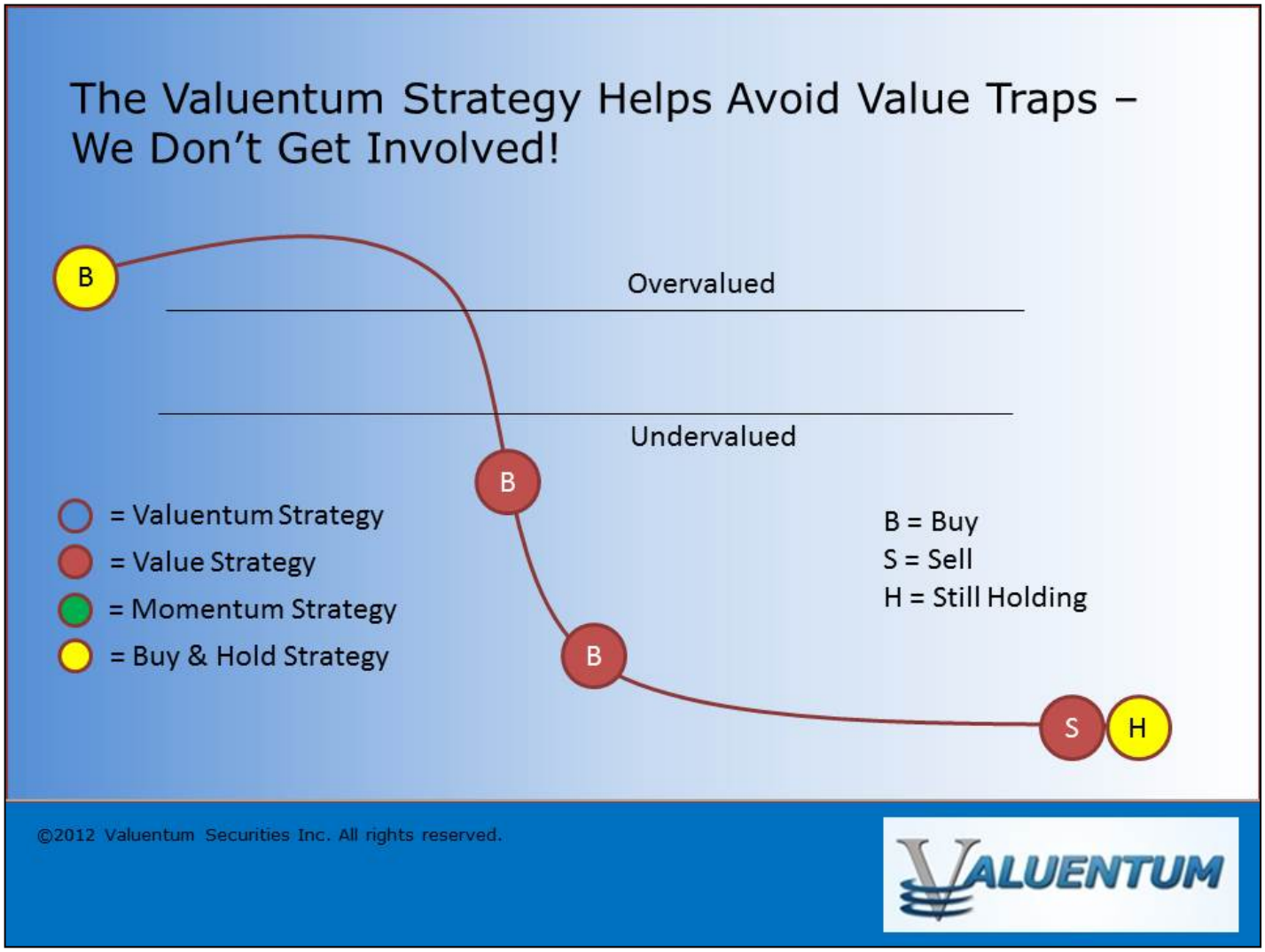
Illustration for educational purposes only.

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

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

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

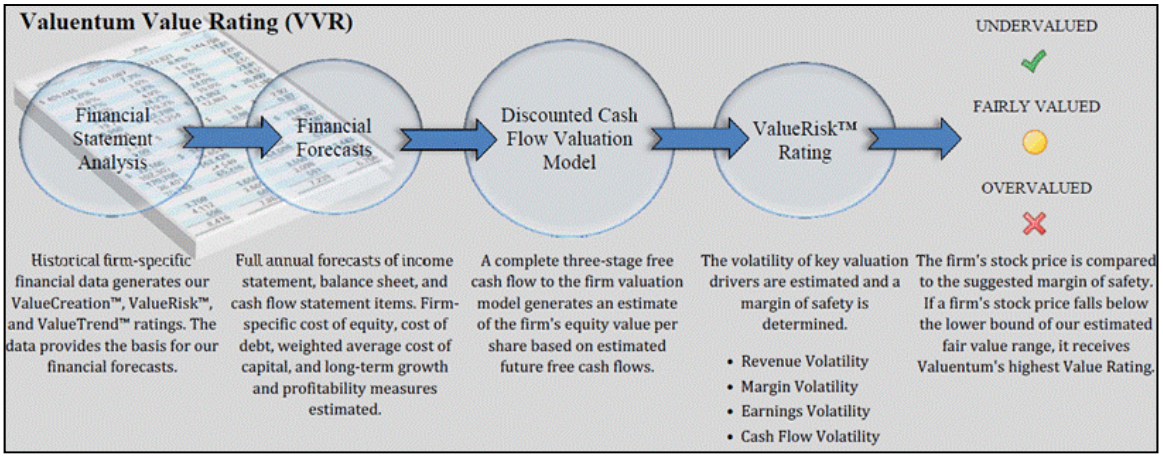


Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

I. We Use a Rigorous Discounted Cash Flow Valuation Process

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



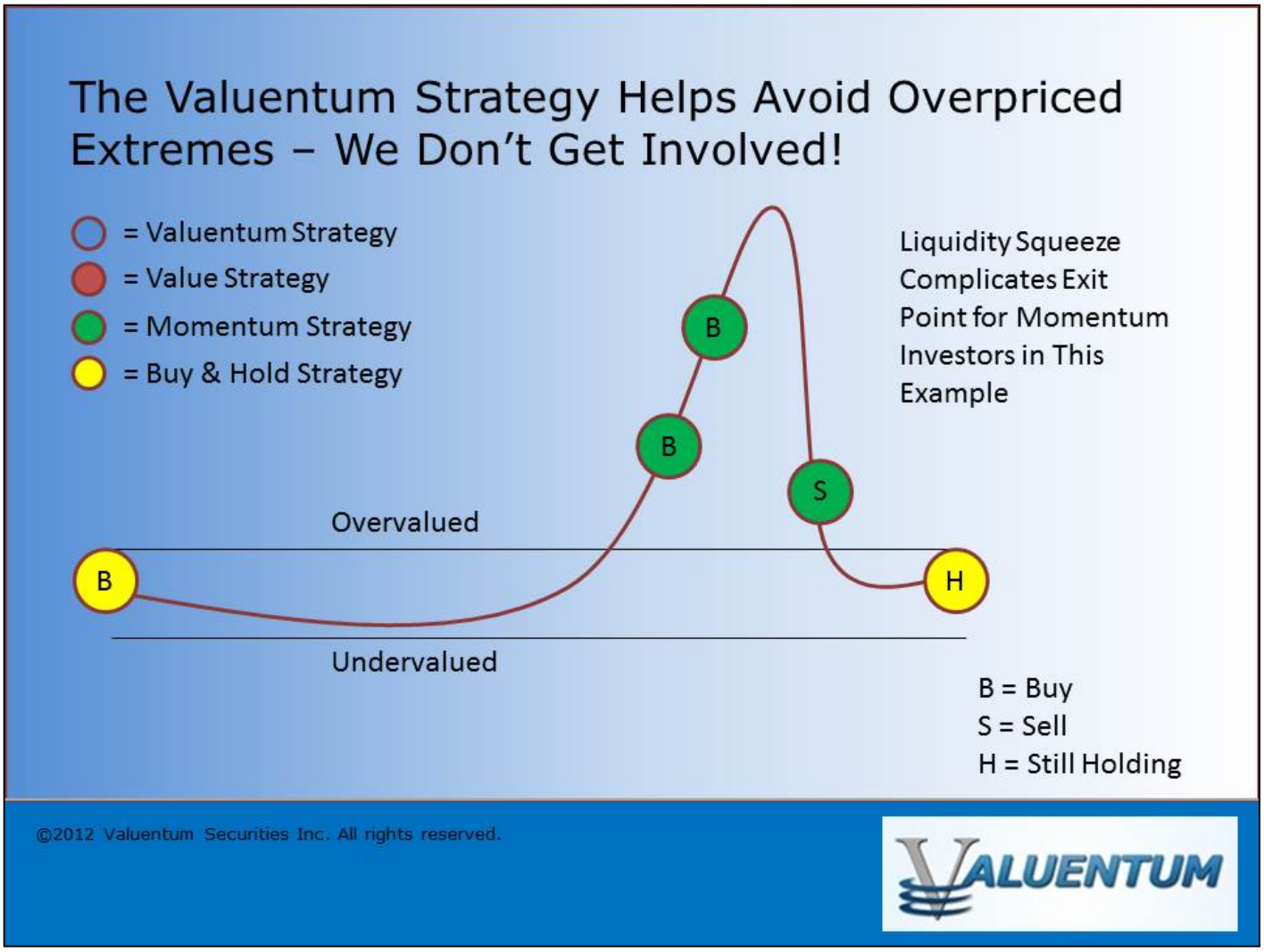
After evaluating historical trends, we then make full annual forecasts for each item on a company's income statement and balance sheet to arrive at a firm's future free cash flows. We derive a company-specific cost of equity (using a fundamental beta based on the expected uncertainty of key valuation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

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

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

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page



II. We Perform a Forward-Looking Relative Value Assessment

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

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

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

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

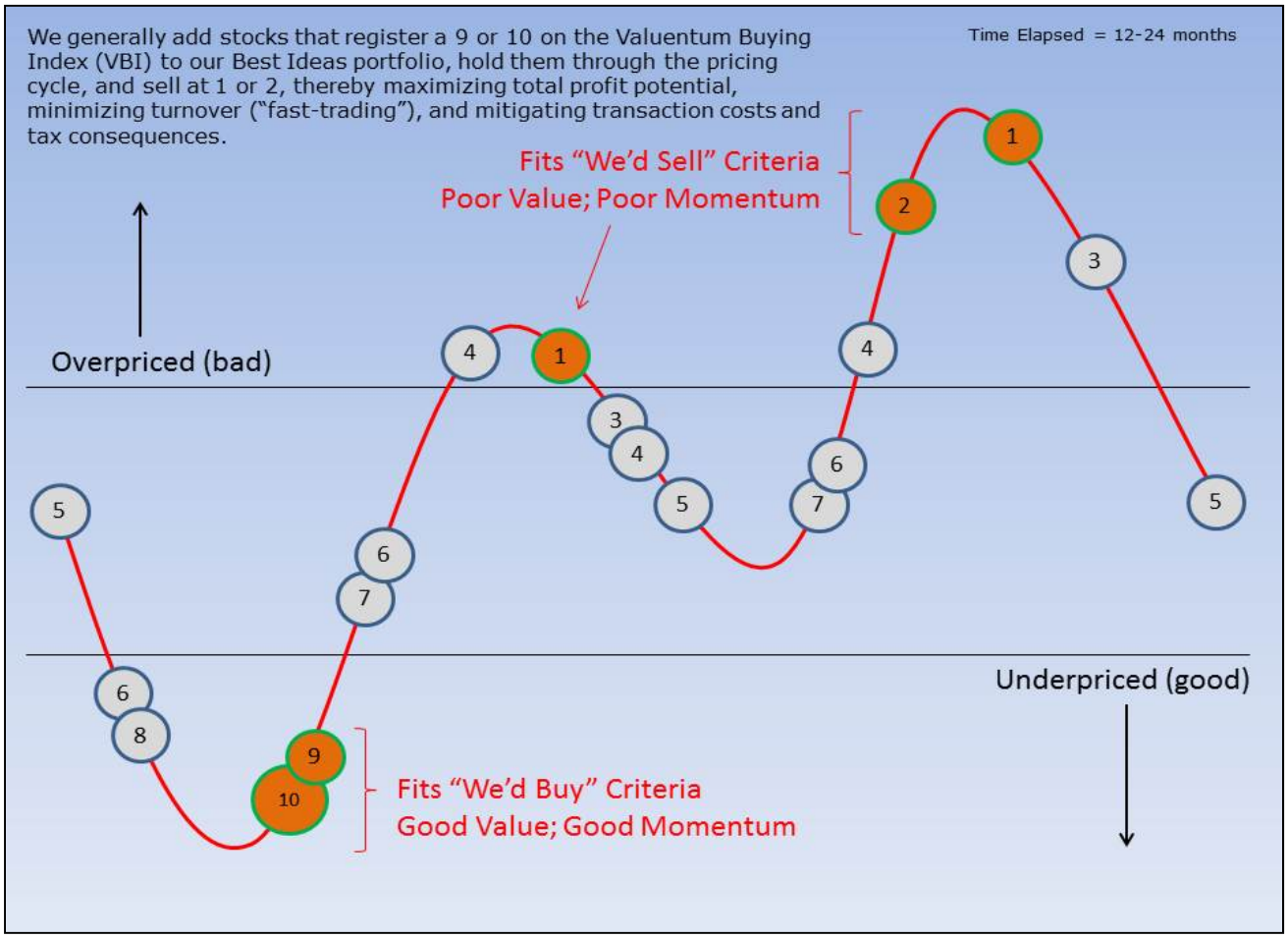
valuation criteria). Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster returns. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we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

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

Putting It All Together - the Valuentum Buying Index

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

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



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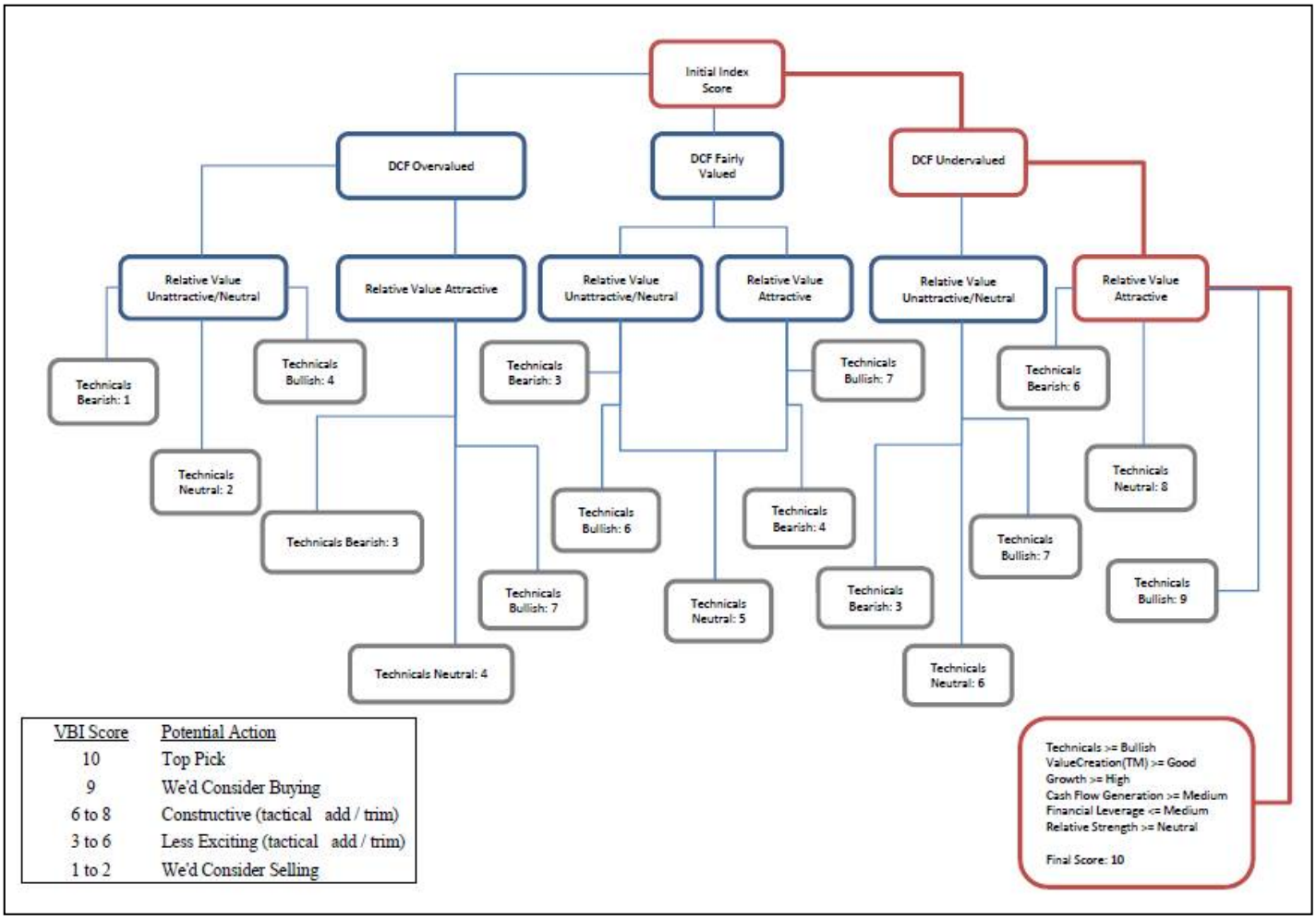
Our Methodology – The Valuentum Buying Index continued from previous page

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

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



Our Methodology – The Valuentum Buying Index continued on next page

Yeah -- About the Fair Value Range

By Valuentum Analysts

Understanding the Fair Value Range and Why It's Important

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

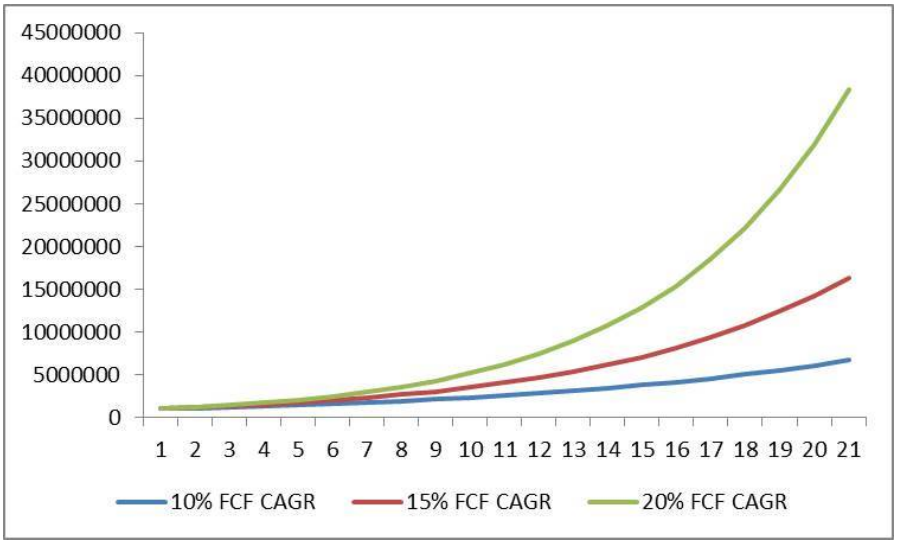
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth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

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

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

But why the large range in many cases?

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



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

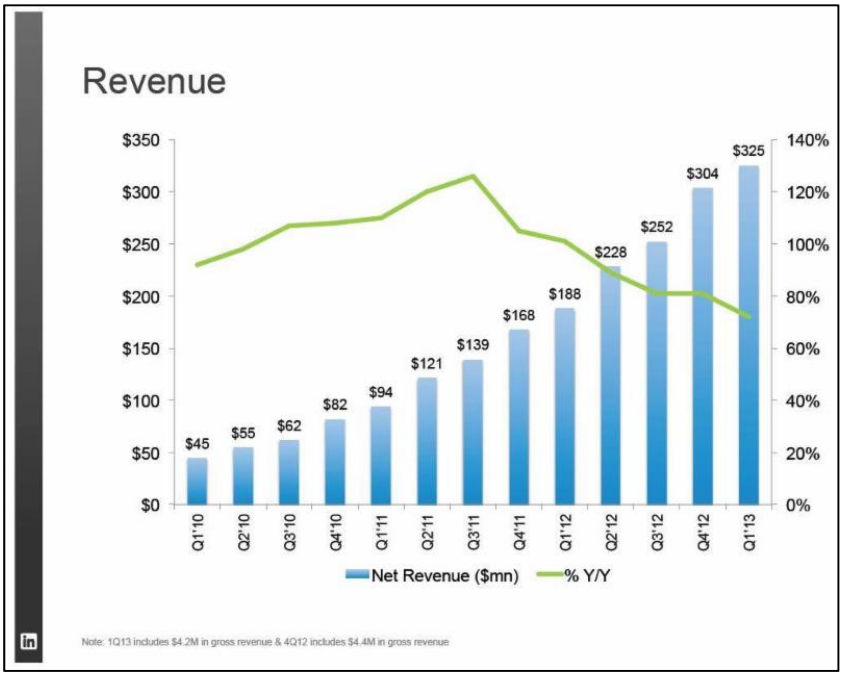

Image Source: LinkedIn

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

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

Shares collapsed in a huge way.

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

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

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